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Mortgage Mess Meddlers

By Richard W. Rahn

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The global financial problem, stemming from the U.S. subprime mortgage mess, is a direct result of the irresponsibility and incompetence of the U.S. Congress, which is now making a bad situation worse.

To understand how Congress did this, let's start with the basics. For many years, banks and other financial institutions that provided mortgages were careful to make sure the property was not overvalued, and the borrower had a good credit history and enough income to make the mortgage payments without undo strain, because the bank owners neither wanted to lose their own or their depositors' money.

Over time, financial institutions became more specialized. Some specialized in originating loans, and others specialized in raising the capital to fund the loans. Those institutions that were good at raising the capital started buying the mortgages from those that were good at originating them. Thus began the development of the secondary mortgage market.

The problems started back in 1938 when Congress and the Roosevelt administration thought they had come up with a “brilliant” idea to expand homeownership by involving the government. They created the Federal National Mortgage Association, more commonly known as Fannie Mae, to buy mortgages from banks as private companies did, but with taxpayers' dollars. Fannie Mae had a great advantage, given that it could borrow money from the federal government more cheaply than private institutions could obtain their money. Thus Fannie Mae was able to quickly nearly monopolize the secondary mortgage market.

The banks that were good at originating mortgages liked this arrangement because it gave them a ready market to resell their mortgages at a profit. As would be expected, over the years credit standards slipped because those who ran Fannie Mae were not using their own money but the taxpayers' money and were able to excuse their own increasingly sloppy behavior as doing a “social good” by making it easier for people to buy homes who were not really creditworthy.

In 1968, the federal government "privatized" Fannie Mae and started requiring it to raise capital in the private markets. But because everyone knew Congress would not let Fannie Mae go bust (an implicit, not an explicit, guarantee), private suppliers of capital were willing to charge Fannie Mae less than other competitors because they rightly felt the risk was less. Fannie Mae thus became a virtual monopoly in the secondary mortgage market. But rather than break it up and make it truly private, members of Congress, as is their want, did the wrong thing in 1970 and sponsored another company, "Freddie Mac," to be the competitor (which has the same implicit federal guarantee).

With their competitive advantage, the duopoly of Fannie Mae and Freddie Mac grew larger and larger by buying more and more mortgages. The originating financial institutions continued to let standards slip because they had two ready and undemanding buyers for all the new mortgages they could write. By 2002, the Federal Reserve Bank (another congressionally created government monopoly) was offering virtually unlimited amounts of money to the banks at rates sometimes even below inflation, thus the housing boom was artificially bolstered by the issuance of 100 percent mortgages to uncreditworthy borrowers.

The originating banks could pass off these "subprime" mortgages to Freddie Mac and Fannie Mae, who would put them in "pools" that, in turn, were sold to investment funds and the public as "hi-grade" investments.

It is a game of musical chairs, in which market participants get implicitly taxpayer-subsidized money, and as long as they can quickly pass the risk to the next player before the inevitable default, they come out as winners. This "Ponzi scheme" was well-known, as was the fact both Fannie Mae and Freddie Mac have been home to a series of major accounting and financial corruption scandals in recent years. Politicians have used the board positions in these organizations to reward political cronies (the fired and indicted head of Fannie Mae was Bill Clinton's Office of Management and Budget director). Both Fannie Mae and Freddie Mac have been very major contributors to congressional campaigns.

So, rather than clean up the basic mess they created by getting back to market basics, the majority-Democratic House of Representatives last week passed the "Mortgage Reform and Anti-Predatory Lending Act of 2007" (H.R. 3915), which is guaranteed to make matters worse.

This bill will further reduce the ability of lenders to make sound judgments about who are good credit risks. Thus many who should have mortgages will be unable to get them.

The vagueness of much of the bill's language, coupled with increasing government micromanagement of the mortgage process, will put all legitimate mortgage lenders at greater risk. The winners are the trial lawyers, and the losers are responsible families who need mortgages and investors who only seek a reasonable return for lending money that is not threatened by never-ending legal actions.

Taxpayers are unlikely to make a mistake if they vote against every member of Congress who voted for this bill.

Richard W. Rahn is the chairman of the Institute for Global Economic Growth.

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