The Devils and the Details

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Eakinomics: The Devils and the Details

Let us review. Fannie Mae and Freddie Mac, the housing government-sponsored enterprises (GSEs), operated with charters that implied that the government would back them if they encountered financial distress. This implicit subsidy permitted them to borrow cheaply, underprice their key product (mortgage guarantees), and accumulate huge portfolios of undiversified housing risk. When the subprime bubble burst and the financial crisis erupted, these financial houses of cards (pun intended) collapsed.

In a better world these devils would have simply disappeared, but – voila! – the government stepped in to bail them out. In a better world, Congress would have enacted comprehensive reform legislation that corrected the flaws in the GSEs business models, protected the taxpayer, and better coordinated the backstop to housing finance provided by the GSEs and the Federal Housing Administration – it did not.

Instead, the GSEs spent 12 years in conservatorship. For the past 8 of those years, the Treasury pocketed any profits, removing any incentive to control costs and allowing the GSEs to gold-plate their business models. They are primed and ready to resume making private profits by subjecting the taxpayer to risk.

To do so, they have to be released from conservatorship, something that the Trump Administration appears to be trying to accomplish. To its credit, however, the Federal Housing Finance Agency (FHFA) is doing its due diligence first. In particular, in 2008, the Housing and Economic Recovery Act mandated risk-based capital requirements for the GSEs. Unlike its predecessors, this FHFA proposed and finalized a capital rule. Under it, the GSEs would have to hold $283 billion in combined capital, a step in the right direction because holding more capital further protects the taxpayer from the risk of having to bail out the GSEs in the future.

The hitch is that the GSEs currently have only $35 billion in capital, a far cry from the cushion that makes it safer for them to freely roam the housing markets. Rather than wait the many years it will take to accumulate the necessary capital, the Treasury and the FHFA appear to be contemplating entering into a consent decree with the GSEs and releasing them from conservatorship with their actions governed by the terms of the consent decree.

Yesterday, the editorial page of *The Wall Street Journal* declared this the "least bad option" and argued: "A consent decree could hard-wire strict capital requirements so Biden appointees couldn't water them down. It also could and should include limits on the GSE investment portfolios, guarantee activities (e.g., no cash-out refinances and vacation homes) and dividends. If the GSEs are to be released, they need to be kept on a tight leash."

Amen to the tight leash. But how tight a leash can a consent decree really provide? The GSEs are notorious for sidestepping caps on compensation, lobbying bans, accounting standards, and more. Capital accumulation is the easy part. A really tight leash would require a consent decree specifying in great detail the management and operation of the GSEs, and with sufficient foresight to anticipate the conditions that will prevail in future

housing and financial markets.

The desire to provide the flexibility to adjust in the future is at odds with the straitjacket that the GSEs deserve and the taxpayers need. That conflict makes me, at least, a fan of the theory but a skeptic of the consent decree in practice.