The Nationalization of the Mortgage Market

BY ROBERT P. MURPHY

On Sunday, September 7, the United States government took control of more than half the U.S. mortgage market, through its seizure—and that is the word used in mainstream press accounts—of Fannie Mae and Freddie Mac, two colossal government-sponsored enterprises (GSEs), hybrid organizations owned by private individuals yet created by the government. The likes of this and other recent actions taken by Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke have not been seen since the 1930s. Will the GSE takeover someday be viewed as a decisive step in bringing state socialism to the United States?

What is especially noteworthy is the process through which the American public has been desensitized to the explicit expansion of state power in eight short years. It is a virtue that humans adapt quickly to new environments, but this strength can be turned into a weakness by clever politicians.

The housing boom and bust was a product of interventionist monetary policy, namely Alan Greenspan's decision to slash interest rates after the dot-com crash. The crash in real-estate prices has in turn led to large defaults on mortgage payments, inflicting billions in losses for investment banks and other large institutions that had bet heavily on mortgage-backed assets. The heavily regulated financial sector was vulnerable to these unexpected events. What should have been a large hit to real estate and a few institutional investors has now spread and is currently threatening the global financial system itself. (We should keep this episode in mind whenever someone claims that the free market is too unstable and requires wise government oversight to promote stability.)

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Villains and Saints

A panicked citizenry looks about for villains and saints, and the government is only too happy to dispense the labels. The villains are predatory lenders, short-selling speculators, and "do nothing" officeholders and regulators allegedly blinded by their laissez-faire faith, while the heroes (naturally) are the populist politicians who promise to clean up the greed and irresponsibility of the nefarious financial industry. If citizens would just suspend their abstract aversion to nationalization of large sectors of the economy, the government could keep them safe from further economic harm.

The Federal National Mortgage Association—FNMA or Fannie Mae—was founded as an agency of the federal government as part of the New Deal in 1938. Its function was to create a secondary market for mortgages, meaning that Fannie Mae, rather than originating loans to homebuyers, would buy mortgages (and their expected payment streams) from community banks and thrifts. In 1968 Fannie Mae was transformed into a private-sector company with shareholders, and its official connection with the gov-

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ernment was transferred to the Government National Mortgage Association (GNMA or Ginnie Mae). The Federal Home Loan Mortgage Corporation (Freddie Mac) was chartered in 1970 as another government-sponsored enterprise in the secondary mortgage market; it too is owned by shareholders.

The ostensible purpose of Fannie and Freddie is to promote homeownership. The two GSEs buy mortgages and bundle them into mortgage-backed securities, which are sophisticated derivatives that slice and dice the incoming monthly mortgage payments such that outside investors can (in theory) limit the risk of their real-estate investments. By providing a huge and liquid secondary market for mortgages, Fannie and Freddie make it more lucrative for others to originate mortgages. Make no mistake about it: The official mission of Fannie and Freddie is to cause banks to lend to applicants who would be rejected in the absence of government meddling. This point needs to be stressed as analysts wonder, "Why did banks make so many bad loans?"

All of this raises an obvious question. How exactly do Fannie and Freddie achieve their goal of promoting more mortgage origination than would have occurred in a free market? The answer is that these GSEs enjoyed implicit—and now explicit—government backing. Until quite recently, the official position of the federal government has been that Fannie and Freddie were private companies, earning private profits to be distributed to private shareholders. No taxpayer money stood behind them. However, investors suspected the GSEs were too big and too symbolic to be allowed to fail. Consequently, investors were willing to lend money to Fannie and Freddie—by buying bonds issued by these two GSEs—at lower interest rates than these same investors would have charged a truly private firm that performed Fannie's and Freddie's operations. Because their bonds were presumably guaranteed by the "full faith and credit" of the U.S. government—meaning the IRS and printing press—Fannie and Freddie were able to gain a huge share of their market; they directly owned or guaranteed roughly $6 trillion in mortgages. To repeat an earlier observation: The vulnerability of the overall system to a few giant firms is itself a product of intervention in these markets. If the government suddenly promised that it would use tax dollars to make creditors whole if Apple defaulted on its bonds, then we would expect it to become more "profitable," cut prices, and gain market share from Microsoft.

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It is worth pointing out that plenty of insiders got rich during the good times. Former Fannie chairman Franklin Raines earned some $90 million in compensation from 1998 to 2003. Even during the "bad times," things weren't so tough for the people running the two politically connected firms. As part of its takeover, the government ousted CEOs Daniel Mudd (Fannie) and Richard Syron (Freddie), yet they are entitled to compensation packages that could be worth up to a combined $24 million.

A Culture of Recklessness

Besides the implicit backing of their debt, the GSEs also enjoyed less regulation than their purely private counterparts. This bred a culture of recklessness and short-term thinking. To hit targets and trigger bonus payments to top executives, Fannie Mae manipulated its earnings over the period 1998–2004. Yet even when it was "caught," Fannie was only fined $400 million in what was an $11 billion accounting scandal. Furthermore, one suspects that the full $400 million penalty did not fall entirely on the executives who defrauded their own investors, meaning the gamble was well worth it from their narrow point of view. Students of political economy know that regardless of the official motivation for a new government agency or program, once it is up and running, politicians, bureaucrats, and corrupt businesspeople will find ways to enrich themselves at taxpayer expense.

What is particularly insidious about government debt guarantees and rescue loans—whether the implicit backing given to Fannie and Freddie for decades or the explicit guarantee given to the Mexican government during its own credit crisis in 1995—is that they can often seem costless. Indeed, the U.S. Treasury actually made money on its "bailout" of Mexico because the Mexican government didn't default on the bonds it had sold to investors around the world. In similar fashion, it didn't cost the government anything for its implicit protection of the GSEs when housing prices were booming in the mid-2000s.

All of this changed, however, once house prices began sharply falling. Speculative buyers and those who had planned to refinance out of ARMs were now caught with mortgage payments they couldn't afford, and so they began walking away. The stream of monthly payments into the bundled securities created by Fannie and Freddie was now drying up, and so the giants began losing money because as part of their normal operations they had guaranteed some of these payments. From the fourth quarter of 2007 through the second quarter of 2008, the two reported combined losses of $11.7 billion. *Now* the cost of the government's backing would be evident.

Parsing Paulson

It will be instructive to parse the actual announcement of the Fannie and Freddie seizure. Right out of the chute, Paulson explained:

> In July, Congress granted the Treasury, the Federal Reserve and FHFA new authorities with respect to the GSEs, Fannie Mae and Freddie Mac. Since that time, we have closely monitored financial market and business conditions and have analyzed in great detail the current financial condition of the GSEs—including the ability of the GSEs to weather a variety of market conditions going forward. As a result of this work, we have determined that it is necessary to take action.

Note that the Congress didn't send a bill to President Bush asking to nationalize the two corporations. On the contrary, it merely gave the relevant agencies the legal permission to take such actions if deemed "necessary." This latter strategy is far harder to contain, because who could possibly object to giving the executive branch options? That seems to be a different issue from the question of which options were good ones. Thus members of Congress can truthfully say that they merely voted in the interest of *preparedness* for a takeover. The president and his minions can take the blame or praise for the specific exercise of the powers so delegated.

Paulson went on to say:

> Since this difficult period for the GSEs began, I have clearly stated three critical objectives: providing stability to financial markets, supporting the availability of mortgage finance, and protecting taxpayers—both by minimizing the near-term costs to the taxpayer and by setting policymakers on a course to resolve the systemic risk created by the inherent conflict in the GSE structure.

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The problem here is that the "critical objectives" are incompatible. When Paulson talks of "supporting the availability of mortgage finance," this means making mortgages more available than they would be in a purely free market. To achieve that objective, then, the government must expose taxpayers, and the skewed incentives will necessarily distort the financial markets. Again, there is no way around this. If the government induces lenders to make loans that they originally thought were too risky, then the government has obviously made the overall system *more* volatile.

After Paulson's opening remarks, he turned the podium over to James Lockhart, director of the new regulator, the Federal Housing Finance Agency. Lockhart explained that the GSE structure was inherently flawed because private shareholders pocketed gains while the taxpayers were ultimately on the hook for massive losses. Even so, Lockhart further explained that as part of the takeover, Fannie and Freddie would expand their portfolios of mortgage-backed securities before reducing them steadily starting in 2010. As usual with government, when something isn't working, the solution is to make the problem grow—call it a "surge" in mortgage portfolios. No doubt future administrations will continually revisit whether conditions "on the ground" warrant a reduction in the monstrous agencies.

Lockhart also revealed that in exchange for its guarantee, the Treasury received senior preferred equity shares and warrants (similar to call options) that entitle the Treasury to purchase up to 79.9 percent of the common stock of the two companies under certain conditions. (To the best of my knowledge, those "certain conditions" were not revealed to the public—it's not merely that reporters have omitted the precise details out of laziness.)

It is significant to point out that the preferred and arguably even the common shareholders were robbed in this procedure. The Treasury's "senior preferred equity shares" bump the original preferred shareholders down a peg, forcing them to absorb losses before the Treasury takes a hit. On the other hand, if things turn around and Fannie and Freddie stocks recover, then the Treasury would find it profitable to exercise its warrants and thereby dilute the values of the other shareholders. For these reasons, the term *seizure* is far more accurate than *rescue* to describe the government's actions with respect to Fannie and Freddie.

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The government cannot create wealth. Although he is very smart and understands financial markets, Henry Paulson cannot centrally plan the mortgage market to improve on the spontaneous outcome of voluntary interactions among millions of professionals in the private sector. The fundamental causes of our current financial crisis were mortgages granted to unqualified applicants, as well as investors making very risky bets on assets derived from these mortgages. The bailout of those who lent to Freddie and Fannie, and the easing of the GSEs' regulatory limits, will only sow the seeds for a potentially worse crisis down the road.

The Trend Toward State Socialism

Beyond the harmful effects on the real-estate and mortgage markets, the seizures of Fannie and Freddie—as well as the bailout of AIG the following week—reinforce the trend toward outright state socialism. Investors are looking less at fundamentals and more at government announcements. The idea that these moves are encouraging "stability" is ludicrous, as the once-mighty Lehman Brothers was allowed to fail in between the two massive bailouts.

During normal economic times, if the government began seizing firms and disbursing hundreds of billions of dollars to particular institutions, and furthermore if each action were discretionary and impossible to predict even one week in advance, then everyone would recognize these policies as incredibly destabilizing. Yet this destabilizing effect still exists when laid over a backdrop of massive losses, and in fact hurts even more because of the victim's initial weakness.

Hard as it is to believe, the best course of action would have been for the government to allow these troubled firms to fail. This would be akin to pulling the Band-Aid off quickly, which is temporarily painful but soon forgotten. But with the possibility of federal bailouts and other novel techniques to revive the housing sector, troubled firms have been postponing the inevitable, hoping for a reversal of misfortune. As the financial crisis has now entered its second year, Bernanke and Paulson are pulling off the Band-Aid very slowly indeed.

As government-sponsored entities, Fannie Mae and Freddie Mac allowed their private executives to profit greatly from implicit taxpayer support over a period of decades. However, now that their excessive risk-taking has finally caught up with them, the GSEs' shaky balance sheets have been absorbed by the federal government, which at the same time has announced that the two failing giants will take on even more obligations. Besides the further bilking of the taxpayer, the seizure is an ominous sign of just how much power the executive branch has accumulated. The takeover of Fannie and Freddie will do nothing to promote stability in the financial markets in the long run, but it will serve as a precedent for further "necessary" expansions of government control of the economy.