

The Philadelphia Inquirer

SATURDAY, JANUARY 22, 2011

Mark Zandi: Reforming Fannie and Freddie

Washington is gearing up for its next epic policy debate: what to do about Fannie Mae and Freddie Mac.

Fannie and Freddie are the two mortgage behemoths that the federal government created decades ago, and then took over as the financial system unraveled in 2008. What policymakers decide will determine how high mortgage rates go in the future, how easy it will be to obtain a home loan, and whether the popular 30-year fixed-rate mortgage continues to exist.

No one wants to return to the situation that existed just before the financial crisis. Fannie and Freddie had evolved into odd combinations of public and private; profit-maximizing, shareholder-owned companies with unique charters and implicit — but never clearly spelled out — federal backing. Each could thus borrow more cheaply than other financial institutions could, and both used that advantage to earn rich profits investing in higher-yielding mortgages. Fannie and Freddie were also allowed to operate with very thin capital cushions to protect them if their investments went bad.

There was a political quid pro quo for these advantages: Fannie and Freddie had to give a significant share of their mortgage loans to lower-income homeowners and members of disadvantaged groups. It wasn't a bad goal, although it was probably taken too far, and the nation clearly paid a high price for it. Of all the federal government's bailouts during the financial panic, those of Fannie and Freddie will cost taxpayers the most — almost \$150 billion. Rescuing Detroit's automakers, by comparison, cost about \$15 billion, while the bank bailouts actually resulted in a net gain for taxpayers.

One solution to the Fannie and Freddie problem is to formally and permanently make them part of the federal government. The chief benefit: a guaranteed steady flow of credit, at reasonable rates, in both good and bad economic times.

But nationalizing Fannie and Freddie would saddle the government with significant new risks, as well as with the institutions' debts, which would add to an already-mountainous federal debt load. In the long run such a system could also stifle innovation, while tempting lawmakers to subsidize mortgages for favored constituents, distorting a huge part of the U.S. economy.

Another solution is to take the opposite approach; that is, full privatization. Allow no government backstop for the mortgage market, either implicit or explicit. Government might retain a small role, but Fannie's and Freddie's operations would be spun out to the private market.

A privatized system would give all parties more incentive to be prudent. Mortgage originators, issuers of mortgage-backed securities, rating agencies, and investors

would all suffer if they made bad decisions. Nobody would be too big to fail, and taxpayers would be off the hook — at least in theory.

But full privatization probably works better in theory than it would in practice. Whatever legislators pledged never to do, global investors assume the U.S. government would rescue the housing market in a crisis. Meanwhile, a privatized mortgage finance system would significantly raise costs for borrowers, and would be a much less reliable source of credit.

Privatization would also endanger the 30-year fixed-rate mortgage, a bedrock of home lending since the Great Depression. Such loans are practically unique to America; nearly everywhere else, homeowners can obtain only adjustable-rate mortgages, with monthly payments fixed only for specified short periods. But because they are risky for banks and difficult to manage, long-term fixed-rate mortgages will almost certainly disappear without some form of continuing federal support.

Fortunately, there is a middle way between nationalization and privatization. A hybrid mortgage finance system would allow private institutions and the federal government to share the risks. Such a system holds the most promise for delivering consistent, affordable mortgage loans on prudent terms to borrowers, with minimal costs to taxpayers.

In a hybrid system, some of Fannie's and Freddie's operations would be turned over to the private market, while others would be transferred to the government. Instead of the market-distorting implicit government support for Fannie and Freddie, the government would offer insurance at an explicit price. The hidden cost of Fannie and Freddie's subsidies to homeowners would also be made visible on the government's books. Private institutions would provide the bulk of the system's capital and would also originate and own the mortgages. The federal government would insure the system against catastrophe, regulate it, and clearly spell out whatever subsidies are given to low-income families or others.

A hybrid system would preserve the key benefits of both nationalization and full privatization. Investors would remain on the hook for most losses, keeping incentives in place for prudent lending and risk pricing. The government's involvement, however, would keep mortgage rates lower and help mortgage credit flow freely, especially during difficult times.

Decisions made in coming months about the future of Fannie and Freddie will affect homeowners and the economy for decades. Success will depend on striking the appropriate balance between the benefits of the private market and the backstop of the federal government. Finding the right balance will result in a stronger housing market, a more stable financial system, and a healthier economy.

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