It's time to privatize Fannie Mae and Freddie Mac

By Gregory D. Hess

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Like most homeowners, I recently refinanced my mortgage. Why? The times had changed (thanks, Bob). Long-term rates had fallen sharply, and I could save a bundle on my monthly payment. The lesson learned is that, when the environment changes, you change with it.

Now, government programs aren't very good at change and typically outlive their useful purpose. This is clearly the case with Fannie Mae and Freddie Mac. Both programs were necessary when created: then, mortgage markets were less liquid, the U.S. banking system regionalized and substantially less capitalized, financial markets less developed, and the baby boom push for more housing well under way.

Today, Fannie and Freddie are back in the headlines, a place they do not like to be. They'd much rather frequent corporate charity circles and fine K Street restaurants. But this summer, Freddie made news for employing a few officials who liked to book profits when it pleased themselves rather than the rules of accounting. And Fannie was spotlighted in summer 2002 for having a maturity mismatch in which her assets were substantially shorter than her liabilities. Fortunately for all of us, financial scrutiny has increased; the Bush administration deserves kudos for thinking about ways to improve things in Fannie's and Freddie's world.

The administration's response is important because Fannie Mae and Freddie Mac are key components of our financial system. Performing as intermediaries in the market for housing mortgages, they purchase and hold mortgages originated by banks and then bundle packages of these mortgages together to sell as mortgage-backed securities with a guarantee to investors. By "guaranteeing" the securities, Fannie and Freddie assume the credit risk associated with the underlying mortgages which they hold on their portfolios, and off-load the interest rate risk to the investors. Presumably, given the diversification benefits of risk pooling, Fannie and Freddie can diversify the household-specific and region-specific credit risks inherent to the housing market.

No one can doubt the benefits of securitization of mortgages on the development and deepening of financial markets in the United States. But the benefits that Fannie Mae and Freddie Mac currently bring to the housing finance markets would continue even if the perceived "implicit guarantee" that they currently receive were to be removed.

Homebuyers then could choose among a variety of competitive financial options to finance their purchases. Savers would benefit by holding mortgage-backed securities. And Fannie and Freddie could earn profits – though any profit would be based on performance, rather than on legislated, government-sponsored tax and regulatory advantages, which create in market participants' eyes an implicit federal guarantee. And U.S. taxpayers would delete a large potential liability from their balance sheet for which they receive no benefit. It's time to cut the cord.

Besides, Fannie and Freddie quit making profits from securitization alone a long time ago. A huge portion of their profits now comes from the direct assumption of interest rate risk – which sounds a bit like "Animal
Farm” to me. What Fanny and Freddie do now to boost profits is buy back their own mortgage-backed securities (which were earning high returns) and issue long-term debt (which was getting a low return) and making money off the spread. Good idea? Sure! But it's a risk, and one that set off warning sirens in August 2002, when Fannie’s interest rate gamble was working against her and getting all those headlines. Plus, if the bet goes bad, U.S. taxpayers will likely end up holding much of the losses, not the overpaid executives at Fannie and Freddie.

The latest word from Washington, D.C., however, is that supervision of Fannie and Freddie may be moved to the Treasury Department to strengthen oversight: a bad idea, though perhaps not a terrible one. Now, as a Democrat, I feel it's ironic that I must lecture Republicans on regulation – lesson one: it's always better to fix the problem than to shift it. The problem is that Fannie and Freddie have a presumed competitive advantage over other financial firms, which helps to drive their strong profits (from which their private shareholders benefit). And if their financial moves go badly, they have the U.S. government as a backup. Can the Treasury department solve these problems? In one word: no.

Moreover, for some unfathomable economic reason (hint: Fannie and Freddie's extremely effective lobbyists), both agencies are required by the U.S. government to hold less capital as a financial cushion than their competitors, despite their implicit guaranteed and favorable status. But the White House position does not push higher capital standards – instead, it may allow a five-year moratorium on capital requirement changes, for fear of roiling competitive financial markets. Since when did Republicans go all wobbly when confronted with competitive financial markets?

Insisting that Fannie Mae and Freddie Mac perhaps hold a little bit more capital in five years and report a bit more about their activities are not bad things in and of themselves. Yet the U.S. taxpayer remains financially exposed to the risks undertaken by these government-protected, for-profit institutions. Better just to leave them for-profit, explicitly remove the implicit guarantee, treat them like any other financial institution, and fix the problem once and for all.

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