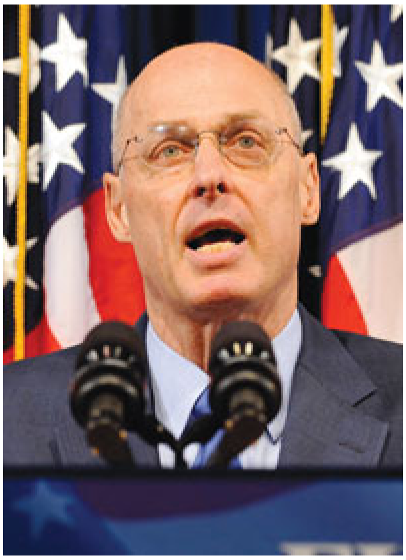
Written by **Steven J. DuBord** on September 29, 2008

Bailing Out Scam Artists (aka Fannie and Freddie)

ITEM: *Writing in the* Washington Post *for September 10, columnist Steven Pearlstein declared: "It's not hard to imagine, for example, that if nothing had been done, Fannie and Freddie would have been forced by nervous bondholders to hunker down and throttle back its housing-finance activities, further destabilizing financial markets and accelerating the housing market's downward spiral. Those, in turn, could have easily turned a short recession into one that was longer and deeper — one that cost Americans an extra $200 billion in lost income, several hundred thousand additional lost jobs and a net loss to the Treasury of $80 billion. Suddenly, a Fannie/Freddie rescue begins to look like a bargain."*



CORRECTION: There are always apologists for more and supposedly improved interventions in the market. To what end? Previous regulations led to more central powers, which resulted in economic dislocations, which in turn are used as an excuse for even more government controls. If the government doesn't save us, we are told, widespread cataclysms and calamities are certain. Each crisis breeds more controls. As a result, the market corrections — which, to be sure, are painful — are postponed, the agonies prolonged. The next crisis will be worse.

So it has been with the housing market and the Federal National Mortgage Association (FNMA, or Fannie Mae) and the Federal Home Loan Mortgage Corporation (FHLMC, or Freddie Mac). To help confuse matters, these entities are often called private companies in the mass media. The *New York Times*, for example, recently mocked vice-presidential candidate Sarah Palin for an alleged gaffe, smugly proclaiming that she didn't know that "Fannie and Freddie are not government entities but instead are private-sector companies."

This is so untrue that even the mortgage giants don't make that claim. Fannie and Freddie do have private stockholders, but they are "government-sponsored enterprises" (GSEs). The stockholders reap the benefits in good times; the taxpayers shoulder the risks and pick up the pieces in bad times.

As we write, it's one of those bad times, and the government is overtly taking over Fannie Mae and Freddie Mac. While there have been different responses to this move, and various expert opinions have offered recipes for what to do in the future, most of the experts in the spotlight have been mouthing variations of the conventional wisdom that got us into the mess in the first place.

The *New York Times*, as seen above, called the takeover "reasonable and reassuring," which is probably to be expected, but that has also been the general response of many who are not generally tagged as left-wingers. Senator John McCain and Governor Sarah Palin, writing in the *Wall Street Journal*, called the move "sadly necessary." Treasury Secretary Henry Paulson's "surprisingly aggressive move to essentially nationalize" the mortgage entities, said *Business Week*, "has been well received overall."

"Defaulting on their bonds," averred Steve Forbes in *Forbes* magazine, "would have triggered the worst financial meltdown since the Great Depression."

Yet, the Treasury's latest supposedly bold stroke isn't a solution, but a politically driven reaction — just as were the policies that led to the creation and expansion of Fannie Mae and Freddie Mac. There is nothing "sadly necessary" about more intrusions into the housing insurance market. As noted by William Poole, the former chief executive of the Federal Reserve Bank of St. Louis, "There are lots of insurance businesses around: property, auto, life and many others. These markets work fine without any government-sponsored enterprises. They are not highly concentrated into a small number of dominant players whose failure would threaten the entire economy; rather, lots of companies compete and spread the risk. Indeed, there are well-established firms in mortgage insurance, but their growth has been stunted by the special advantages Fannie and Freddie enjoy."

These giants grow by buying mortgages from traditional lenders and packaging them into bundled securities, which are then resold to investors. As opposed to authentic private companies, these enterprises don't pay state and local taxes, can receive loans from the government, and are given more latitude by Washington, which essentially has guaranteed that they cannot fail.

Moreover, as pointed out by Hans Bader of the Competitive Enterprise Institute, "Government meddling, along with federal regulatory pressure on lenders to promote 'affordable housing' and 'diversity,' helped erode traditional lending standards, resulting in more risky mortgage loans to irresponsible people with bad credit (as some longtime supporters of federal meddling now admit)."

Fannie Mae's actions, for example, help spawn many high-risk subprime loans; of late, with the bursting of the government-inflated housing bubble, many of those poor risks are defaulting. As Bader writes: "Lawmakers and regulators encouraged foolish bank managers to follow those fads … rather than … requiring applicants to show a good credit rating and make a substantial downpayment. Economically destructive banking regulations such as the Community Reinvestment Act also played an important role in promoting risky loans."

Although the *New York Times* pretends otherwise, this latest federal move is really not "an extraordinary intervention in private enterprise." Quite the contrary. It is "the state bailing out statism," as succinctly put by Sheldon Richman for the Foundation for Economic Education.

To be sure, some small holders took a hit, but not the big boys. Reassuring "the Chinese and other holders of Fannie senior debt is the main point of this bailout," explained the *Wall Street Journal*. As the *Journal* expressed it, in an editorial entitled "Bailouts for Billionaires," the situation for such large investors "rarely gets better than this: Buy paper you know carries a higher risk but also a higher return, and then have Uncle Sugar eliminate that risk so you also make a windfall profit."

The Treasury secretary intends to make the GSEs profitable again, but what is likely to happen is that they will be put back on the dole, acknowledges Peter Wallison, a senior fellow of the American Enterprise Institute and general counsel of the Treasury Department during the Reagan administration. For two decades, says Wallison, Fannie and Freddie have been using "government backing to enrich their shareholders, managements, lobbyists, former government officials and Washington insiders, after they rigged the political process with campaign contributions and after their congressional supporters resisted every effort at reform until the two companies were on the verge of collapse. Now a Treasury secretary in a Republican administration aims to put them back in the same business, and get the taxpayers to finance it."

It is to the benefit of the plugged-in players in Washington to keep the taxpayers on the hook while the legislators and major investors back up each other, aided by the power of the federal government. Writing of Fannie and Freddie, Wallison says:

> Recent statements by Barney Frank (D, Mass.), the chairman of the House Financial Services Committee, and Chuck Schumer (D, N.Y.), a powerful member of the Senate Banking Committee, make clear that Congress will never let them be privatized, broken up, slimmed down, nationalized or any of the other options hopeful reformers are putting forth today. Fannie and Freddie in their current form are just what Congress wants: an inexhaustible source of campaign contributions and funds for favored groups....

But the huge profits from this government-subsidized arbitrage do not mean lower mortgage rates for the American homebuyers. Studies by the Federal Reserve have shown that Fannie and Freddie have essentially no effect on mortgage rates. The profits instead go to shareholders and managements, lobbyists, favored community groups, and of course to members of Congress through campaign contributions.

The Paulson plan, regrettably, will restore these two companies to their positions as poster children for corporate welfare. The Federal Housing Finance Agency (Fannie and Freddie's new regulator) has been appointed as a conservator for both companies. But while a conservator can keep the companies running, it does not have the power to change the business model, break them up or liquidate them. When the conservatorship ends, the shareholders will regain control.

Even if the plan succeeds, as Wallison explains, "any gains to taxpayers should be of little consolation; we will once again be saddled with two companies that create enormous risks for the financial system and deliver little or nothing for taxpayers or homeowners."

If you are on the inside, it's hard not to be partial to a situation with public risk and private profit. If there's a "crisis," as there's bound to be, the government will ride to the rescue armed with tax money. As James Madison noticed as long ago as 1794, someone invariably pushes to enhance the power of the state, employing what he called "the old trick of turning every contingency into a resource for accumulated force in the government." Still, while the principle may not be new, the size and audacity built into today's housing mortgage scam might surprise the Father of the Constitution.