REUTERS/MARK AVERY

WAKING UP:

FIXING U.S. MORTGAGE FINANCE AND THE AMERICAN DREAM

REUTERS BREAKINGVIEWS

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PREFACE

Fannie Mae and Freddie Mac – the two giant institutions that buy or guarantee the vast bulk of U.S. mortgages – are in danger of prolonged survival. That's worrying. The two discredited institutions eventually need to go. But a key conference on their future this week comes in the run-up to the November elections. So common sense and taxpayers' interests may once again lose out to political temptation.

The American dream of home ownership, long a staple of Fannie and Freddie's self-promotion, makes tackling them a politically difficult task. And Washington has displayed little desire to do anything about the two agencies to date, despite major flaws evident long before the recent crisis began and the detailed criticism and new legislation aimed at the rest of the financial industry. Even a massive 2008 rescue and the open-ended Treasury commitment to keep the companies going, at a cost of $145 billion and rising, hasn't triggered action.

Fannie – actually the Federal National Mortgage Association – was created in 1938 to help generate an active secondary mortgage market in a lending-starved Depression-era America. However worthy that goal, things started going wrong in 1968 when Congress turned Fannie into a government-chartered but private sector-owned company, taking it off the government's balance sheet – a politically convenient state of affairs that persists today. Fannie's sibling Freddie Mac, the Federal Home Loan Mortgage Corporation, came along in 1970.

The whole model, amounting to subsidized government mortgage lending, needs a complete rethink. The commentaries by *Reuters Breakingviews* journalists republished here foresaw some aspects of the Fannie and Freddie saga as it unfolded over the past three years and presented ideas for reform. With luck, after a series of delays and bland statements, this week's debate may finally start the policy ball rolling.

Broadly, the best long-term option is to get the U.S. government out of the mortgage business altogether. It's unrealistic to expect that to happen overnight. And along the way the private sector needs to be encouraged to step in – or at least not held back. But the transition needs to begin so that the nightmare into which the American dream has descended can start to fade. As that happens, there will be plenty more opportunities for comment.

Richard Beales
Assistant Editor, *Reuters Breakingviews*
August 2010

SECTION 1

THE AMERICAN NIGHTMARE

FREE FANNIE AND FREDDIE

By Richard Beales

The American dream of home ownership has turned nightmarish for subprime borrowers. Some observers see regulated U.S. mortgage buyers Fannie Mae and Freddie Mac as part of the solution. In fact, these so-called government-sponsored enterprises, or GSEs, are giant anachronisms with little public value. They should be fully privatized and left to fend for themselves.

Fannie held its first "annual" shareholders' meeting in three-and-a-half years on Friday. Its stock has dropped some 40 percent this year, and Freddie's is down about 50 percent. The U.S. housing markets are in disarray. It might not seem so, but it's actually a good time to revisit cutting the GSEs loose.

For one thing, it is clear their Jekyll and Hyde nature – as instruments of the government on the one hand and for-profit companies on the other – reduces their policy value. Treasury secretary Hank Paulson has had to lead an industry-wide effort to address mortgage market problems. Fannie and Freddie feature only marginally in such plans. They do provide some liquidity in the secondary mortgage market. That's useful, but doesn't merit special treatment.

True privatization could take years. But it’s the right thing to do. Accounting scandals at both companies in recent years exposed complacency and cost shareholders money. And having failed to foresee subprime mortgage problems, both have had to raise billions of dollars in new capital. The GSEs are also still too big, as well as too intertwined with government, to be allowed to fail. This is moral hazard writ large and invites undisciplined risk-taking.

Also, they have largely accomplished their mission of bringing liquidity to a fragmented U.S. mortgage market. Fannie and Freddie shouldn’t still benefit from hefty subsidies that ultimately fall on U.S. taxpayers. The non-partisan Congressional Budget Office estimates that in 2003 the GSEs’ unusual status equated to a federal subsidy worth as much as $42 billion, mainly in the form of below-market funding costs. This advantage in turn stems from an implicit government guarantee, recognized by both investors and rating agencies.

Successive administrations have claimed there isn’t such a guarantee, but the GSEs' special status suggests differently. Some buyers of debt, including the Federal Reserve, are allowed to treat their credit as equivalent to the government’s, and both companies have access to symbolic U.S. Treasury credit lines. Beyond that, they are exempt from state and local income taxes and from the normal requirement to register their securities with regulators.

The CBO reckons that only about two-thirds of the 2003 subsidy benefited borrowers in the form of cheaper mortgages. The rest has, in better times,

helped Fannie and Freddie enrich shareholders and bosses. By several analyses, the two companies don't even focus that much of their subsidies on promoting home ownership for lower income families.

Instead, mortgage cost savings tend to go to all borrowers in proportion to the size of their loans. Critics point out that this combines with tax breaks to bias Americans, perhaps excessively, towards home ownership and associated mortgage borrowing. In short, government money and time could be better directed.

Privatization would involve phasing out all the special dispensations the GSEs enjoy. It would also make sense to shrink them and bolster their capital to levels that banks are required to hold. Meanwhile, their outstanding debt would have to be gradually refinanced to reflect a market-based cost of funds. The probably damaging impact of the transition on shareholders might have to be softened, too. But even if the government had to buy both sets of shareholders out and re-float the companies, it would cost just $56 billion to do so at Friday's stock prices, only a third more than the CBO's estimate of one year's subsidy back in 2003.

With policymakers more interested in intervening in housing markets than at any time in years, this is unlikely to happen. That's a shame. Cut the two giants loose, and it would become clear what, if anything, they really add to the American dream.

December 17, 2007

WAIL, FAIL, BAIL

By Richard Beales and Edward Hadas

Just what are Fannie Mae and Freddie Mac?

That question may sound easy, but it's not. These entities are part government agencies, part shareholder-owned companies with stock market listings and part hedge funds that speculate in the U.S. mortgage market.

One more time. Just what are Fannie Mae and Freddie Mac?

The Federal National Mortgage Association (Fannie) and the Federal Home Loan Mortgage Corporation (Freddie) were set up to improve efficiency in the U.S. mortgage market and to promote affordable housing. Usually known as government-sponsored enterprises (GSEs) or “agencies”, they have always had their own special regulator and accounting rules.

And what do they do in practice?

Fannie and Freddie operate in the secondary market, buying mortgages from the lenders that write them and guaranteeing mortgage-backed securities, which are bonds that are supported by pools of mortgages. They also buy and sell derivatives based on mortgage securities.

How big are they?

As of June 30, Fannie and Freddie owned some $1.8 trillion of mortgages and MBS between them, and guaranteed another $3.6 trillion. To put that in context, that $5.4 trillion is three times the total balance-sheet assets of Bank of America. Earlier this year, more than 80 percent of all U.S. mortgages were being financed through the GSEs.

What did the government do for the GSEs before the rescue?

The GSEs get some tax breaks, but their biggest gift from the government was an unwritten understanding that the government wouldn't let them fail or default on any securities or guarantees. That promise wasn't quite firm enough for investors to accept yields on agency debt as low as those on government debt. But it was firm enough that bank regulators treated GSE paper as having no risk of default, just like government debt. Most important, the promise kept investors from paying too much attention to the GSEs' balance sheets and business practices.

What did public ownership do for Fannie and Freddie?

The chief executives were paid like corporate chiefs, not like senior government bureaucrats. The trading desks behaved as if they were part of an investment bank, not a government agency. And the GSEs hired a bevy of powerful lobbyists, in the way of private companies trying to take advantage of taxpayers.

What went wrong?

As mortgage specialists, the GSEs have suffered badly from the U.S. housing downturn, reporting billions in losses in recent quarters. As poorly supervised amorphous entities, their capital was always inadequate and their risk-taking excessive.

Didn't they meet the capital standard set by their regulator?

Yes, but that wasn't much of an accomplishment. Their regulator, formerly known as the Office of Federal Housing Enterprise Oversight and recently reconstituted as the Federal Housing Finance Agency (FHFA), recently stated that their capital was adequate, based on statutory criteria. But U.S. Treasury secretary Hank Paulson on Sunday described it as "thin" in comparison with other financial institutions.

How thin?

The combined reported equity of the two amounted to just over $40 billion at the end of June, supporting all $5.4 trillion in potential obligations. And some of that was of dubious quality**.** Breakingviews.com has estimated that to make the GSEs' capital base roughly equivalent to that of a private sector bank like, say, Citigroup or Bank of America, they would need $200 billion of capital between them.

Why did the government intervene?

One reason was the implicit guarantee. If the government welched on it, investors – including foreign governments which buy a large portion of the GSEs' debt – would have been furious. The government didn't want that loss of credibility. Another reason was the fear of what would happen if the GSEs could no longer sell their debt. The whole U.S. mortgage market could well have collapsed, bringing house prices down even further and leading to a cascade of bank failures.

What powers did the government have?

Congress in July gave the Treasury something approaching a blank check to intervene in support of Fannie and Freddie – a capability Paulson called a "bazooka".

What did the government do exactly?

On Sunday, Paulson fired the bazooka, with the assistance of James Lockhart, who runs the FHFA, and in consultation with other Federal regulators. Both the GSEs were put into "conservatorship", a sort of work-it-out bankruptcy specially designed for these institutions. The FHFA will be the "conservator", effectively a trustee. The businesses will keep running pretty much as usual until the government figures out what to do with them.

Bankrupt companies usually shrink. Will that happen to the GSEs?

Eventually, but not yet. The plan is actually to increase the size of their portfolios for a year or so to support the mortgage market, and only start shrinking them in 2010.

So the businesses keep going, and even grow. Just how is this like a bankruptcy?

Well, FHFA will run the show and the current bosses, Daniel Mudd and Richard Syron, will leave. Both common and preferred stock dividends will be eliminated. And the Treasury will provide financial help. Oh, and that political lobbying will stop forthwith.

How much money will the government provide?

The exact numbers aren’t all clear. But the basic package is an agreement to purchase up to $100 billion of preferred stock in each company. It will drip-feed the cash, providing enough to ensure that net worth stays positive. In return for the life-support the Treasury gets $1 billion in senior preferred stock and warrants over 79.9 percent of the companies’ stock – and a requirement that the companies’ portfolios start shrinking from 2010.

Anything else?

The Treasury is offering a backstop secured credit facility that is supposed to expire at the end of 2009. It will also buy some of the agencies' mortgage-backed securities on its own account in the open market. Its plan is to start with a $5 billion purchase. That's only a token amount – the agencies have been issuing $50 billion monthly – but the presence of the government as a buyer of last resort should boost MBS prices. That would reduce the likely losses for the GSEs.

Anything the government didn’t do?

Funny you should ask. The Treasury didn’t actually make that guarantee of the GSEs' obligations explicit. There’s an easy explanation for its coyness. The U.S. Treasury already has $4.7 trillion of debt outstanding. It might not have wanted to more than double that.

Richard Syron, former CEO of Freddie Mac, Daniel Mudd, former CEO of Fannie Mae, Leland Brendsel, former CEO of Freddie Mac, and Franklin Raines, former CEO of Fannie Mae prepare to testify at a House Oversight and Government Reform Committee hearing on Capitol Hill in Washington, December 9, 2008. REUTERS/Jason Reed

What are the immediate consequences of the rescue?

The Treasury appears to have succeeded in boosting sentiment in financial markets, as might be expected from making the U.S. government's backing of Fannie and Freddie's business and senior debt even clearer. The support should be good for house prices, although they may only fall less than they would have otherwise.

And shareholders?

They will be at the very back of the line. Both companies' shares on Monday plummeted by more than 80 percent to trade under $1 a share. A year ago, both traded at around $60.

And preferred shareholders?

The face value of preferred stock of the two companies is “only” about $36 billion, and it was already trading at about half its face value. The announcement at the weekend should hit that value further, and could hurt some U.S. banks that own a disproportionate amount of it. Paulson was willing to take that risk. But a relatively small sliver of subordinated debt – less than $20 billion in face value – appears to have been spared by the Treasury’s plan.

What will happen longer-term?

That remains the five trillion dollar question. Paulson wants the GSEs to shrink, but the next President and Congress may not agree. Barney Frank, an influential Democratic senator, gave the Wall Street Journal his response to the shrinkage plan: “Good luck on that.”

What should happen?

Having got to this point, Breakingviews.com believes the entities need to be fully nationalized – rather than the current three-quarters arrangement – before being shrunk as soon and as quickly as possible and then dismantled. The government should get out of direct support of the housing market.

September 8, 2008

THE $400 BILLION ZOMBIES

By Richard Beales

Amid the fuss over the stress tests of Bank of America, Citigroup and the rest, it’s easy to forget the biggest zombies of the U.S. financial firmament: Fannie Mae and Freddie Mac, the mortgage finance giants. Fannie lost $23 billion in the first quarter. The Treasury will keep it solvent, and has now committed a combined $400 billion to Fannie and Freddie. Both should be delisted and put on the government’s books.

Amazingly, Fannie’s whopping loss was smaller than those it and Freddie reported in the third and fourth quarters of last year. The shortfalls stemmed from supporting enormous books of now-troubled mortgages on mere slivers of capital. Both companies got away with it for years, even as publicly listed companies, thanks to implicit government guarantees and influential friends in Washington.

Part of the charade ended in September, when the government effectively took them over. The Treasury promised them up to $100 billion each – far more, it was said, than they could possibly need. With the rest of the banking system still struggling, Fannie and Freddie have since played an even more prominent role in mortgage lending, largely at the government's behest. Now, at the same time as doubling its loss-covering commitment to each company to $200 billion, the Treasury has increased the quantities of assets and debt each is permitted to have.

Both companies still have long-suffering shareholders. The New York Stock Exchange could move to delist them but has shown remarkable forbearance, even though investors have for months now consigned them to the penny stock shelf.

By happy coincidence, that helps the government continue its implausible claim that Fannie and Freddie are private companies, and therefore don't have to be accounted for in the federal budget. If that's really the case, you'd think they might have been forced to undergo the recent stress tests applied to other big U.S. banks – but they weren't.

May 8, 2009

ALREADY BITTEN?

By Robert Cyran

Is the Federal Housing Administration following Fannie Mae and Freddie Mac down the zombie path? Unlike Fannie and Freddie, the smallest and healthiest-seeming of the U.S. government-sponsored mortgage giants hasn't had to be bailed out. Unfortunately, its relative health led it to ramp up its lending over the past two years to counter the declining housing market.

That may not be a problem if the housing market continues its recent recovery – housing prices in most cities have risen for three straight months, according to the most recent S&P/Case-Shiller figures. But the durability of this recovery is questionable given still-rising unemployment. The FHA could still need to tap taxpayers just as its larger cousins have.

The FHA guarantees home loans, predominantly for lower-quality borrowers who don't have much equity – the agency allows down payments as small as 3.5 percent of the purchase price of a home. Like Fannie and Freddie, it is in theory self-funded, and the debt it issues benefits from an implicit government guarantee.

Also not so differently from its bigger relatives before they were bailed out, the FHA has a fairly thin cushion of capital should things go pear-shaped. It has $30 billion of reserves against its $675 billion of outstanding guarantees. To be fair, this is much fatter in percentage terms than the cushions Fannie and Freddie used to hold. But it's still worrying considering how poorly its loans have performed recently.

The default rate on its portfolio was 8.1 percent in August. That's up from 5.7 percent a year ago. And it is likely to rise further because of the combination of the FHA's ill-timed recent expansion and the economics of the loans it makes.

The agency's share of the mortgage market slipped to 3 percent in 2006, the height of the subprime boom. While the FHA is hardly at the cutting edge of risk management – it has only recently got around to hiring a chief risk officer – it nonetheless lost market share because its practices didn't allow it to match aggressive private sector tactics such as offering loans with minimal documentation requirements to the unemployed.

But by sidestepping that crisis, the FHA set itself up for the possibility of another. The government encouraged the FHA to fill the vacuum that resulted when other lenders collapsed – and even when Fannie and Freddie were stretched.

For example, last year Congress increased the size of the mortgages the FHA could guarantee to $729,750, partly to support rapidly deflating coastal property markets. Since 2006, its market share has risen to about one-quarter of all single family mortgages. It now has $675 billion of guarantees, as opposed to $395 billion at the end of 2006.

Because the FHA accepts such low down-payments and house prices have fallen sharply over the past two – by 29 percent even after a recent upturn, according to the S&P/Case-Shiller index of 20 U.S. regional markets – this suggests many FHA loans of recent vintage now exceed the values of the properties they were used to buy.

The FHA, for its part, says its capital buffer is adequate. And it says it is now tightening up on things ranging from borrowers' credit scores to the lenders it will work with. Yet the damage may have been done. Expanding its reach so quickly at the same time as housing markets were going into steep decline is a potentially toxic combination.

Throw in still-rising unemployment and the result is lots of delinquencies, defaults and foreclosures. Furthermore, the amount lost by mortgage lenders on loans that are foreclosed is high and climbing. The FHA's losses could hit $70 billion or more according to Edward Pinto, a former Fannie chief risk officer who

recently testified on the matter in Congress.

The FHA may get by if initial hints of a housing recovery turn into a clearer upward trend. But if that doesn't happen, its fiscal position will deteriorate. As with Fannie and Freddie, taxpayers may end up regretting their elected representatives' focus on supporting housing markets by making mortgages easier for buyers to obtain – just when everyone else was learning that excessive leverage could be dangerous.

October 27, 2009

THE SAME BUT DIFFERENT

By Agnes T. Crane

Fannie Mae and Freddie Mac are escaping public wrath – and much in the way of accountability. That's despite their 12-digit bailout and open spigot of U.S. taxpayer cash. The failure of the Obama administration and lawmakers to address the problem means the housing time bomb is still ticking.

The two U.S. housing finance giants piled fuel under the mortgage boom just as the much-criticized Wall Street banks did. Both groups helped inflate the housing market by taking big mortgage lending risks and then needed Uncle Sam to clean up the mess.

But Fannie and Freddie did so employing even higher leverage ratios. And more taxpayer money has been used to shore up each of the two agencies than was poured into Bank of America or Citigroup. The U.S. government has doled out $60.9 billion to Fannie and $51.7 billion to Freddie, and those numbers are likely to climb. Treasury's investment in BofA and Citi capped out at $45 billion apiece.

Popular and legislative outrage, though, has remained focused on banks and insurer American International Group. That's despite the Fannie and Freddie bailout being open-ended. Treasury on Christmas Eve quietly removed a $200 billion cap on each agency's rescue funding, giving them a blank check from taxpayers for three years.

Despite their financial troubles, the two companies have been growing and now between them own or guarantee an eye-watering $5.3 trillion of America's mortgages. They also remain publicly traded even after their effective takeover by the U.S. government in September 2008.

Yet their bosses haven't testified in Congress since that same month, and lawmakers haven't held a hearing to grill the companies' regulator, the Federal Housing Finance Agency (FHFA), since October last year. By contrast, bank

executives including Goldman Sachs' Lloyd Blankfein were publicly lashed just this month.

Meanwhile, there don't appear to be any independent overseers like Elizabeth Warren of the Congressional Oversight Panel and Neil Barofsky, the special inspector general, both of whom keep tabs on how Treasury is spending its $700 billion of Troubled Asset Relief Program funds.

True, Fannie and Freddie have a dedicated regulator. But the FHFA currently has an acting director, Edward DeMarco, who is a holdover from the regulator's pre-bailout incarnation. And while an inspector general position was created 18 months ago, the White House hasn't nominated anyone to fill it.

So why are blind eyes being turned? In the short term, it's because Fannie and Freddie have been propping up the U.S. housing market by providing mortgage funding when fully private-sector banks couldn't or wouldn't.

But the two agencies' Teflon existence goes back many years, despite accounting scandals and other shortcomings. They aren't allowed to lobby any more, but in the past were hugely influential. In Washington they have long been treated, in effect, as piggy banks for subsidizing home ownership that are conveniently kept off the government's balance sheet.
Democrats are especially fond of them, but Republicans haven't been immune to their charms. It's also a brave political call to speak out against entities associated with the promotion of home ownership, an aspiration dear to many Americans' hearts.

With the two giant companies on intravenous government support, the issue should be coming to a head. In particular, there's the knotty question of whether the administration really does now need to bring them officially onto its balance sheet.

President Barack Obama's budget proposals next week should include words on their fate, but any detail is unlikely. Treasury Secretary Timothy Geithner has promised reforms, but not until 2011. Barney Frank, who chairs the influential House Financial Services Committee, wants to get rid of Fannie and Freddie in their current form but replace them – leaving wiggle room to maintain the status quo for a while longer.

In short, there's little political will to torpedo the fictions and contradictions surrounding Fannie and Freddie: They're private companies doing government work; they're off the government's balance sheet but backed by taxpayers; they're subsidized but compete with the private sector; they're regulated and too big to fail, but not kept in check.

Delaying the reckoning allows the systemic importance of Fannie and Freddie to keep rising, along with the danger of taxpayers facing a truly gigantic bill. Between bouts of Wall Street-bashing, Fannie and Freddie deserve their share and more of lawmakers' urgent attention.

January 29, 2010

SECTION 2

HOUSING BLUES, BAILOUTS AND BAZOOKAS

MORTGAGING THEIR FUTURE

By Antony Currie

Fannie Mae and Freddie Mac have always had to walk a fine line to please their shareholders on the one hand, and fulfill their public mission to bolster the nation's mortgage market on the other. Freddie, for one, is now adamant that investors come first – it doesn't want to dilute them by raising capital that boss Richard Syron doesn't think the agency needs. But the smarter move would be for both to seek fresh equity.

It's true that they have more capital now than required by their regulator, and if they have called the housing market right they may not need more. But that's a big if, especially for two firms that together lost more than $5 billion last year. Were U.S. house prices to fall, say, 15 percent during 2008, they could find themselves running short of capital.

With that in mind, it would seem prudent to plan for the worst even while hoping for a better outcome. Having more capital would also enable Freddie and Fannie to play a bigger role in stabilizing the U.S. housing market, rather than having to sell assets to keep their balance sheets in order as they did in the latter half of last year. After all, they were set up to act as counter-cyclical balances. Lazard Asset Management points out that they have become pro-cyclical, and their eagerness during the go-go years may even have exacerbated the bubble.

How much should they raise? Perhaps as much as $50 billion each, according to Lazard, more than doubling their capital. Even a more modest effort would leave them safer, and investors might even benefit. If spent wisely, the capital wouldn't just lubricate mortgage markets, but it could bring in decent returns, too. Of course, that's another big if for the agencies, with recent accounting scandals scarcely behind them. But it would be better than sitting still and hoping the worst doesn't happen.

March 14, 2008

WHAT $5 TRILLION?

By Dwight Cass

U.S. lawmakers have grilled senior bankers over the causes of the credit crunch. But they shouldn't be too smug. Like banks that ignored contingent credit exposures to off-balance-sheet vehicles during the boom years and lost billions when things soured, the U.S. government chose to pretend it wouldn't ever have to step in to back Fannie Mae and Freddie Mac. Now it faces an unpleasant reality.

William Poole, a former St. Louis Fed president, said on Wednesday the GSEs are technically insolvent. That doesn't mean they're about to fail. But still, their crisis appears to be coming to a head. With their share prices tumbling, raising much more capital on their own would be a huge challenge. But if they reach the brink, letting them fail isn't an option for the government.

First, the GSEs have bought 80 percent of the mortgages originated in the United States this year. Losing that demand would be catastrophic for the already shredded housing market. Plus, although the government denies it is on the hook for the $5 trillion or so of outstanding GSE debt, investors – including huge buyers of U.S. debt like the Chinese central bank – treat it as quasi-government paper. If the GSEs failed and their debt tumbled in value, those buyers would flee.

If it comes to it, nationalization appears the least-bad scenario. Nominally, it looks cheap: Fannie and Freddie's combined market cap is only some $18 billion. But absorbing $5 trillion of GSE debt would push the government's total liabilities to around the level of U.S. gross domestic product. That would degrade America's credit and make U.S. government borrowing tougher. Mortgages would also become more expensive and possibly scarcer.

If the government does take over the GSEs, it should recapitalize and privatize them again as quickly as possible. The key would be convincing the markets that this time there really was no implicit government backing. Splitting them into smaller, competing companies and forcing them to be capitalized in line with banks might help. Higher funding costs would mean the new lenders' mortgages would be more expensive. But it beats having none at all.

July 10, 2008

BAD BAILOUT

By Hugo Dixon

The bailouts of Fannie Mae and Freddie Mac will cost America dearly. Some sort of support was necessary to avert the domino effects that could have followed from the sudden collapse of the mortgage giants. But Uncle Sam has now underwritten these reckless lenders' activities without a clear plan to rein them in. The dollar and U.S. Treasuries are likely to suffer.

Let's be clear: Fannie and Freddie didn't "deserve" a bailout. The so-called Government Sponsored Enterprises leveraged themselves up to the eyeballs. When Bear Stearns needed a rescue, its $395 billion of assets was 33 times larger than shareholders' equity. As of March, Freddie had $1.9 trillion of loans and guarantees against $2 billion of equity, a ratio of close to 1000 to 1. Fannie's $3.3 trillion is only slightly better capitalized.

The U.S. economy would be better off without woefully undercapitalized institutions pumping too much money into mortgages. But a disorderly collapse could have caused all sorts of collateral damage: savage drops in house prices, further turmoil in global financial markets and even a wave of bank failures. So some sort of rescue had to be mounted.

But there are poorish bailouts and bad bailouts. And the one mounted by the U.S. Treasury and the Federal Reserve Board on Sunday night looks like a pretty bad one. A bailout should have been accompanied by a plan to cut Fannie and Freddie down to a size where they were no longer too big to fail and to wean them off government subsidies. But Hank Paulson, the U.S. Treasury Secretary, says he wants to keep them operating in their current form. When will lessons be learned?

Nor should a bailout have protected investors from their folly. The maximum pain should have been inflicted without killing the patients. On this score, it's not entirely clear what will happen. Fannie's and Freddie's shareholders will probably get badly squeezed. That's goodish. But the bondholders, who supply the lion's share of their capital, look like they have got off scot free. Rather than bailing them out, some way should have been found of bailing them "in' – by getting them to share some of the pain. What a missed opportunity.

As it is, Uncle Sam will be shouldering almost all the pain. In the initial instance, the Federal Reserve may lend Fannie and Freddie money. At a later stage, the government may lend money directly - and help recapitalize the institutions. It looks like the Bush administration, which for many years sought to pretend it was not providing a guarantee to Fannie and Freddie, has written them a blank check.

This matters not just to U.S. taxpayers but to foreign investors – because Uncle Sam is not that rich any more. The U.S. government's own credit could be damaged by the bail-out. As notions of a bail-out circulated on Friday, Fannie's and Freddie's bonds rose in value – but U.S. Treasuries fell. What's more, the dollar took another dive. It was already weak on fears that the United States doesn't have the stomach to take the required pain following years of binging. The bail-out reinforces that impression.

July 14, 2008

BIG HOLE

By Richard Beales and Dwight Cass

The feeble regulator of Fannie Mae and Freddie Mac has long allowed them to get away with having too little capital. If Treasury secretary Hank Paulson wants to strengthen the U.S. mortgage finance giants enough so they can hold their own without further government backing, he might have to inject some $200 billion or more.

The book value of shareholders' equity – common and preferred stock – for Fannie was about $41 billion at mid-year. For Freddie, carrying an accounting loss, the equivalent figure was $13 billion. For regulatory purposes, both are reckoned to be adequately capitalized with north of $40 billion of capital.

Assuming that sliver of capital is really there, it supports a mortgage-heavy balance sheet totaling roughly $880 billion at each of the companies. Fannie also guarantees some $2.2 trillion of mortgage-backed securities, while Freddie's analogous off-balance sheet commitment is nearer $1.4 trillion.

Do the math and, based on the figures on the companies' books, Fannie has capital amounting to less than 5 percent of its balance sheet assets, and only just more than 1 percent of its total potential exposure. Freddie's ratios are slimmer still. Real banks – Citigroup, JPMorgan and Bank of America, for instance - have ratios ranging from 6.5 percent to 9.5 percent on the first measure, and from 3.5 percent to 7 percent on the second, although the latter requires assumptions about what should be included.

For Fannie and Freddie to look credible without further government backing, those banks' capital ratios make a better guide than the inadequate regulatory requirement. To lift their ratios among those of the three U.S. banks, Fannie and Freddie might need some $110 billion and $90 billion of equity, respectively. Call it $200 billion between them. In light of this, recent talk of Freddie raising a few billion more sounds like a drop in the ocean.

With the market values of both companies only a fraction of their book values, beleaguered shareholders seem to accept they may be all but wiped out. Legendary investor Warren Buffett apparently agrees with them. Paulson might toss them something, along with preferred stock and subordinated debt investors, but it shouldn't be much.

The bulk of the Treasury's money should be used to pay down senior debt – between them, Fannie and Freddie have $1.6 trillion of it, effectively supported by the U.S. government – and to bolster the companies' capacity to do business through the housing slump. The cost is enormous, but until the companies have

adequate capital, it's unlikely Paulson will be able to break them up and sell them off as truly private sector entities – which is what needs to happen.

August 22, 2008

U.S. Secretary of the Treasury Henry Paulson and Jim Lockhart, Director of the new independent regulator, the Federal Housing Finance Agency, announce that the government is taking control of mortgage finance companies Fannie Mae and Freddie Mac in Washington, DC, September 7, 2008. REUTERS/Joshua Roberts

TARGET MOSTLY HIT

By Rob Cox

A bazooka isn't an easy weapon to aim. Yet Treasury boss Hank Paulson, who likened the power Congress gave him to sort out America's housing market to a portable rocket launcher, has hit his target with great precision. The proposed takeover of the government-sponsored entities Fannie Mae and Freddie Mac hits most of the right notes, even if it leaves some key questions unanswered.

Exact details on how the nationalization – almost certainly the largest in history – of the GSEs will be conducted have yet to be announced. But on one of the key points, the engenderment of moral hazard, the Treasury looks have it right.

It's making holders of Fannie and Freddie common and preferred shares fend for themselves.

It would have been tempting to assist the latter group of investors. U.S. banks own much of the $30 billion-plus of preferred paper issued by the GSEs. But as Paulson seems to suggest, these banks are unfortunate – but necessary – victims of collateral damage. The Treasury says regulators will help them to shore up their capital as best they can.

The Treasury also looks to have avoided giving any impression that managers of Fannie and Freddie will be rewarded for failure. The chief executives of the two companies, Dan Mudd and Dick Syron, have been shown the door. It's not clear whether they'll receive severance as part of Treasury's action – but clearly they shouldn't.

In addition, the Treasury says the two companies, while under conservatorship, will start reducing their holdings of mortgage-backed securities, at a rate of about 10 percent a year. This begins the process of addressing the huge mismatch between their trillions of assets and the thin slivers of capital on which they reside.

To lubricate this runoff, it also appears the Treasury will itself purchase MBS to ensure the U.S. housing market can stabilize from its slump and consumers – presumably those with conforming financial profiles – will be able to borrow money to purchase homes. This doesn't solve the U.S. housing mess – and values may have further to fall. But it means a GSE takeover may not add to the market's woes.
Notwithstanding the precision of his bazooka, Paulson has left untouched the biggest problem: whether the GSEs should exist at all. On this, he's necessarily deferred to the next Congress and president. But he's left no doubt that they cannot function as both public policy instruments and corporations beholden to private shareholders. Legislators must now begin the process of dismantling Fannie and Freddie.

September 7, 2008

BUTTON MEN

By Antony Currie

Two financial markets heavyweights now occupy the corner offices at Fannie Mae and Freddie Mac. Herb Allison and David Moffett bring some fresh blood and much-needed financial and organizational nous to the ailing mortgage lenders.

That's bound to be helpful. Allison's experience running much of Merrill Lynch in the 1990s, and as chairman of investment firm TIAA-CREF for much of this decade, should put him in good stead at Fannie. Meanwhile, Moffett spent 14 years as finance chief at U.S. Bancorp – one of the few banks to have avoided the worst effects of the credit crunch. That fostered the credit and asset-liability management skills that reportedly put him on the shortlist to be Wachovia's new boss earlier in the summer and that should prove invaluable to Freddie Mac.

Good though all this is, the chief executive role at both mortgage firms has been emasculated: the U.S. government is calling the shots via the conservatorship of the Federal Housing Finance Agency, which has already decreed that both will, as of 2010, have to reduce their balance sheets by 10 percent a year. A future White House administration or Congress might even choose to disband the agencies.

That reduces the role of the chiefs to one of heavily supervised caretakers – with lower compensation than their predecessors to boot. Allison and Moffett were aware of this when they agreed to step in. But those who have convinced themselves that these two big hitters can instigate a reversal of fortunes should think again.

September 8, 2008

SECTION 3

MARKET DISTORTIONS AND QUIRKS

PANTS ON FIRE

By Richard Beales

Remember Ninja mortgages – no income, no job, no assets? And “liar loans”, with no check of borrowers’ stated incomes? Staid old Fannie Mae and Freddie Mac, the government-chartered U.S. mortgage giants, were supposed to have shunned such subprime excesses. Maybe they did. But Fannie now seems to be going out on a similar lending limb.

The company is offering borrowers who are behind with mortgage payments up to $15,000 each to clear their arrears. The money comes – get this - as a 15-year unsecured personal loan, with “verbal confirmation of financial capacity” acceptable, according to Fannie’s published details. To be fair, there are a few other criteria. And it’s billed as a way to help homeowners over a hump. But the biggest financial benefit could actually come Fannie's way.

For Fannie, the “HomeSaver Advance” program should help reduce the need to modify mortgage loans formally, a complicated and expensive process, and to foreclose, a bad result all round. But as it happens, it will also reduce the number of delinquent loans Fannie buys back from the pools underlying mortgage-backed securities it guarantees – and the related losses it would otherwise have to take. That’s a nice kicker for Fannie, which has already had to raise one big batch of new capital to cover billions in write-downs.

For borrowers, Fannie says, the program is a way to “bring delinquent mortgages current and keep their homes”. That’s true, provided they can afford the regular payments on their mortgage and those on the new loan, which kick in after six months. That may be fine for borrowers in truly temporary difficulty. But longer term, it’s going to increase, not reduce, their debt burden.

The program might also upset investors in the company's MBS instruments. They like the idea that Fannie has to buy back troubled individual mortgages under certain conditions. If HomeSaver Advance makes formerly delinquent loans look pristine, even though the borrowers are actually still struggling, it undermines that comfort.

Overall, it looks like it might be Fannie that stands to reap the clearest benefits, at least in the short term. The company isn't saying how big the new program might get. But bruised shareholders – and U.S. taxpayers, who are implicitly on the hook – might wonder whether a collection of unsecured loans to demonstrably stretched borrowers could, before long, become a bit of a millstone.

February 29, 2008

MORE BAZOOKA AMMO

By Rolfe Winkler

Uncle Sam is adding a risky new weapon in its battle to shore up the housing market. Granted, the latest Standard & Poor's/Case-Shiller figures showed a fifth month of improvement. But analysts had already discounted that, expecting prices to fall 10 percent or more next year as various government supports are wound down.

The Treasury's Christmas gift of almost unlimited support for Fannie Mae and Freddie Mac might be able to fend some of that off. But it will be a tough fight. A housing tax credit – of up to $8,000 for first-time buyers - ends in April. Meanwhile, the Federal Housing Administration plans to tighten its loose lending standards as its reserve fund has dwindled.

Moreover, mortgage rates can reasonably be expected to increase as the government ends purchases of mortgage-backed securities. Treasury's $220 billion buyback program ends this week. The Federal Reserve's $1.25 trillion program ceases in March.

And then there’s the continuing flood of Treasuries to finance the federal deficit. Morgan Stanley estimates that could drive 30-year mortgage rates back above 7.5 percent, an effective 40 percent increase in the cost of financing home purchases. Even a smaller jump risks driving buyers from the market, which could force house prices down.

Then there are foreclosures. Credit Suisse expects 4.2 million next year and estimates that 3.2 million must be prevented to keep prices stable. That's a tall order, considering mixed results from modification efforts that mostly focused on extending terms or lowering interest payments. Banks, mortgage bond investors and servicers are loath to go further, by forgiving principal, because it’s either a direct hit to capital or tricky to do under current bond documents.

Enter Fannie and Freddie. With unlimited support from Treasury the two have theoretically unlimited capacity to eat losses, useful to Treasury if it wants to finance an expanded modification program that includes principal forgiveness.

It's a tempting weapon to deploy ahead of midterm elections. But financing principal write-downs with taxpayer money only adds to America's debt burden while rewarding irresponsible borrowers and lenders.

December 29, 2009

SMOKE AND MIRRORS

By Agnes T. Crane

Fannie Mae and Freddie Mac are finally admitting that bad loans are bad loans. The two U.S. government-run mortgage finance giants on Thursday committed to scrub the mortgage-backed securities they guarantee of seriously delinquent loans totaling some $200 billion. It's about time. The trouble is the two firms have predictably wasted money putting it off – until an accounting change made it look less bad for them.

When a homeowner misses a payment on a loan underlying a guaranteed mortgage security, Fannie and Freddie can make the payment so as to leave holders of the security unaffected. This makes sense for a few months since there's a chance a homeowner will start paying again. But once payments are four months overdue, it's throwing good money after bad.

That's what Fannie and Freddie have mainly done until now. Their alternative was to buy the loans out of the securities. But mortgage strategists say little of that happened in 2009, and there's a reason. Last year, Fannie and Freddie would have had to mark any loans they bought in this way to market prices, taking a big hit.

Enter a 2010 accounting change which rightly forces the companies to account on their balance sheets for the trillions of mortgage bonds they guarantee. But it brings a twist: now they can pull loans out of the securities without having to mark them immediately to market. The potential for losses is still there, but Fannie and Freddie can defer the impact on their bottom lines – making buying the loans now look like the cheaper option.

Considering the scale of the potential losses, it's also handy for the companies that the U.S. Treasury on Christmas Eve last year quietly agreed to prop them up with unlimited funds for three years, removing the previous caps on assistance of $200 billion apiece.

At least Fannie and Freddie will now stop wasting money avoiding the issue. But the episode is symptomatic of the opacity surrounding the two housing finance behemoths. There's been plenty of talk from lawmakers and officials about post-bailout transparency in the financial sector. But they still seem content to make an exception of two of the biggest drains on taxpayers' pockets.

February 11, 2010

THE CIRCLE OF LOSS

By Agnes T. Crane

The bailout of Freddie Mac is certainly paying dividends. U.S. taxpayers extracted a handsome $4.1 billion payout last year in exchange for their $51.7 billion of support since the 2008 rescue of the housing finance giant. And they're set to receive an even richer dividend from Freddie this year. But these pounds of flesh make little sense right now.

Sure, Freddie managed to get by without any extra public funds in the fourth quarter. A more hospitable market for mortgage-backed securities helped. But Freddie is far from done tapping government coffers. The U.S. Treasury's equity line initially was supposed to be capped at $100 billion. Yet the government was worried enough about the mounting losses late last year that it decided to give Freddie, and onetime rival Fannie Mae, unlimited access for three years.

The support comes in the form of senior preferred stock with a 10 percent dividend. It's similar to the terms Warren Buffett struck with Goldman Sachs, but that life-line helped Goldman move on to generate huge profit. Freddie is still losing money – and taxpayers' money at that. Freddie gushed $25.7 billion of red ink last year.

The dividend isn't linked to results. If Freddie can navigate the worst housing market in generations without taking another dime from Uncle Sam, it'll still be on the hook for $5.2 billion in 2010. But that's an optimistic scenario. The delinquency rate on Freddie's $2.25 trillion portfolio is still rising, to 3.87 percent in the fourth quarter.

Freddie should pay an onerous price for failure – just not while the government still needs it to help turn the housing market around. In that context, the current arrangement is illogical. Every time Freddie draws on taxpayer funds, it needs to use a portion of them to pay taxpayers their dividend.

The bigger questions on Freddie – privatize, nationalize or run it down – remain unanswered. Those will probably wait until a recovery is considerably further along. It doesn't mean, however, that the smaller issues don't deserve attention. The dividend that is only making a bad situation worse is one of them.

February 24, 2010

NO FOND FAREWELL

By Richard Beales

Fannie Mae and Freddie Mac are at last slipping into a form of obscurity. The U.S. mortgage giants will delist from the New York Stock Exchange under order of their watchdog. When they start trading in the penny stock market, investor attitudes may change – but the government fiction that the two are private companies almost certainly won't.

The ostensible rationale for the Federal Housing Finance Agency's directive to move them off the big markets is that Fannie's stock has lately averaged less than the $1 minimum price required by the NYSE and that Freddie's has fallen close to that level. With no obvious argument to reset their share prices, a delisting was inevitable.

More significantly, the two companies can't continue pretending to act in the interests of public shareholders while behaving as fully paid-up arms of the government. Fannie and Freddie are propping up the U.S. residential housing market. They end up holding or guaranteeing almost all new mortgages – and their regulator wants them to back more home lending to people who, with the best will in the world, can scarcely afford the payments.

Disappearing from the NYSE will make Fannie and Freddie less noticeable, though they'll continue to file reports with regulators. The ranks of shareholders, who by keeping the companies' market capitalizations not far off $1 billion apiece seem to have clung to some kind of option value, will no doubt be further reduced to those who can tolerate illiquid over-the-counter trading. But what perhaps really should happen – a purchase of the shares by the government – won't.

That's because separate ownership is critical to the conceit of keeping the debt and guarantee obligations of the two behemoths, more than $5 trillion combined, off the government's books. The U.S. Treasury has undertaken to pour money into Fannie and Freddie – roughly $140 billion so far, but with no limit – to keep their net worth above zero. That's in substance a full guarantee, but not one the government recognizes.

Leaving the two companies' stocks trading on the equivalent of the pink sheets will help spare the government's blushes for a while longer.

June 16, 2010

SECTION 4

FALLOUT, FIXES AND THE FUTURE

PRINCIPLES FIRST

By Edward Hadas

The Fannie Mae and Freddie Mac debacle is far from over. But the crisis is already advanced enough to teach two lessons about free markets.

The first is that governments can really mess up competitive markets – in this case the market for housing finance. This should need minimal help from the authorities. Mortgage lenders need adequate capital and legal protection, but other than that they should be left alone to fight it out for customers and profits. Everyone should benefit from the competition.

But U.S. authorities didn't let the market do its magic. In the interests of increasing home ownership, they promoted the growth of Fannie and Freddie, which were subsidized by the implicit – now increasingly explicit – government guarantee on their debt. The privileged position of the Government Sponsored Enterprises helped drive less favored banks to look for riskier mortgage business.

In the last few years, the execution was even worse than the anti-market idea. Fannie and Freddie took huge bets on thin capital bases, while dodgy subprime lending from other sources ballooned. The result: too many houses, too many foreclosures and a government which is redoubling its meddling in an effort to help cure mistakes largely of its own making.

The second lesson is that free markets are easier to praise than to find in modern economies. In Europe, left-wing intellectuals often moan about the onslaught of American neo-liberalism, the ideology of totally free markets in which savage competition destroys human values. The United States is seen as the home of this heartless "Washington Consensus".

Some U.S. industries might indeed qualify for such criticism, but the government-coddled housing sector is probably more typical. Like agriculture, education and health care, shelter has been deemed too important to be left largely to an unfettered market. It is felt that competition is best kept within strict limits.

To judge from the rush to keep Fannie and Freddie operating in something like their current form, a crippling crisis hasn't changed U.S. authorities' opinion.

July 16, 2008

INVISIBLE HAND, NOT HANDOUT

By Martin Hutchinson

Fannie Mae and Freddie Mac have no place in a well-ordered economy, but are difficult to euthanize. The market, which has brought them down, should finish the job. The guarantee fees charged by the U.S. mortgage behemoths should be raised enough to make them uncompetitive once the mortgage market recovers.

The two government-sponsored enterprises are supposed to make home mortgages cheaper, but arguably have not done so. The spread between prime home mortgage costs and 20-year Treasury bonds was more than 0.2 percent higher between 2000 and 2006 than between 1971 and 1977, before Fannie and Freddie dominated the market. Introducing government guarantees, explicit or implicit, into the home mortgage market only distorts the financing of a straightforward asset pool.

The GSEs, however, enjoy powerful political protection, which is likely to survive even the current disaster – despite the fact that their formerly generous lobbying has been halted. Home ownership is an attractive political goal and any push to wind down the GSEs would meet strong opposition from Democrats, who are likely to be in control of Congress for at least the next several years.

Now that it has taken control of the GSEs, the government could take action to make them unattractive to other market participants – the only sure means of outweighing their political clout. When they buy or guarantee mortgages, the two companies currently charge 0.25 percent up-front for the best credits plus 0.15 percent to 0.25 percent per year for securitized mortgages. These levels should be at least doubled.

In today's difficult market conditions, GSE involvement would still be attractive – even if the higher fees would marginally increase mortgage costs. As the housing market stabilizes, however, mortgage lenders should find it profitable to go back to the old method of holding home loans on their balance sheets, avoiding the expensive of getting the GSEs to buy or guarantee them.

For homeowners, bureaucracy would be reduced and the lending relationship returned to their local banks. With market forces acting to shrink Fannie and Freddie, their effect on housing finance could, over a few years, be reduced to a modest level. Then the United States could get itself properly off the hook by closing them down or otherwise offloading them, leaving no hint of government backing.

September 8, 2008

NO FANNIES PLEASE, WE'RE BRITISH

By Ian Campbell

The UK housing market keeps falling and the siren calls for help wail – it's worse here than in the United States and the U.S. government is doing something. The UK government may be desperate, but it should plug its eager ears and ignore the cries.

The house bubble was worse in the UK than the United States. Between 2000 and 2007, while U.S. home mortgage debt more than doubled – with government-sponsored Fannie Mae and Freddie Mac a fount of funding – UK mortgage lending tripled. This treble was achieved by the private sector, with no Fannie at their rear, though with never a word of caution from the government.

The higher UK flow of loan liquid is evident in house prices. The average U.S. house rose by 69 percent from 2000 to 2007, the UK one by 127 percent. Now the UK house price fall is therefore liable to be steeper than the American one. But not, as a result, more in need of assistance.

For government efforts to spur mortgage finance would emulate the U.S. mistake – which was to create Fannie and Freddie in the first place. Nor would the UK housing market be saved. Mortgages are markedly scarcer and a little more expensive than before, but the problem is also on the demand side.

Britons don't want to buy. And not only houses. New car registrations in August were at their lowest since 1966. UK consumers rightly fear a downturn and an increase in unemployment. They lack the confidence to buy – and know the house price is not right.

According to the Halifax, the average house price to earnings ratio was 3.5 in 2000 – close to a long run average – but 6 times in the third quarter of 2007 when the market peaked. By the second quarter of 2008 the improvement is still modest: to 5.3 times.

UK house prices must fall much further to bring them into line with earnings. Any effort to avert that process is doomed to expensive failure. The rescue of Fannie and Freddie ought to be a warning, not an incitation to imprudence in new areas.

September 8, 2008

PAPER LOSS ANNIVERSARY

By Robert Cyran

Fannie Mae and Freddie Mac shouldn't be allowed to languish in Uncle Sam's arms. But as the anniversary of their seizure by the government approaches, the $5.4 trillion mortgage giants remain the biggest black holes in the financial firmament. Lawmakers seem content to allow the two companies to slowly expand. That's a shame – forcing them to wind down their portfolios of mortgage-backed securities (MBS) would be a good first step toward eventually deflating them.

The headquarters of mortgage lender Fannie Mae is pictured in Washington, September 8, 2008. REUTERS/Jason Reed

The Obama administration won't release its recommendations for the companies until February. This gives it time to wage battles in areas ranging from climate change to healthcare. These issues are already drawing heavily on the president's political capital.

That may leave little appetite to tackle the government sponsored enterprises (GSEs), especially given their popularity among some lawmakers and their increasingly dominant role in the mortgage market. The United States has already committed up to $400 billion to cover the firms' losses, providing enough of a cushion to tempt politicians to let the issue slide.

The problem arises from the companies' dual roles. They have a public policy mandate to boost lending to the housing market. And they are supposed to reward shareholders. The conflict between these two goals caused the companies to nearly collapse.

The GSE's principal business of guaranteeing mortgages caused economic distortions that helped fuel the housing boom. As private mortgage lenders pulled in their horns, the GSEs' share of the market grew from under 50 percent to around 80 percent by the end of last year, despite the fact that their aggregate portfolios have only increased by about 3 percent since their conservatorship.

Their success is the sticking point. Society benefits from the efficiency and lower costs derived from the standardization of mortgage pools, which allows them to be easily securitized. The GSEs scale this advantage up significantly. Fannie alone has $2.8 trillion of guarantees on MBS.

On the other hand, the guarantees have unintended consequences. Since investors always reckoned the government stood behind the GSEs, mortgage rates fell below appropriate risk-adjusted market rates. This acted as a subsidy for home buyers at the expense of other taxpayers and contributed to the housing bubble.

Solving this problem without throwing the mortgage market into disarray will be difficult. Winding the GSEs down, or splitting them into smaller firms without government backing would get rid of the subsidy, but could reduce the benefits they brings to the MBS market. In any case, this would be a difficult sell politically due to the firms' dominant positions. Fannie guaranteed more than half the mortgages for new single-family homes in the second quarter.

Policymakers aren't helpless. They can initially target the GSEs' portfolios of MBS. Fannie alone holds more than $800 billion-worth. The figure has grown at an annualized rate of 6 percent in the year to date.

The MBS holdings are an arbitrage that benefited the GSEs' shareholders at the expense of taxpayers. Their quasi-governmental status means they could borrow more cheaply than others and plow the money into higher-yielding MBS. The resulting profits went to shareholders.

Moreover, the GSEs successfully lobbied to be able to hold low levels of capital against their investments, boosting returns. This also gave them little margin for error. Since the government now runs the show, there's little reason these holdings can't be wound down, although this would have to be done gradually.

True, the GSEs can act as mortgage buyers of last resort during crises, when

the mortgage markets would otherwise seize. Yet Fannie didn't significantly shrink its portfolio of MBS during the easy money years between 2002 and mid-2007. Also, their purchases – as distinct from their guarantees – during this period probably didn't have much of an effect on mortgage rates, since they represented a relatively small part of the overall market.

Moreover, when housing markets crashed, the direct mortgage portfolios left Fannie and Freddie saddled with avoidable losses. These are now taxpayer's problem. A quick way to avoid exacerbating this privatization of gains and socialization of losses would be to ban the GSEs from buying more MBS and force them to run off their portfolios. Then the government can turn to the more nettlesome issue of their guarantees.

August 31, 2009

HOUSE BOUND

By Agnes T. Crane

Mortgages should be made less attractive. That's one lesson of the recent housing bubble and bust. As long as borrowing seems like the easy road to riches, people will do too much of it. But right now in the United States, the tax code encourages many people to take out big mortgages. That's why it's a good idea to put the elimination of the tax deductibility of mortgage interest on the political agenda.

American homeowners can for tax purposes deduct the interest on mortgages of up to $1 million. It's been a politically popular arrangement, and the lure of paying a bit less to the government has been an incentive to stretch housing budgets up to, or past, the limit. Even extra cash borrowed under home equity loans can share in the tax largesse, whether or not the funds go into home improvement.

Take a married couple spending $400,000 on their home, a bit more than twice the $164,700 median price reported by the National Association of Realtors. The mortgage interest deduction, plus the deduction of property tax, is worth well over $20,000 a year, based on a 20 percent down payment, a 6 percent interest rate, and a 1 percent property tax. That's an alternative to the $11,400 standard deduction the couple would otherwise be entitled to – but at a 28 percent tax rate, it would still reduce their annual taxes by some $3,000.

And the more the couple borrows, the more they save. A $900,000 home could reduce their taxes by nearly $13,000, assuming a 33 percent tax rate on income.
But not everyone benefits from the mortgage interest tax perk. The gross tax deduction for a married couple in the NAR's median home would come to a bit

more than $9,000, not enough on its own to make it worthwhile to forgo the standard deduction, which is available to every taxpayer.

The high income needed to take advantage of this tax benefit undercuts the claims of supporters that tax deductibility of mortgage interest promotes home ownership, which almost all Americans seen to assume is a good thing. In fact, it is a distortion in favor of those who need the least help.

The tax logic also encourages families to borrow rather than save. When the U.S. personal savings rate is a paltry 3 percent and policymakers are wringing their hands about entrenched global imbalances, this is the wrong message to send. Moreover, potential investment is skewed toward housing rather than, say, infrastructure, manufacturing and education.

Economists have been pointing out these distortions for years, but for politicians advocating the elimination of this deduction is seen as suicidal. One problem is that an immediate elimination would probably pull down house prices – the last thing the already weak U.S. housing market needs.

The danger comes from the lower purchasing power that higher taxes would bring. For the couple who used to be able to afford a $400,000 home, the maximum purchase price would fall by 11 percent. The $900,000 home would have to drop about 21 percent in value to offset its owners' higher tax payments. That sounds like an invitation to open another chapter of the financial crisis.

But even such a big change in tax policy could be phased in slowly enough to avoid disaster. Britain removed the tax advantages of home ownership over 12 years. In the 1990s, the mortgage tax relief rate gradually fell from 25 percent to 10 percent before it disappeared completely in 2000.

The British experience teaches another lesson besides the feasibility of implementing a fairer approach to housing tax. Mortgage tax relief ended just as a huge housing bubble began. Far from slumping, the median UK house price rose by 145 percent between 2000 and the peak in 2007, according to the Halifax bank.

Higher taxes for mortgage borrowers would not prevent excesses in the U.S. housing market either. They would need to be complemented by careful controls on lending. But it would be a step in a good direction. As U.S. policymakers consider how to reshape this troubled sector of the economy – and the need to raise taxes to shrink an enormous deficit – getting rid of a poorly designed tax incentive is good place to start.

March 23, 2010

IT'S A LOUSY LIFE

By Martin Hutchinson and Richard Beales

It's close to an article of faith that Uncle Sam's guarantee is needed to ensure broad mortgage availability in America. But today's system absolves lenders of responsibility, while the UK example shows the private sector can do the job.

Our colleague James Pethokoukis writes that Wall Street is touting the idea of the government getting even deeper into the mortgage market. That comes as Fannie Mae and Freddie Mac are already massive drains on taxpayers' funds. It's also a recurring theme of comments on the future of the two government-sponsored enterprises (GSEs) submitted to the U.S. Treasury that government support, currently provided through the GSEs, Ginnie Mae and other agencies, is critical. Wells Fargo, for instance, wrote that a guarantee was "desirable and necessary ... both now and in the future."

The old-style U.S. model of local direct mortgage lending - what might be called the Jimmy Stewart model, after the star of Frank Capra's 1946 movie "It's a Wonderful Life" - did suffer from financing shortages when high housing demand overwhelmed the local savings pool. The creation of the GSEs helped develop a more liquid, national mortgage market. But other changes, including the ending in 1994 of interstate banking restrictions and the potential availability of additional financing channels, make the recurrence of such shortages less likely even without government involvement.

Meanwhile, Fannie and Freddie's guarantees helped start the bank habit of securitizing and trading mortgages rather than holding them to maturity, distancing the initial lenders from the credit risk and sowing the seeds of the lax lending that fueled the recent crisis - though this ultimately proved most damaging in the subprime market where the GSEs didn't operate.

In any event all this, plus the resulting standardization of loans, does not seem to have resulted in lower costs for borrowers. The differential between prime mortgage interest rates and 20-year Treasury yields increased from 1.08 percentage points in the largely pre-securitization period between 1972 and 1978 to 1.22 points in the mortgage bubble years of 2000-06.

International experience, for example in Britain, has also shown government mortgage guarantees to be unnecessary for the development of a liquid and affordable home loan market. True, a U.S. market without guarantees would look significantly different and the transition would have to be made over time to avoid major upheaval. But the goal should be for D.C. to exit the mainstream home loan business - not look for new ways into it.

August 4, 2010

ANOTHER FREE LUNCH

By James Pethokoukis

is it time for another "free" lunch? One Wall Street idea to boost U.S. growth is for the government to loosen rules so millions more Americans can refinance mortgages, thereby freeing up cash for spending. A desperate Washington might be tempted, but should think twice. It's too reminiscent of how the economy first fell into trouble.

A top Morgan Stanley economist ran the "slam dunk stimulus" plan past the Senate Budget Committee on Tuesday. With the political mood making it almost impossible to contemplate spending more taxpayer money to juice demand, the bank's economists are suggesting a different route to a stimulus - namely having government-run mortgage lenders loosen the refinancing rules on 37 million mortgages they currently guarantee. That would open the door to many homeowners who haven't been able to take advantage of the current low interest rates because they owe more than their homes are worth, are unemployed or have low credit scores.

The logic is that with the government already on the hook for these loans, there's nothing to lose from dispensing with any creditworthiness criteria for refinancing. The median interest rate on the mortgages concerned is 5.75 percent. These loans, the thinking goes, could be refinanced to around 4.5 percent. The 125 basis-point reduction would leave a borrower with a typical $200,000 mortgage better off to the tune of $2,500 a year. If, as Morgan Stanley guesstimates, half the affected homeowners took advantage of this, they would collectively have an extra $46 billion a year burning a hole in their pockets.

One problem is that the government has already tried to streamline the refinancing process with little success. Another is figuring out who would pay any associated fees. But most importantly, the whole idea seems like a deliberate re-creation of the super-cheap credit and lax lending standards that led to the financial crisis in the first place. That's counter to the White House message that America needs a "new foundation" built on fiscal prudence.

Then again, the approach of elections in November means Washington is filled with jittery politicians who might latch onto a "hair of the dog" fix for a sluggish economy. Better they push themselves away from the bar.

August 4, 2010

FEEDBACK LOOP

By Antony Currie

Washington faces a mortgage market conundrum. A conference on Tuesday hosted by the U.S. Treasury is supposed, finally, to start addressing what to do with Fannie Mae and Freddie Mac. But the bunch of fixes proposed by regulators and lawmakers in attempts to make private home loans safer is causing other problems.

Assuming the eventual goal is to sharply reduce the role of government agencies in mortgage finance, then there's a matching need to increase private sector funding for mortgages. The most obvious difficulty is crowding out by the subsidized agencies. But there are other structural barriers to private lending, too.

The most glaring case of crowding-out is in so-called jumbo mortgages, where borrowers may meet all other criteria to conform with Fannie and Freddie standards except that the loan they want is too large. Until the crisis, the maximum loan the GSEs could guarantee was $417,000 for single family properties; now it's $730,000. Neither banks nor asset-backed investors - both of which increasingly want to hold loans of this kind - can compete with the lower funding costs the government agencies enjoy.

Another example is the subprime market. The Federal Housing Administration has made it almost impossible for banks to consider jumping back in, however cautiously. The agency made $451 billion in loans last year, accounting for a quarter of all new U.S. mortgages. Not only are its funding costs lower than the private sector's, it is also using methods discredited by the housing crunch, such as taking only minuscule down payments from borrowers. In that regard, its decision last week to increase the minimum equity requirement to 10 percent is encouraging.

If the government loosened its grip on these parts of the market, banks should be able to pick up the slack, especially in jumbos. Bank lending alone, however, would struggle to compensate for any broader moves to shrink Fannie, Freddie and the FHA.

That's because even with the inevitable somewhat higher mortgage interest rates, there's simply not enough room on American banks' books. Over the past decade, lenders' balance sheets have rarely accounted for more than 15 percent of U.S. mortgage financing, according to a report last year from the Federal Reserve Bank of San Francisco.

If banks had held onto all mortgages extended last year rather than selling them on, they would have needed an extra $180 billion in equity capital, assuming a

10 times leverage multiple. And that's one year - to take on the entire $5.8 trillion of mortgages Fannie and Freddie currently own or guarantee, the banking system would need to go in search of $580 billion of fresh ammo.

A demonstrator holds a sign reading "the American dream is over" during a rally outside Wall Street in New York April 4, 2009. REUTERS/Shannon Stapleton

That's where alternative forms of financing come in - including securitization, in which home loans are repackaged and sold to a broad range of private investors. But recent actual and mooted regulatory changes have bred uncertainty. The Federal Deposit Insurance Corp, for example, is still debating the rules on what happens if a lender fails. Securitized assets ought to be protected from a bankruptcy, but early drafts called this into question and have spooked the market.

Another logical-seeming new rule requires that lenders retain risk in their securitizations. As the argument goes, that should keep them more mindful of their lending standards. That's also supposed to be one of the strengths of covered bonds, the primarily European funding tool that creates extra funding capacity for banks while keeping mortgages on their balance sheets. Congress recently passed legislation which should make it easier to establish covered bonds in the United States.

Yet plenty of U.S. lenders, including HSBC, Wachovia and Washington Mutual, kept mortgages on their balance sheets that have since turned horribly sour. Meanwhile, the existence of covered bonds did nothing to prevent housing bubbles inflating and bursting in Spain and the UK.

More worrying, though, is the interplay of U.S. accounting and capital rules. The way these are currently shaping up, lenders will often be forced to hold reserves against the entirety of a securitized package of mortgages despite only retaining, say, a 5 percent slice. That will make securitization expensive and won't increase the amount of capital available to fund mortgages much, if at all.

In short, reforming Fannie and Freddie will be even more of a struggle unless constraints and anomalies affecting the private market are also dealt with. Otherwise, attempts to wean the industry off the agencies could leave mortgage funding scarce.

August 16, 2010

BORROWER BEWARE

By Antony Currie

U.S. mortgage finance needs a new foundation. Sure, fixing up Fannie Mae, Freddie Mac and the private home loan market is crucial -- and remains a work in progress. But the crisis had a third leg: borrowers got ahead of themselves.

In the decade of easy money before the crash homeownership rates shot up to 69 percent by 2004 from an historical and fairly steady average since the 1960s of roughly 64 percent. With around 110 million homes in the United States, simplistically this means the lending boom handed some 5 million properties to people who perhaps should never have owned them. As of June, the rate had dropped back to about 67 percent, implying at least part of the excess has been painfully worked out.

Some of the ways future bubbles could be limited aren't new. First, borrowers should have to make a decent down payment. Back in 2000, only 5 percent of subprime borrowers had no equity in their homes, yet by 2006 -- in a market that had more than tripled in volume -- some 70 percent had mortgages worth at least as much as their real estate.

Second, lenders should concentrate on the borrower's ability to repay the loan rather than on the potential increase in value of the property. Sure, the crash has already imposed some of this discipline on the market. But credit standards will loosen again -- and regulators must be prepared and willing to rein in any recklessness.

One idea is not so obvious: Give lenders recourse to the borrower when a home loan goes sour, not just to the property. That's how Canada does it, for example, and America's neighbor had a much less severe downturn. It's not a panacea, but being on the hook ought to discourage home buyers from borrowing more than they can really afford.

A fourth idea would be to curtail borrowers' ability to refinance. The U.S. market is almost unique in offering 30-year, fixed-rate mortgages that can be refinanced at lower rates at very little cost thanks to the involvement of government agencies like Fannie Mae and Freddie Mac. But the uncertainty and built-in expense discourage private sector mortgage lending.

The last in a handful of possibilities would be to reduce or eliminate the deductibility of mortgage interest for tax purposes. Of course, all these measures would make mortgages harder to get, more expensive, or both. But considering the recent damage caused by blind belief in the dream of home ownership, that might be no bad thing.

August 17, 2010

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ON THE COVER: A foreclosure sign in front of a home at 1456 Albillo Loop in Perris, California, May 2, 2007. REUTERS/Mark Avery

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