Will Free-Marketeers Save Fannie and Freddie?: Phillip L. Swagel

Here is one clear lesson from the economic meltdown of 2008: Any future U.S. administration will intervene directly and heavily if faced with a potentially devastating economic crisis. Market purists might not like it, but it is a fact I witnessed firsthand at the Treasury Department during the George W. Bush administration.

As a corollary, it is also true that the government will be compelled to step in if it becomes concerned that American families cannot obtain mortgages at reasonable interest rates. Indeed, it is inevitable that the government will also intervene if secondary mortgage markets -- that is, the trade in securities and bonds made up of bundled mortgages -- lock up.

The math is simple: Home mortgages represent $10 trillion out of $53 trillion in total U.S. credit market debt; remember that the Treasury and Federal Reserve felt compelled to stabilize money-market mutual funds in the fall of 2008 when they held just under $4 trillion.

Acknowledging these facts is central to solving a problem Congress is finally taking seriously: deciding the future of the government-sponsored enterprises at the center of the housing collapse, Fannie Mae and Freddie Mac.

Members of Congress, who began debating several bills to reform Fannie and Freddie last week, must start from this implicit promise of government intervention. Thus it makes little sense for Republicans to push for an ideal, purely market-based system. That head-in-the-sand approach will only help those like Representative George Miller, Democrat of California, who call for increasing government involvement.

Instead of holding out for an unattainable goal, conservatives would be wise to move forward with housing reform that specifies an explicit, but limited, government role.

The centerpiece of any proposal should be protecting taxpayers. The best way to make that happen is to bring private capital back into the market and ensure that it would take losses ahead of any government guarantee on mortgages and securities composed of them.

Fortunately, Congress already has a good model to follow: a bipartisan proposal now before the House sponsored by **John Campbell**, a California Republican, and Gary Peters, Democrat of Michigan. Under the plan, at least five private firms would be set up to finance and securitize high-quality conventional mortgages. The government would guarantee the resulting financial instruments, but the companies would have to pay insurance premiums for that backstop. The firms themselves would not be guaranteed -- only the mortgage-backed securities they created would be protected.

Such a program would create a competitive market in which Fannie and Freddie would become just two of many firms involved in securitization, and neither would be too important to fail. Over time they would probably be sold back into private hands or wound down.

Critics will no doubt make the case that Fannie and Freddie made housing possible for the less affluent, who would be left behind in a freer system. Under such a proposal, a portion of the insurance premiums could be earmarked for affordable-housing initiatives.

More important, an open market is also the best way to spur useful innovation in mortgages, as lenders would compete to find ways to help credit-worthy borrowers with modest incomes become owners. An irony is that the large banks so many Americans blame for the economic crisis are the companies most likely to compete effectively with Fannie and Freddie. (Disclosure: I have done consulting work for some large banks on reforming those enterprises.)

In order to give all competitors equal footing, regulators should require all firms involved to issue standardized mortgage-backed securities, as opposed to the current system in which Fannie's and Freddie's securities trade separately from other mortgage-backed instruments. This would have side- benefits: unifying the market would improve mortgage liquidity and thus probably lower interest rates for borrowers.

There are a few caveats. There is a risk in having the government price insurance -- something that it has done a terrible job at with flood insurance, for example. But any price it charges will be better than zero, which was the de facto rate in the Fannie-Freddie system that was ostensibly private but had its implicit federal guarantee.

The larger concern is what would happen to interest rates as the government backstop receded. If private investors overwhelmingly balked at taking on housing risk, it could lead to a surge in interest rates and further depress home sales and construction. Thus the prudent path would be to go quickly to a competitive system but phase out the current federal role at a slower pace, namely by gradually bringing in private capital ahead of a secondary government guarantee.

The longer Fannie and Freddie stay in government hands, the more likely they will become permanent wards of the state. This would be the worst of possibilities, yet it becomes more likely as conservatives push for a supposedly private housing financing system that has no hope of enactment. The government will always be part of the housing market; let’s make sure we keep its role as small and contained as possible.

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