

It's time to privatize Fannie and Freddie.

Beyond Regulation

BY PETER J. WALLISON

American Enterprise Institute

I CANNOT DISAGREE WITH THE PRINCIPAL thesis of Scott Frame and Lawrence White's article; if competition develops for Fannie Mae and Freddie Mac, it may cause them to take greater risks in order to maintain their profitability. The authors recognize that privatization is the only long-term solution to this problem, but see it as an unlikely policy choice. In the absence of privatization, they advocate stricter regulation as a second-best option. However, attempting to regulate Fannie and Freddie is not at all the same as regulating, say, banks or insurance companies. Indeed, the differences are so profound that stricter regulation of Fannie and Freddie is likely to be no solution at all, leaving the American taxpayer and the economy generally in the same position of jeopardy as exists today.

Although I have serious questions about the efficacy of bank regulation in general, bank regulators (in which group I include the regulators of savings and loan associations) have, over the years, been able to adopt regulations and impose them effectively on individual institutions through supervisory actions. However, in cases where a large part of the banking or S&L industry has been threatened with severe regulatory action, the record of bank regulators has not been so successful. A case in point is the S&L debacle of the 1980s, where the Federal Home Loan Bank Board (FHLBB) — then the regulator of savings and loans — failed to take the actions necessary to close down insolvent S&Ls until the problems of the industry had grown to monstrous proportions.

It is no secret why this happened. To close down a large number of insolvent institutions would have bankrupted the Federal Savings and Loan Insurance Corporation and caused the demise of many community institutions throughout the United States. Congress, pressed by the powerful lobby then known as the U.S. League of Savings Associations — as well as homebuilders, realtors, and others who benefited from imprudent S&L lending — brought pressure on the FHLBB to adopt a policy known as forbearance. The Reagan administration, plagued by complaints about budget deficits, did not

intervene. Under the forbearance policy, insolvent institutions were permitted to remain open and functioning as long as they could meet their obligations as they came due. As a consequence, when the losses had grown so large they could no longer be sustained, the house of cards came tumbling down and the hard-pressed taxpayers of America were required to bail out S&L losses of about \$150 billion.

POLITICAL POWER I recount this sad tale of regulatory failure because it illustrates an important point: When politically powerful forces exert their pressures on Congress, it gives way, and in turn uses its power to compromise the efficacy of regulation. It is this dynamic that sets the regulation of Fannie and Freddie apart from the regulation of banks. If an individual bank — even a large one — were to have financial difficulties, regulators would face no political interference in placing the bank under restrictions, reducing its activities, and requiring it to increase its capital and limit its risks. But Fannie and Freddie — in terms of political power in Washington — are to banks what New York is to Nome; they are simply not in the same league.

The political power of Fannie and Freddie is legendary. Both organizations, but primarily Fannie, are either managed by former political insiders or have powerful lawyers and lobbyists on retainer. Both companies spend more than entire industries on lobbying activities each year and regularly employ former congressional staff either as full-time employees or special representatives to maintain contact with important lawmakers for whom they previously worked. Both companies also make substantial political contributions, either through a PAC or through individual contributions by their well-compensated management.

Perhaps even more important as sources of political power are the constituency groups both companies can call upon to influence Congress. The securities industry (important members of which profit handsomely from underwriting their securities), homebuilders, and realtors are three groups that can be counted on to press Congress and the White House to adopt positions favored by and favorable to Fannie and Freddie. And all three groups will sponsor fundraisers for lawmakers who endorse positions Fannie and Freddie espouse.

Peter J. Wallison is a resident fellow at the American Enterprise Institute. He was general counsel of the treasury and White House counsel in the Reagan administration.

Those combined resources — an enormous and well-connected network of lobbyists and powerful constituency groups ready to spring to their defense — make Fannie and Freddie the two most politically powerful organizations in Washington. And it is this political power that makes any significant regulation highly unlikely — no matter who is the regulator, where it is located in the government hierarchy, and what authority that agency is given by Congress.

CURRENT EFFORTS This year, the Bush administration has been pressing for stronger regulation of Fannie and Freddie. That seems reasonable; between them, the firms have more than \$3.5 trillion in outstanding obligations, including about \$1.5 trillion in straight debt and the balance in mortgage-backed securities that they have guaranteed. A serious financial problem at either institution would have severe — perhaps systemic — consequences for the economy.

Recently, Freddie was found to have cooked its books, Enron-like, in order to smooth its earnings and obscure the scope of its derivatives use. The Office of Federal Housing Enterprise Oversight, Fannie and Freddie's regulator, has started a "forensic audit" of Fannie in which it has already found that the company failed to account for the full extent of its losses on impaired assets. Under those circumstances, one would imagine that any lawmaker concerned about the taxpayers or the future health of the economy would favor stronger regulation of Fannie and Freddie by a more powerful regulator.

But Fannie and Freddie are able to get their supporters in Congress to oppose even this obviously necessary initiative. In a recent letter to the president, 76 members of the House, including Minority Leader Nancy Pelosi (D-Calif.) and House Financial Services Committee ranking member Barney Frank (D-Mass.), protested the administration's effort to obtain stronger regulation. Although some will say that this disproves the proposition that the Democrats have never met a regulation they did not like, what it really means is that there are some loyalties that can override principle and responsible politics. The Democrats protested that the administration should be focusing on getting Fannie and Freddie to do more for affordable housing rather than spending its efforts on the companies' safety and soundness.

In fact, the administration is doing both. The Department of Housing and Urban Development, which has authority to regulate Fannie and Freddie's affordable housing obligations, recently proposed much more stringent regulations on the subject — regulations that would finally force Fannie and Freddie to live up to the claims in their advertising that they help minorities become homeowners. Although their advertising obscures this fact, study after study has shown that they do not do as much as banks for minority and low-income homebuyers.

Again, the administration's affordable housing proposal seems obviously sensible as a matter of policy. Why subsidize Fannie Mae and Freddie Mac unless they provide benefits to people who could not otherwise buy homes? But in this case, the Bush White House is receiving protests from Republicans,

who purport to be concerned that HUD's tougher requirements for affordable housing will diminish the funds available to the middle class. (Since the formula for mortgage lending by Fannie and Freddie now permits them to finance mortgages up to \$333,700 in principal amount, "deserving rich" can be substituted for "middle class" in the last sentence). Thus it appears that, on regulatory matters, Fannie and Freddie can move Congress in two ways — they can get the Democrats, in defiance of their traditional position, to protest against too much safety-and-soundness regulation, and they can get the Republicans, who should not support this kind of corporate welfare, to protest that there is too much attention to affordable housing. With this double whammy, it appears unlikely that stricter regulatory legislation or HUD's proposed guidelines will be adopted in their current form in this session.

WHAT'S A REGULATOR TO DO? In a broader sense, what this shows is that Fannie and Freddie — like the S&L industry in the 1980s — can get Congress to protect them against tougher regulation. And that says everything we need to know about the likelihood that a new regulator and new regulatory authority will protect the taxpayers or the economy as a whole against the dangers the two firms represent. Imagine, if you will, that the new, powerful regulator — if ever put in place — concludes that Fannie and Freddie are taking the serious risks posited by Frame and White. What is the regulator to do?

The first step might be to require Fannie and Freddie to increase their capital — the conventional requirement of a bank supervisor in similar circumstances. But wait. If the two are required to increase their capital, that will raise mortgage interest rates. Current homeowners might or might not protest, but everyone else will. Homebuilders, realtors, and mortgage bankers will all be outraged and will purport to be speaking on behalf of those Americans who will not be able to buy homes and fulfill the American dream. Letters from Congress will pour in; there will be hearings at which lawmakers will be shown on television pointing fingers at the regulators and accusing them of depriving Americans of an opportunity to own a home. There will be threats of retaliation — perhaps a moratorium on new regulation included in the next appropriations bill that gets through Congress. Under that barrage, it is likely that even the strongest regulator will recede. So much for tougher regulation as the way to deal with greater risk taking by Fannie and Freddie. We have seen this movie before; it was called the S&L debacle before Congress forgot about it.

Unfortunately, there is only one way to protect the economy and taxpayers from the dangers posed by Fannie and Freddie, and that is to privatize both of them. This fall, the American Enterprise Institute will publish a plan that will show how Fannie and Freddie can be privatized without leaving them — after privatization — as the dominant companies in the real estate market.

It is certainly true, as Frame and White argue, that privatization is an "unlikely event." One can even say that this is an understatement. Yet, because regulation is no solution at all, privatization is in fact the only realistic and reasonable course. **R**