Shutting Down Fannie and Freddie: Locking the Barn Door

Given the immense role these two government-sponsored enterprises (GSEs) had in the Great Meltdown, they remain an embarrassment for every politician even remotely related to them. As noted cryptically in his latest book, *Rollback*, Professor Thomas Woods said,

> In the decade leading up to Fannie and Freddie's collapse in 2008, the two mortgage giants spent millions of dollars lobbying congressmen. With "affordable housing" charities dotting the landscape in congressional districts across the country, and with comfortable sinecures thereby available to the relatives of important politicians, the result was an American political class that was all too happy to do Fannie and Freddie's bidding.

And when Fannie Mae executives were caught cooking their books to justify larger bonuses for themselves, no one went to jail, as would have happened in the case of a genuinely private firm.

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There are attempts to see how homeowners might be impacted if and when the massive GSEs disappear, with some suggesting that they will find it harder to arrange financing, and will have to pay more when they get it. And certainly some mortgages will likely become "luxuries" only the well-off can afford, such as 30-year fixed-rate mortgages. But there have been precious few suggestions that the government would ever allow mortgage lending to become "genuinely private."

Fannie Mae, founded in 1938 as part of President Roosevelt's New Deal, was a huge expansion of government's role in the economy. Marriner Eccles, who served as head of the Federal Reserve under Roosevelt, was the individual most responsible for creating the 30-year mortgage concept in the first place. Prior to such interventions, private mortgage bankers offered very conservative financing, with 10-year loans and 20-percent down payments being their bread and butter. But as the interventionists and ideologues gained influence, pressure to extend mortgages to those who "deserved" to own the American dream but couldn't afford it began to build. Fannie Mae was created from the ground up to respond to such pressures. It was given a virtual monopoly in the secondary mortgage market, and direct access to funds of the U.S. Treasury at low interest rates, and very quickly carved out a profitable niche in the mortgage market.

The one single advantage Fannie Mae had over its competitors was the unwritten "guarantee" that the Treasury would back up Fannie Mae if any of the mortgages went into default. Investors enjoyed the implicit promise of the government guarantee and eagerly provided the mortgage giant with funds to loan to increasingly risky borrowers. Freddie Mac was created in 1970 in an attempt to introduce some "competition" into the mortgage market.

With the encouragement and application of political pressure, as carefully detailed in Dr. Wood's best-selling book *Meltdown,* more and more money was loaned to more and more people who were less and less likely to pay it back. In September of 2008, both GSEs were placed into conservatorship by the U.S. government, with the combined portfolios containing approximately $1.5 trillion of toxic mortgages.

A truly free market in mortgage lending has so rarely existed in history that it is worth the effort to see how it would work. The interested parties, of course, would be the borrower and the lender. The borrower most likely would be interested in the most favorable terms possible, including interest rate, down payment, and the contract period. The lender and his investors on the other hand would be seeking a rate of return on their investment that would reflect the risk involved over the period of the contract, plus a profit. A free market would answer all the questions about risk and reward, safety, liquidity, insurance, default, borrower's inability to pay, and so forth, or else there would be no agreement. That's both the beauty and the simplicity of a free market in any good or service — there would be no contract unless both sides determined they were gaining something from the transaction.

In a free market, complications would be expected and anticipated: faulty construction, home builders, realtors, lawyers, appraisers, flood plain studies, and so on would all be part of the transaction, when necessary. In a recent conversation with a thriving realtor in Colorado Springs, it was learned that a successful purchase and sale of an existing residence involved no fewer than 23 distinct steps to closing.

When an outside entity gets involved, however, the market becomes distorted, allowing, inviting, or forcing the interested parties to make incorrect decisions based upon wrong market information. Lower-than-market interest rates, for example, will invite a buyer to invest in more real estate than he would under normal circumstances. Shifting responsibility for defaults to a third party, such as the U.S. taxpayer, allows investment decisions to be made that would otherwise never see the light of day. However, one must never discount the force of ideology by statists who are determined not to let a free market operate, as it might not result in the perfection they seek.

And so the Obama administration, in its offer to let go of Fannie and Freddie, remains determined to retain control of the housing market. As noted in the *New York Times,* they are offering three options to replace the bankrupt entities: The government would still provide insurance against default to borrowers of modest means, it would still provide such insurance but only "during times of crisis," and the third option would be to grant federal insurance guarantees for mortgages that met certain undefined "underwriting criteria. "

Rep. Scott Garrett (R-N.J.), who chairs the subcommittee that oversees Fannie and Freddie, has an optimistic point of view: "A purely private mortgage finance market is a very serious and a very achievable goal."

At present, the chances of shutting down Fannie and Freddie and letting a genuine "purely private" mortgage finance market takeover are slim. But as more understanding is gained about how such a market would work to the benefit of all, those chances will improve.