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Fannie and Freddie don't deserve blame for bubble



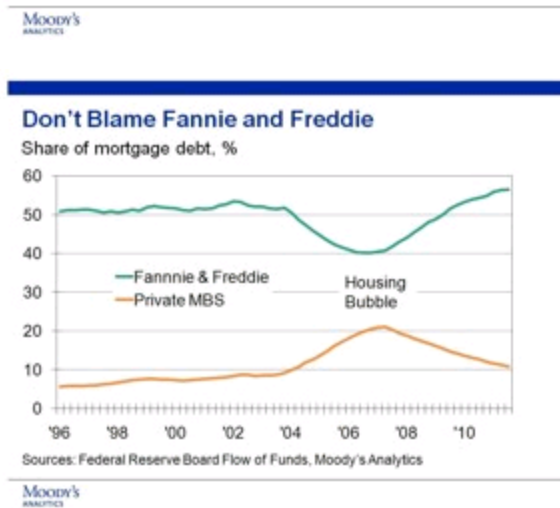
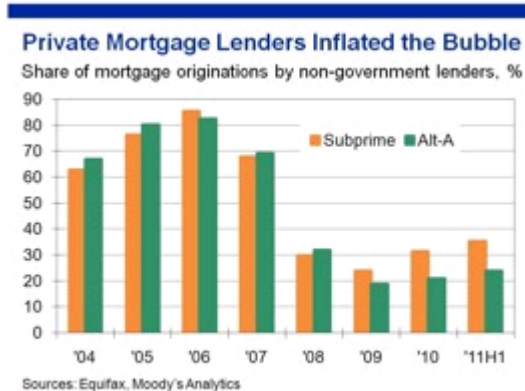
By [Mark Zandi](#), Published: January 24

There is plenty of blame to go around for the U.S. housing bubble, but not much of it belongs to Fannie Mae and Freddie Mac. The two giant housing-finance institutions made many mistakes over the decades, some of them real whoppers, but causing house prices to soar and then crater during the past decade weren't among them.

The biggest culprits in the housing fiasco came from the private sector, and more specifically from a mortgage industry that was out of control. These included lenders who originated home loans, investment bankers who packaged them into securities, rating

agencies that misjudged these securities, and global investors who bought them without much, if any, study.

In other words, America's mortgage securitization machine was fundamentally broken. It created millions of mortgage loans that, even under reasonable economic assumptions, stood little chance of being repaid — and were not. As a result, hundreds of billions of dollars were lost as defaults and write-downs brought the financial system, and the wider economy, to the brink, requiring a massive government bailout.



Also to blame, of course, were regulators, who gave the private mortgage market little, if any, oversight. The market's watchdogs were lulled to sleep by a misplaced view that self-interested private financial institutions would regulate themselves. This flawed thinking was most pervasive at the nation's most important financial regulatory agency, the Federal Reserve.

Getting history right for this dark economic period is critical if we are to design a better mortgage finance system for the future. If Fannie Mae and Freddie Mac are responsible for the debacle, then perhaps government's role in a future mortgage finance system should be minimal. But if private lenders deserve most of the blame, the case grows for giving government an important role in backstopping and overseeing the system.

"If it grows like a weed, it probably is a weed." This age-old banking adage aptly

applies to the private mortgage lending business during the housing bubble. Between 2004 and 2007, private lenders originated three quarters of all subprime and alt-A mortgage loans. These were loans to financially fragile homeowners with credit scores under 660, well below the U.S. average, which is closer to 700. But only a fourth of such loans were originated by government agencies, including Fannie, Freddie and the Federal Housing Administration.

The dollar amount of subprime and alt-A loans made during this period by the private sector was jaw-dropping, reaching nearly \$600 billion at the height of the lending frenzy in 2006. For context, this is about equal to the total amount Americans currently owe on bank credit cards. By contrast, government lenders made just over \$100 billion in subprime and alt-A loans in 2006. Even in 2007, when the housing market was beginning

its free fall, private lenders still handed out more than \$300 billion via these very shaky mortgage loans.

All this can be seen in the share of total residential mortgage debt insured or owned by Fannie Mae and Freddie Mac. At the start of 2002, before the housing boom got going, the two agencies' market share accounted for almost 54 percent of all mortgage debt. By summer 2006, the bubble's apex, their share had fallen to only 40 percent. It is difficult to see how the agencies could have been responsible for inflating the housing bubble at a time when they were losing a full 14 percentage points of market share. Indeed, the opposite was true, as their position in the housing market rapidly diminished.

It wasn't that Fannie and Freddie made a prescient strategic decision to stay clear of the housing frenzy. They couldn't have participated even if they had wanted to. The two

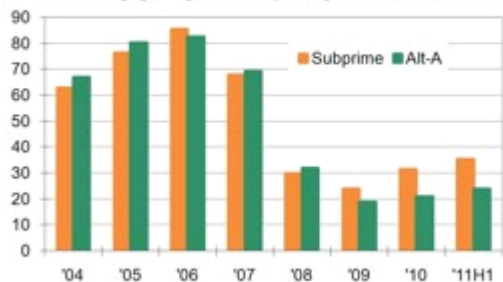
agencies had committed various accounting irregularities earlier in the decade, and their regulator forced them to rein in their growth.

Moreover, Fannie and Freddie couldn't compete with rapaciously expanding private lenders. Securitization was in full swing, enabling private lenders to offer low rates and increasingly aggressive terms to borrowers. In 2006, almost half the loans made by private lenders required no down payment and no

documentation. Fannie and Freddie simply couldn't play in that league, even though Congress had given them aggressive lending targets to help boost homeownership among lower-income and minority households.

Private Mortgage Lenders Inflated the Bubble

Share of mortgage originations by non-government lenders, %

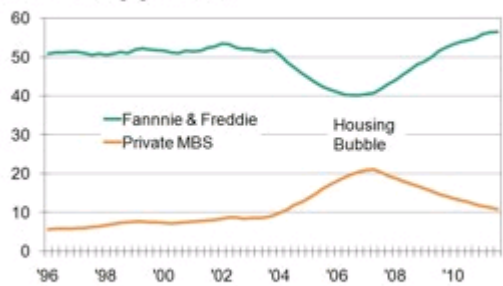


Sources: Equifax, Moody's Analytics

Moody's
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Don't Blame Fannie and Freddie

Share of mortgage debt, %



Sources: Federal Reserve Board Flow of Funds, Moody's Analytics

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regulators placed them into conservatorship. The two agencies had jumped back into the housing market at precisely the wrong time.

Fannie and Freddie did play a significant part in the financial panic. As financial conditions began to weaken in 2007 and the private mortgage industry pulled back, the agencies partially filled the void. This was their chance to get back in the game. The memory of their accounting scandals had faded, and policymakers hoped the agencies could keep the housing market from unraveling. Fannie's and Freddie's originations of sketchy loans actually peaked near \$160 billion in 2008, the year

The government's takeover of Fannie and Freddie arguably ignited the global financial panic. The Treasury Department's decision to wipe out shareholders of Lehman Brothers and Bear Stearns, two of the largest financial institutions on the planet, sent a shock wave through markets as it became apparent that no institution was safe any longer. Investors ran for the door, sending Lehman Brothers into bankruptcy one week later; a string of failures at other venerable institutions followed.

Despite Fannie and Freddie's role in the panic, it is wrong to blame them for creating it; that distinction belongs rightly to the private mortgage market. Understanding this is critical to creating a stable, efficient mortgage finance system for the future. While Fannie and Freddie themselves deserve to pass from the scene, given their numerous past missteps, it is equally clear that the government needs to remain an important player in housing finance, providing consistent regulatory oversight and a backstop in case the private market collapses again.

Mark Zandi is chief economist at Moody's Analytics, a subsidiary of Moody's Corp. He is the author of "Financial Shock," an book about the financial crisis. His column will appear regularly.

http://www.washingtonpost.com/realestate/fannie-and-freddie-dont-deserve-blame-for-bubble/2012/01/23/gIQAn3LZMQ_story.html