What to do about Fannie and Freddie

Gretchen Morgenson's piece in Sunday's Times points out how Fannie Mae and Freddie Mac are serving as a source of back-door bailouts for the banks.

And she quotes Dean Baker, co-director of the Center for Economic Policy Research in Washingto,n DC, to the effect that their continuing status as half governmental agency, half private enterprise creates an irreconcilable conflict between taxpayers and shareholders.

While Treasury secretary Tim Geithner acknowledges the problem, he's given no indication what the Obama administration plans to do about it, nor is the issue even mentioned in the Congressional debate over financial reform.

It should be, given the taxpayer dollars continuing to flow to these institutions while they are in government conservatorship and buying mortgages from banks at losses.

As I've said before, they should either be turned into full-blown government agencies or sold off.

The argument against turning them into agencies is that such a move will simply reinflate the housing bubble because of their efforts to subsidize homebuyers who can't otherwise afford mortgages.

In fact, Perrie Weiner, a lawyer who represents private-equity and other financial players as co-chair of DLA Piper's securities litigation practice, told me last Friday that abolishing Fannie and Freddie is all that it would take to put the financial system on firm ground again. Weiner described the GSEs' efforts to subsidize housing as the "genesis of the subprime mortgage problem," and said no other rule changes were necessary for the financial services industry.

In an email to me this morning, Baker disputed that view, terming it "dishonest" to say Fannie and Freddie were responsible for the crisis when "we know that the worst loans were securitized by the private issuers." He added that "Fannie and Freddie got into this game late and only then because they were losing market share. Blaming Fannie and Freddie turns reality on its head."

Still, Baker acknowledges that the GSEs could have helped deflate the bubble by refusing to buy mortgages that were used to buy homes at inflated prices. But their executives were incentivized to do the opposite, paid as they were to take risk through stock options, which rose in value when the company's stock price climbed but cost the executives nothing but the opportunity to profit when it fell.

And Baker says Fannie and Freddie could still play a useful public role in supporting housing as government companies. In that case, he points out, they would pay government salaries, "which means big pay cuts for the CEOs."

But Baker says that it may be preferable to wind them down given the current climate in Washington. "If members of Congress can't get over their ideological fixations about government enterprises being bad, then let's just get rid of them and find another way to help homeowners."

He notes "there is no way it is worth 1,001 contortions to structure some mixed entity that issues government guarantees just to save homebuyers 25 to 50 basis points on a mortgage."