Commentary from
Congressman Joe Pitts
Sixteenth Congressional District of Pennsylvania

420 Cannon House Office Building, Washington DC 20515 www.house.gov/pitts 202 225-2411 Andrew Cole, Press Secretary

September 12, 2008

Socialized Risk a Recipe for Disaster

By Congressman Joe Pitts

The federal government has yet again waded into the market at the distress of a financial institution that has been deemed "too big to fail." The most unfortunate aspect of this recent episode is that the disaster that Fannie Mae and Freddie Mac have become is as much a creation of poor government policy as poor financial decision making on the part of Fannie and Freddie executives. As Arnold Kling at the Cato Institute writes, the "GSE crisis may have been the most avoidable financial crisis in history."

Fannie Mae and Freddie Mac are government sponsored enterprises (GSEs) that were created with the best of intentions—helping more Americans own their home. But through lack of proper regulation on the part of the government, and an ever increasing willingness to embrace risk by Fannie and Freddie executives, they turned into multi-billion dollar enterprises that were privatizing profit and socializing the possibility of losses. In addition, they spent millions of dollars lobbying each year in order to keep legislators on Capitol Hill from imposing any kind of regulatory changes to this sweetheart deal.

Fannie and Freddie have come to dominate the mortgage market in the United States. The reason Fannie and Freddie were able to get so big is that they were able to use the U.S. treasury as a backstop. Credit rating agencies place no risk premium on debt held by the U.S. government, so Fannie and Freddie were able to take advantage of rates on their capital that private banks simply could not compete with.

When Fannie and Freddie embraced the bundling of the riskier mortgages of the subprime market, they exposed themselves to the fallout from the subprime crisis. It does not take a financial expert to understand how the assumption that the government would back Fannie and Freddie's debt liabilities led to decision making that created a self-fulfilling prophecy. When the subprime crisis continued to broaden and the markets began to doubt the financial stability of the GSEs, the feds had to step in to help.

Now suddenly, the American taxpayers find themselves responsible for some $5 trillion in debt held by the GSEs. The executives and the boards have been replaced, and the conservators have announced they are putting a stop to any payment of dividends on stock in the companies. This will recoup only $2 billion in the possible losses the treasury will be responsible to pay out should the mortgage crisis worsen.

This seems like a nightmare, but the most amazing part of the whole affair is that many in Washington are still committed to the basics of the Fannie and Freddie model—the model that is based on taxpayer backing of debt in order to allow a quasi-private company to privatize billions of dollars in profit on the assumption that losses would be socialized and the taxpayers left to foot the bill.

Capitol Hill has more than it's fair share of Fannie and Freddie sympathizers, many of which urge support for the GSEs as a way to increase home ownership, even though many economists seriously question the model of Fannie and Freddie in their current state as a way to achieve that goal. As Kling notes, "Economists have long complained that the risk posed by the GSEs were large relative to any social benefits."

Fannie and Freddie must be dismembered. They should be divided up and sold off. The private financial markets will be able to provide the capital services in their place, and lawmakers can go back to the drawing board to find policies that encourage home ownership without putting the taxpayers on the hook for trillions of dollars in liability.

The only thing worse than the situation we find ourselves in would be a situation in which Fannie and Freddie are allowed to return to their old ways.

###