The Arc of Policy History Is…Flat

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Periodically, I ask the AAF staff probing questions about economic policy such as: "Haven't we learned anything?" Yesterday's answer was: "No, Doug. We never learn anything." Sad but true.

This exchange was prompted by *The Wall Street Journal's* article entitled "Fannie, Freddie Are Poised to Tighten Real-Estate Lending Rules," which contained this gem: "The new rules might also require lenders to complete due diligence on the appraised value of a property, by evaluating its financial performance, for example." You have to ask yourself which is more perverse:

- Having to require someone to do due diligence, when due diligence is the steps a lender takes to protect itself against loan losses, or
- The qualification that the rule might (but might not!) require such steps.

Of course, we are in the land of the government-sponsored enterprises Fannie Mae and Freddie Mac, so nothing should be expected to make sense. The *Journal* goes on to note: "Fannie Mae and Freddie Mac are preparing to impose stricter rules for commercial-property lenders and brokers, following a budding regulatory crackdown on fraud in the multitrillion-dollar market." The woes in commercial real estate are longstanding, so this is an exercise in closing the barn door after the cows have left, emptied the farmers' bank accounts, and flown off to summer on the Riviera.

What are the tough new rules?

Lenders would have to independently verify financial information related to borrowers for apartment complexes and other multifamily properties, according to people familiar with the preliminary plans. Additionally, lenders could face tougher requirements for confirming whether a property borrower has adequate cash and verifying their source of funds.

In other words, please do the things any normal lender would do, except that the mortgage originator can simply sell the loan to Fannie Mae or Freddie Mac and stop worrying about its performance. Any losses would ultimately be borne by…the U.S. taxpayer! Just say subprime loans, student loans, and other financial stuff 10 times fast. This solution is the "eat your peas" approach to financial regulation. Take something that someone doesn't need to do and doesn't want to do and make them do it.

To be fair, Fannie Mae and Freddie Mac can construct the contracts used to purchase mortgages to contain compensation for losses if the financials for the underlying mortgages are flawed. So, due diligence is something that a lender should do to ensure that these clauses are not triggered. The existence of a regulatory crackdown on the entire market segment suggests that this incentive is not working strongly enough.