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Fannie and Freddie: Time to Clean up the Mess and Move Forward

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After years of warning and months of high drama, the Treasury Department recently took the unfortunate but necessary step of seizing Fannie Mae and Freddie Mac (Fannie and Freddie). Treasury placed the two institutions into conservatorship and provided the means and terms by which Treasury would recapitalize them as necessary. The cost to the taxpayer is unknown at this time and represents payment for serious mistakes made years ago and repeated regularly.

The Treasury's actions were unfortunate because the problems with Fannie and Freddie could have been avoided had previous Congresses heeded the many warnings about their systemic risk.¹ The actions were necessary, however, because the collapse of either or both of Fannie and Freddie would have had devastating repercussions for the housing market, credit markets, and the economy generally. By acting as it did, Treasury chose the lesser of two evils.

The takeover of Fannie and Freddie was a vital move toward reform, but this should be seen only as the first step. Fannie and Freddie are the result of outdated "Great Society" programs, and they should be wound down—not replaced, reformed, or rejuvenated. The private sector can and should be allowed to perform the roles formerly exercised by Fannie and Freddie. At the very least, as Congress crafts future legislation it must ensure that neither Fannie and Freddie nor any successor institution ever again becomes a systemic risk by becoming "too big to fail."

The First Step. Placing Fannie and Freddie into a conservatorship is not an end unto itself but a first step toward the final breakup. Unfortunately, the vital step of settling the long-term policy will have to be left to the next President and Congress.

Looking to the future, the worst action Congress could take would be to retain the current structure whereby Fannie and Freddie are quasi-governmental entities with conflicted goals and distorted incentives. This system has failed at an as yet untold cost to U.S. taxpayers.

The Treasury's current plan is to shrink Fannie and Freddie's portfolios of mortgage-backed securities gradually over the coming years. Just as important is denying Fannie and Freddie the authority to continue securitizing mortgages in the future. Many years ago the private sector could not have picked up this business, which is why Fannie Mae was created in the first place. However, the private sector today is already a major participant, rising to a market share that reached 56 percent in 2006. Fannie and Freddie should be forced to step aside and allow private-sector participants to perform this role. If preserved in any form, Fannie and Freddie should be so constrained in their activities that

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they can never again be suspected of being too big to fail.

Going Forward. First, clean up the mess. Then, implement real reform. The Treasury Department was put in a tough spot, and Secretary Henry Paulson did what was necessary. Decades of policy mistakes creating and protecting Fannie and Freddie finally led the predicted system risk to become a dangerous financial reality. However, once the market is stabilized, free-market reform must be implemented to prevent a recurrence. The next President and Con-

gress should allow Fannie and Freddie in their current form to wither to extinction. The private sector is ready, well-prepared, and subject to the proper incentives to continue to ensure a steady flow of correctly priced capital to America's housing markets.

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1. Ronald D. Utt, "Time to Reform Fannie Mae and Freddie Mac," Heritage Foundation *Background* No. 1861, June 20, 2005, at <http://www.heritage.org/Research/GovernmentReform/bg1861.cfm>.