POLICY BRIEF
HOUSE REPUBLICAN CONFERENCE | Mike Pence, Chairman

With Fannie and Freddie, Hearts Change as the Political Winds Blow

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> **"These two entities—Fannie Mae and Freddie Mac—are not facing any kind of financial crisis. The more people exaggerate these problems, the more pressure there is on these companies, the less we will see in terms of affordable housing."**
>
> – Rep. Barney Frank (D-MA), 2003

BACKGROUND

Fannie Mae and Freddie Mac, the bankrupt government sponsored enterprises (GSEs), are at the heart of the nation's current financial hangover. On August 5, 2010, after posting its twelfth consecutive quarterly loss, Fannie Mae requested an additional $1.5 billion of taxpayer funds. On August 9, 2010, after reporting quarterly net losses for ten out of the past eleven quarters, Freddie Mac requested an additional $1.8 billion of taxpayer funds. To date, the taxpayers have lost $148.2 billion bailing out the two firms. Accounting and bonus scandals that contributed to Fannie's failure provided former President Clinton's appointees, Franklin Raines and Jamie Gorelick, approximately $116 million in combined compensation, and Democrat fundraiser, James Johnson, received over $21 million. Current White House chief of staff, Rahm Emanuel received over $330,000 as a member of the board of directors of Freddie Mac. AEI's Peter Wallison recently noted, "As a senator, he [Barack Obama] was the third largest recipient of campaign contributions from Fannie Mae and Freddie Mac, behind only Sens. Chris Dodd and John Kerry."

Holding nearly $5 trillion in outstanding debt obligations and mortgage guarantees, the potential for future Fannie and Freddie losses represents a taxpayer risk of unparalleled proportions.

Fannie and Freddie were created to expand homeownership by providing liquidity and flexibility to the mortgage market through the purchase and securitization of mortgages from lenders around the country. In attempting to meet federally-mandated affordable housing goals and achieve bonus targets, Fannie and Freddie purchased risky mortgages, which inflated the market for the unsound loans and set the stage for the nation's financial turmoil. As those loans failed to perform, both firms experienced significant financial losses and were placed into federal conservatorship by the Treasury Department in September 2008, turning their implicit government guarantee into explicit taxpayer support. On December 24, 2009, Treasury Secretary Tim Geithner approved the removal of Fannie's and Freddie's $400 billion funding caps ($200 billion for each firm), in effect turning Fannie and Freddie into full government agencies and exposing the taxpayers to *all* of Fannie's and Freddie's losses through 2012.

ISSUES OF CONCERN

Principal Reductions: James Pethokoukis, writing for *Reuters*, reported that on August 17, 2010, the Obama administration may announce a plan to require Fannie and Freddie to write down portions of all underwater mortgages backed by the GSEs. (An underwater mortgage is a loan with a principal balance of more than the value of the home—i.e., negative equity) Since being placed into conservatorship, Fannie and Freddie have not been required to forgive any portion of a mortgage, but are permitted to modify loans in other ways (change of terms, interest rate reduction, etc.). If Fannie and Freddie are directed to reduce the principal of underwater mortgages, the GSEs would be required to write down the value of those loans. Such a move would amount to the Treasury Department bailing out millions of homeowners with taxpayer money, even those who do not need a bailout. Additionally, the Obama administration would circumvent Congressional approval, undermining the ability of the American people to participate in the decision process through their elected representatives. According to Pethokoukis, "An estimated 15 million U.S. mortgages—one in five—are underwater with negative equity of some $800 billion…The move, if it happens, would be a stunning political and economic bombshell less than 100 days before the election." The move would also add a significant amount to the nation's $14 trillion debt.

Change of Heart as Election Nears?: In response to recommendations by the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) to improve the Administration's failing Home Affordable Modification Program (HAMP), Treasury stated in two separate letters its concerns over making principal reductions mandatory for servicers restructuring underwater mortgages. In a letter dated May 20, 2010, Treasury argued that these writedowns would represent a "material adverse change" that could cause servicers to "pre-emptively opt-out" as allowed in their original Participation Agreements. Assistant Secretary for Financial Stability, Herbert Allison, wrote, "[Treasury] could not risk a substantial number of servicers and investors withdrawing from the proposed principal reduction alternative."

In a more detailed argument against the mandatory principal reduction, Assistant Secretary Allison wrote on July 16, 2010, "the most serious consideration was the potential moral hazard of strategic default," meaning the market could not bear the risk of a large number of homeowners deciding to purposefully discontinue their mortgage payments in order to qualify for the program. The letter goes on to state an "equally serious consideration was the recognition of the very real frustration on the part of responsible borrowers who, although they are overleveraged, are continuing to make their scheduled payments but believe that their tax dollars are being used to subsidize principal reduction." President Obama's Treasury officials have been accurate to date in outlining the massive disruptions to the financial system that would result from a government-mandated principal reduction for underwater mortgages. Democrat attempts to intervene in private market functions will continue to have disastrous unintended consequences.

Opportunities Intentionally Missed: Fannie and Freddie were at the center of the mortgage market meltdown. Yet, the Democrats' 2,315-page financial regulatory "reform" bill empowers government at the expense of families and small business owners, but failed to reform Fannie Mae and Freddie Mac. In fact, the Democrats rejected all efforts to rid the taxpayers of the on-going bailouts of the GSEs during the legislative process for the financial regulatory reform bill.

REPUBLICAN SOLUTIONS

Taxpayer Protection: The Republican GSE reform plan would put an end to the taxpayer bailouts for Fannie Mae and Freddie Mac. Fannie's and Freddie's current government-subsidized structure will cost taxpayers hundreds of billions of dollars. The Republican plan would end the model that allows privatized profits and socialized losses by phasing out the GSE charter. Once the charter ends, Fannie and Freddie would be required to conduct all new operations as fully private sector companies competing on a level playing field.

Restoring Market Discipline: The plan would repeal the GSEs' exemption from paying state and local taxes and repeal the exemption allowing GSE securities to avoid full registration with the Securities and Exchange Commission. The plan would also end the current GSE conservatorship by a date certain and place Fannie and Freddie in receivership if they are not financially viable at that time. If they are viable, the plan would initiate the process of transitioning Fannie and Freddie into fully private entities. Lastly, the plan would provide for the orderly wind down of the GSEs' existing business commitments, following the model successfully used in transitioning Sallie Mae from a GSE to a private company.

Encourage Innovation and Choices for Consumers: Fannie and Freddie have monopolized mortgage finance and used their government privileges to crowd out competition, stifling innovation and increasing systemic risk. Consumers benefit from competition as a result of innovation and lower costs. The Republican plan would put an end to Fannie's and Freddie's monopoly and force them to compete fairly in the financial marketplace.

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