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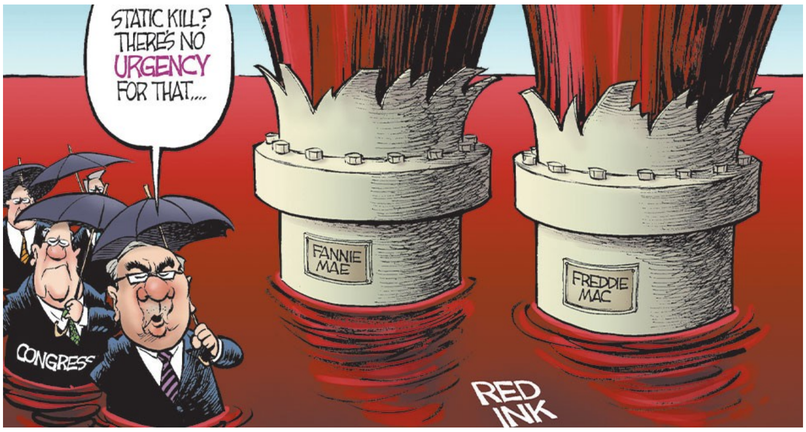
Cleaning Fannie's and Freddie's Stables



Students of mythology and users of the English language have likely heard something decidedly unpleasant labeled as "the Augean stables." The phrase originated in the myth where King Augeas housed 3,000 oxen and never bothered to get the building cleaned. After 30 years, the rancid structure finally got a cleanup when Hercules diverted the river Alpheus through its horrific odors and disorder.

The phrase came to mind recently when I read a small item about some more bailouts being requested by Fannie Mae and Freddie Mac. The Associated Press writer casually mentioned that the requested new bailouts "will cost the taxpayers as much as $259 billion." That cost is in billions, not millions. It's a figure far in excess of the $132 billion the two mortgage giants have been awarded since the September 2008 crash.

House Republicans are currently debating a plan to slash the federal budget by only $100 billion, far less than the projected $1.6 trillion deficit for the current fiscal year. And even that looks improbable. Shouldn't they look to Fannie and Freddie for a place to do some meaningful slashing?

Fannie Mae (real name Federal National Mortgage Association) came to life in 1938 as part of Franklin Delano Roosevelt's New Deal. Set up as a "government-sponsored enterprise" (GSE), its purpose was to expand the availability of mortgages by providing local banks with federal funds so borrowers could become homeowners. Converted into a publicly traded company in 1968, Fannie started earning dividends for investors.

Fannie Mae became so popular, with easy money and nice dividends, that the government launched another GSE known as Freddie Mac (real name Federal Home Loan Mortgage Corporation) in 1970. Competition in doling out taxpayer money was considered a splendid idea.

In 1992, with the twin GSEs functioning merrily, Congress passed and President George H.W. Bush signed the Housing and Community Development Act, which stated that the two GSEs "have an affirmative obligation to facilitate the financing of affordable housing for low-income families." The result was an explosion of new homeowners and the creation of an enormous housing bubble. The bubble grew even larger in 1999 when the Clinton administration made it even easier for anyone designated as a "low and moderate income borrower" to become a homeowner.

Many jumped on the gravy train. Increased demand for housing created a boom, and home prices skyrocketed. The "no lose" situation saw people "flipping" their first home purchase for a newer and more expensive domicile. Home prices rose dramatically. Others used equity on their rapidly appreciating homes for any one of a long list of improvements, vacations, purchases, etc.

Some analysts who warned about an imminent collapse were ignored. In 2006, Mike Stathis saw what was coming and spelled out his projection:

With close to $2 trillion in debt between Freddie Mac and Fannie Mae alone, as well as several trillion held by commercial banks, failure of just one GSE or related entity could cause a huge disaster that would easily eclipse the Savings & Loan Crisis of the late 1980s. This would certainly devastate the stock, bond and real estate markets.... Not only would investors get crushed, but taxpayers would have to bail them out since the GSEs are backed by the government. At its bottom, I would estimate a 30 to 35 percent correction for the average home. And in "hot spots" such as Las Vegas, selected areas of Northern and Southern California, home prices could plummet by 55 to 60 percent from peak values.

Which is precisely what happened! Soon, bailout billions helped Fannie and Freddie satisfy investors — at least for a time. And it certainly delighted bankers who ended up with lots of fresh cash. Foreclosures on homes that occupants could no longer afford glutted the market. The housing bubble not only burst wide open and crippled the housing industry, it contributed substantially to the nationwide recession that continues to grip our nation.

The Federal Housing Finance Agency (FHFA) now oversees Fannie and Freddie. Only five months ago, FHFA estimated that preserving Fannie and Freddie will likely cost taxpayers an even higher total, as much as $360 billion. Still in business, Fannie and Freddie own or guarantee about half the nation's home loans. Along the way, the two GSEs have regularly supplied campaign funds for federal lawmakers who sit on committees that are supposed to oversee what these mortgage giants are doing.

The U.S. Constitution contains no authorization for the federal government to create mortgage companies. Fannie and Freddie should be abolished. The market should determine the cost of loans, just as it should determine the cost of other goods and services. It's time to start cleaning out stables. Doing away with Fannie and Freddie would be a wonderful beginning, but only a beginning. The federal government has become a modern Augean stables in dire need of a thorough cleansing.