Fannie Mae Alchemy

Both Fannie Mae and Freddie Mac lost lots of money last quarter and last year—and we mean *lots.* If they continue losing money at current rates, in fact, they could find themselves below their mandatory capital requirements in another six months or so.

The mortgage giants try to turn losses into gold.

Fannie and Freddie think that the best way to deal with this problem is to allow them to leverage up even further by reducing those same capital requirements. Some on Capitol Hill, notably New York Democrat Chuck Schumer, agree. Like maxed-out consumers who were about to reach their credit limit, Fannie and Freddie already hit up investors for a cool $13.8 billion in additional capital last quarter. But as they continue to lose money, their capital position remains tenuous.

So now, with the help of Senator Schumer and other friends on the Hill, they're trying to get their credit limits raised. Like political alchemists, they want to turn their losses into the gold of more profit-making opportunities. James Lockhart, the regulator responsible for Fannie and Freddie, gave them a bit of relief this week by eliminating caps on the size of their investment portfolios, and their stock prices jumped. Now the pressure is also on Mr. Lockhart to lower their capital requirements, but nothing about their results suggests that Fannie and Freddie need more risk in their lives—or ours.

The two government-sponsored mortgage giants lost $6.1 billion between them in the fourth quarter. In both cases, the lion's share of the reported losses came from losses on derivatives that the companies use to hedge their huge portfolios of mortgage-backed securities, or MBSs. Supposedly, we are to take some comfort from this. The companies contend that these are paper losses and that the price of derivatives can fluctuate from quarter to quarter or year to year. That's true.

But bear in mind why Fan and Fred buy these derivatives in the first place. Each of them has an MBS portfolio worth more than $700 billion on its books. These portfolios are entirely separate from their original mandate, which was to buy mortgages from banks, package them into securities and sell them to investors with a guarantee. Both companies still do this too, of course, and the recent turmoil in the housing market has allowed them to greatly expand their market share in that business. But these days they make more money (on an "operating basis," at least) by holding mortgages or MBSs for their own account, or by buying MBSs on the open market and holding them.

To do that, they borrow. A lot. In fact, almost every dollar they invest in MBSs is a dollar they borrow by issuing bonds. This they can do cheaply because of a market perception that, if loss comes to shove, Uncle Sam will make their creditors whole. The two companies then make money off the spread between their borrowing rates and the interest paid by the mortgage holder or the mortgage-backed security.

To make sure that spread stays positive, and hence profitable, they then purchase interest-rate swaps and other derivatives to hedge their exposure to changes in interest rates. And in the fourth quarter in particular, Fannie and Freddie saw huge declines in the value of those derivatives as interest rates fell. It may be that those losses will never get realized or that the value of the derivatives will recover.

But in the meantime, Fannie and Freddie continue to bleed capital. In the fourth quarter, Freddie raised $6 billion and Fannie $7.8 billion in preferred-stock offerings. And it's a good thing they did, because without that capital last quarter's losses would have put both companies below the minimum capital levels required by their regulator. Fannie's capital base stands $3.9 billion above the minimum, while Freddie has a cushion of $3.5 billion.

That doesn't sound too, too bad, maybe. Except that Freddie is holding $100 billion in subprime asset-backed securities in its portfolio while Fannie has $74 billion or so. It wouldn't take too much in the way of portfolio losses to wipe out those capital cushions. How likely are further write-downs? Well, 21% of Freddie's $100 billion in subprime assets are 60 days delinquent or more, and 40% of those securities on watch for downgrade.

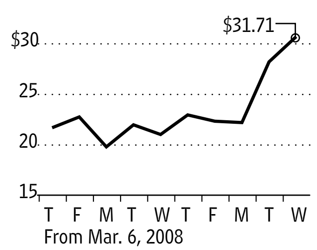
So, what in the world is Congress doing? Mr. Schumer cheered Wednesday when Mr. Lockhart lifted the caps on the companies's portfolios. We guess he thinks that what we really need is *more* taxpayer exposure to the risk of a meltdown at Fan and Fred. Meanwhile, the reform bill passed by the House last year is stalled in the Senate Banking Committee, thanks in part to Democrats like Mr. Schumer. This is the bill that would strengthen the regulator's power to make sure the two giants stay solvent.

What Fannie and Freddie really need is a regulator with the clout to cut up their credit cards before they get into even deeper trouble—and take the rest of us along with them.

A More Honest Socialism

How do you turn $5.9 billion into $200 billion overnight? By magic. Political magic in the case of Fannie Mae and Freddie Mac—due to their status as publicly traded private companies back-stopped by taxpayer guarantees.

Yesterday, Fannie and Freddie announced, alongside their chief regulator Jim Lockhart, that they would be leveraging up their businesses in the name of riding to the rescue of the mortgage-backed securities market. Here's how the wizardry works: Mr. Lockhart, the Director of the Office of Federal Housing Enterprise Oversight, agreed to cut the amount of capital Fannie and Freddie are required to maintain by a combined $5.9 billion and to allow them to increase their leverage to 33-1 from about 30-1. That means Fan and Fred can borrow up to $33 for every dollar in freed-up capital, and presto—the two mortgage giants get $200 billion or so to spend buying up mortgages or mortgage-backed securities.



Fannie Mae 10-day stock price

Source: WSJ Market Data Group

There is a catch. In exchange for this freedom, Fan and Fred have promised to raise "significant" new capital over the next year. We're told it's on the order of $10 billion each. That's the good news. The bad news is that the companies can leverage any new capital right alongside the old, meaning that the total increase in business—and risk—could be well above the $200 billion set by Mr. Lockhart.

Let's put some of these numbers into context. J.P. Morgan Chase is leveraged about 12-1 against its Tier 1 capital base. Investment banks are usually more highly leveraged than commercial banks, and Bear Stearns, formerly the industry leader in this category, was leveraged at 34-1 at the end of 2007. You know how that turned out.

The oddest argument is that Fan and Fred need to be unleashed to help the mortgage market. That's what they were supposed to be doing all along, yet so far in this crisis they have themselves become sources of systemic financial fear. After taking big losses in last year's fourth quarter, investors and counterparties have become nervous that Fan and Fred might face solvency problems similar to those of other mortgage players. Their refinancing "spreads"—the price of their paper—have periodically blown out nearly as far as everybody else's on Wall Street.

This isn't supposed to happen. The two companies are chartered to liquify the mortgage market, especially at the lower-income end. But of course the low end isn't where the money is if you are a publicly traded company whose executives need to enhance shareholder value. Thus in this crisis, Fan and Fred have both so far been hunkering down, often not even buying back their own mortgage-backed paper. What good are quasi-socialists if they won't act like socialists in a capitalist crisis?

Yesterday's capital expansion merely lets the companies continue their double lives as profit-making companies backed by taxpayer guarantees—and to do so by taking even greater risk at a very risky time. No wonder their stock prices are up by more than a third in a week (see nearby). If the politicians really want to double-down on Fan and Fred, the honest way to do it is to provide them the taxpayer money up front.

Here's one idea: How about issuing the companies some subordinated debt, with an option to convert that paper into Fannie and Freddie stock down the road? Fan and Fred would get the money to return to the mortgage markets, but once the crisis ends at least the taxpayers would get some upside from the risk they are taking now.

Yes, this amounts to a form of nationalization, but at least it's honest socialism. As it stands now, Fannie and Freddie get to gear back up, and if they get into deeper trouble because housing prices keep falling, the taxpayers pick up the tab. If the crisis ends, Fan and Fred's private shareholders get all the upside and their executives get even richer than they are. If Washington wants to socialize the housing market—as it seems eager to do—let's do it in the open and put Fannie's debt on the federal budget so taxpayers can see what they're buying.

Of course, the last thing Congress wants is all of this to be transparent. The Members benefit from the current private-public confidence game because the two companies ladle them with campaign contributions to protect their privileged status. That's why Congress continues to dither over reforms that might actually provide a regulator capable of staring down Fan and Fred.

With a couple of brave exceptions (Mr. Lockhart, Alabama Senator Richard Shelby), Fannie and Freddie own Washington. It'd be better for the housing markets and taxpayers if Washington finally admitted it and bought Fannie and Freddie.

The Price of Fannie Mae

As opposed to GM or Ford, most Americans have never heard of Fannie Mae and Freddie Mac. Yet the insolvency of either mortgage giant would have far more profound consequences for every American taxpayer than the bankruptcy of those car companies. It's time Americans understood the price they could soon pay for the Beltway's confidence game with these high-risk "government-sponsored enterprises."

Taxpayers may soon pay for this Beltway-Wall Street creation.

These columns have warned about Fannie and Freddie going back to 2002, and our fate has been to climb a wall of denial and hostility. This week reality began to set in. The duo's share prices tanked nearly 20% on Monday on fears that their capital levels may not be adequate. They rallied on Tuesday as their regulator played cheerleader, but they sank again yesterday to prices in the teens, compared to more than $60 a share last October. Investors are saying that a Bear Stearns-like run on the companies is a real possibility, and they're right.

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What Americans need to know is how damaging such a failure would be. This wouldn't merely be a matter of the Federal Reserve guaranteeing $29 billion in dodgy mortgage paper, a la Bear Stearns. Fannie and Freddie are among the largest financial companies in the world. Their liabilities—mortgage-backed securities (MBSs) and other debt—add up to some $5 trillion.

To put that in perspective, consider that total U.S. federal debt is about $9.5 trillion, compared to a total U.S. GDP of $14 trillion. About $5.3 trillion of that debt is held by the public (in the form of Treasury bonds and the like), while $4.2 trillion is intragovernment debt such as Social Security IOUs. This is the liability side of America's federal balance sheet, and its condition influences how much the government can borrow and at what rates.

The liabilities of Fan and Fred are currently not on this U.S. balance sheet. But one danger is a run on the debt of either company, putting pressure on the Treasury and Federal Reserve to publicly guarantee that debt to prevent a systemic financial collapse. In an instant, what has long been an implicit taxpayer guarantee for both companies would be made *explicit*—committing American taxpayers to honoring as much as $5 trillion in new liabilities. U.S. debt held by the public would more than double, and the national balance sheet would look very ugly.

The companies have a stronger liquidity position than Bear, but investors are saying the chance of a collapse is greater than our politicians want to admit. With its share price decline this week, Fannie Mae's market capitalization is down to $15 billion. Yet at the end of the first quarter, the company had $42.7 billion in capital. Investors are saying that as a business Fannie is worth only slightly more than *one-third* of its capital cushion. Fannie's debt is also priced at the highest spreads over Treasurys since 2000—another sign of eroding confidence.

Freddie's market discount from its capital cushion is even worse. Its shares fell nearly 24% yesterday—to a market cap of some $6.8 billion. Yet its capital, at the end of the first quarter, was $38.3 billion. The message from markets is that both companies are in danger of exhausting their capital and becoming insolvent if home prices keep falling and mortgage losses mount.

Why is there so little Washington or Wall Street alarm about this? Because the politicians and financiers are part of the consensus that has long promoted the growth of Fannie and Freddie. Congress created the companies to spur home ownership and, in return, got an endless stream of campaign contributions and election support. Beltway elites like James Johnson and Jamie Gorelick made tens of millions working there. Wall Street marketed their MBSs to buyers around the world, pitching them as virtually as safe as Treasurys (due to the implicit taxpayer guarantee) but with a higher return. Everybody made a bundle.

The assumption was that the taxpayer guarantee would never have to be honored, just as everyone before the savings and loan debacle thought deposit insurance would rarely have to be paid. But these political bills always come due.

The double irony amid the current credit crunch is that our politicians have been promoting Fannie and Freddie as mortgage saviors even as their risk of insolvency has grown. Chuck Schumer, Chris Dodd and many others have encouraged the duo to take on even greater mortgage risk as the housing slump has unfolded. They're the arsonists posing as firemen while putting more dry tinder around the blaze.

So how do we get out of this mess? The worst option would be to let the situation erode until the Fed and Treasury panic amid market pressure and issue an explicit taxpayer guarantee. The consequences from putting $5 trillion in liabilities on the federal balance sheet would raise America's borrowing costs and jeopardize the Treasury's AAA credit rating. The dollar could face greater selling pressure, especially if the Fed tried to inflate away this greater debt burden. And all without a single Congressional appropriation or public debate.

Hank Paulson's Treasury is now pressing Congress to move quickly to create a new regulator with greater powers—not least to reassure Fannie and Freddie's borrowers. The question is whether this is too little, too late. Congress is refusing to set a statutory limit on their MBSs, though reducing this business and their debt is the only way to limit taxpayer risk. And under pressure from Congress, the regulator recently *eased* the companies' capital requirements.

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Our own proposal, made months ago, is to require a more honest form of socialism by injecting taxpayer money now into both companies (say, in the form of subordinated debt or preferred stock) to recapitalize them enough to weather the current storm. This would help prevent a U.S. balance sheet debacle, and it would force the politicians to acknowledge the mess they have created. Then as the crisis passed, the taxpayers would at least get something for their money, while regulators could work to unwind Fan and Fred's liabilities and shrink these monsters to a less dangerous size.

This would be real "change" in Washington. Instead, the political class continues to promote the status quo illusion that Fannie and Freddie are risk-free purveyors of the American housing dream. It is one of the great political scandals of our age, and it has unfolded in broad daylight. As usual, the American taxpayer will get stuck with the bill.

Paulson's Fannie Test

We're about to find out why Hank Paulson left that lucrative job at Goldman Sachs to be President Bush's last Treasury Secretary. Was it merely to add a fancy title to his obituary, or does he want to leave the U.S. financial system better than he found it? That's his test in the wake of his Sunday commitment to use taxpayer money to rescue Fannie Mae and Freddie Mac.

The best way to protect taxpayers is receivership.

The past week's market turmoil over the mortgage giants has certainly been instructive for most Americans, not least Mr. Paulson. For 18 months, the Treasury Secretary had been told by Fannie, Freddie and their friends on Capitol Hill that the companies were in good shape. He was told that Fannie's critics at the Federal Reserve, in the Senate (Richard Shelby) and in the media (us) were "ideologues" who should be ignored. Ease up on reform, they told him, cut a deal with House Financial Services Chairman Barney Frank to let the companies grow, and they'll help end the mortgage crisis. Mr. Paulson went with the Beltway flow.

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We hope he now realizes he was lied to. More pointedly, on Sunday he was left naked on Pennsylvania Avenue, with no recourse but to disavow his own prior statements about Fan and Fred's good health and to bail them out. Now we'll see if he has the fortitude to stand up to these "government-sponsored enterprises" and protect taxpayers going forward.

The issue isn't whether the government should rescue the companies. Congress made that decision when it created the duo with an implicit taxpayer guarantee. Everybody has long known that, as the owner or guarantor of half of America's mortgages, the companies are too big to fail. The question has been how to manage and regulate these monsters in a way that minimizes risks to the larger financial system and taxpayer. Had Treasury and Congress acted two years ago, or even three or six months, the current panic could have been avoided.

The good news is that the crisis gives Mr. Paulson new political leverage, if he's willing to use it. The companies are straining to raise capital, with their share prices falling yesterday even after the Treasury's commitment to keep them solvent. Thus they are more politically vulnerable than ever. Their main patrons in Congress—Mr. Frank, Chuck Schumer, Christopher Dodd—should also be on the defensive after shilling for the companies for so many years.

Mr. Paulson's Sunday statement at least began to show more leadership. The Treasury Secretary wants Congress to give the government more power to rein in the companies, including with a preferred stock capital injection if required. This is progress, but it's not aggressive enough given the risks. He could make more progress more rapidly toward a safer financial system by putting the companies into federal receivership. If current law doesn't give Treasury that power—and we hear conflicting legal claims—Mr. Paulson should seek it from Congress.

The Secretary could then appoint a prominent financial figure with bipartisan credibility as a receivership czar, with a mission to protect taxpayer interests. A czar would have the power to replace Fan and Fred's management and directors, as well as give priority to taxpayers above the current private shareholders if the government does inject capital.

It's true that this might well require a larger up-front taxpayer contribution. But after Sunday, the taxpayers know they are on the hook for big losses in any case. Putting the companies in federal receivership would insulate them from a political class that has shown itself unable or unwilling to control their risks. Without such a move, the companies could easily use the taxpayer cash as protection in the short run, emerging both larger and more dangerous. Mr. Paulson will have been stripped naked twice.

Receivership doesn't mean the companies will fold up overnight. They continue to hold trillions of dollars in mortgage assets, and they would continue to buy and package mortgages. But as a first priority, a receiver would be able to rein in their portfolios of mortgage-backed securities (about $1.5 trillion now) that are a major source of their risk. Down the road, as the mortgage crisis eases, the receiver could decide whether to wind the companies down, sell them in parts to the private sector, or let them continue in far more restricted form.

Keep in mind that these semi-socialist giants (private profit, public risk) were founded in an era when mortgages were sold and held by the same lender. The idea was that Fannie and Freddie, by buying and packaging those loans, could supply more liquidity to the mortgage market. Whether or not that taxpayer risk was worth it at the time, it clearly isn't now that the bill is coming due and private companies can do the same thing.

The receivership option would also help Mr. Paulson get out ahead of the many other looming financial problems. IndyMac Bank's failure (see below) is only the first of many more failures to come, and Treasury is going to have its hands full. The airline and car companies may follow. Putting Fan and Fred in firmer hands now will reassure investors that at least one risk is being well managed, reducing public fear that the government is overwhelmed.

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Fannie's friends on Capitol Hill and Wall Street will call receivership draconian and unnecessary, and they'll fight it ferociously behind the scenes. But Mr. Paulson now occupies the higher political ground as defender of the taxpayer. Some of us have been saying for six years that Fannie and Freddie posed a systemic financial threat, while most of Congress told everyone not to worry. Mr. Paulson should keep in mind who told him the truth, and who didn't.

REVIEW & OUTLOOK

Whitewashing Fannie Mae

Henry Waxman's House Committee on Oversight and Government Reform met Tuesday to examine "The Role of Fannie Mae and Freddie Mac in the Financial Crisis." Alas, Mr. Waxman didn't come to bury Fan and Fred, but to bury the truth.

Congress begins its self-absolution campaign.

The two government-sponsored mortgage giants have long maintained they were merely unwitting victims of a financial act of God. That is, while the rest of the market went crazy over subprime and "liar" loans, Fan and Fred claimed to be the grownups of the mortgage market. There they were, the fable goes, quietly underwriting their 80% fixed-rate 30-year mortgages when—Ka-Pow!—they were blindsided by the greedy excesses of the subprime lenders who lacked their scruples.

But previously undisclosed internal documents that are now in Mr. Waxman's possession and that we've seen tell a different story. Memos and emails at the highest levels of Fannie and Freddie management in 2004 and 2005 paint a picture of two companies that saw their market share eroded by such products as option-ARMs and interest-only mortgages. The two companies were prepared to walk ever further out on the risk curve to maintain their market position.

The companies understood the risks they were running. But squeezed between the need to meet affordable-housing goals set by HUD and the desire to sustain their growth and profits, they took the leap anyway. As a result, by the middle of this year, the two companies were responsible for some $1.6 trillion worth of subprime credit of one form or another. The answer to Mr. Waxman's question about their role in the crisis, in other words, is that they were central players, if not the central players, in the creation of the housing boom and the credit bust. Mr. Waxman released some of these documents Tuesday but kept others under wraps.

In early 2004, Freddie's executive team was engaged in a heated debate over whether to start acquiring "stated income, stated assets" mortgages. And in April of that year, David Andrukonis, the head of risk management, wrote to his colleagues, "This is not an affordable product, as I understand it, but a product necessary to recapture [market] share. . . . In 1990 we called this product 'dangerous' and eliminated it from the marketplace." Freddie went ahead anyway.

At Tuesday's hearing, both Mr. Waxman and former Fannie CEO Franklin Raines argued that Fan and Fred were following the market, not leading it, as if this was exculpatory. The documents plainly show that people at both Fan and Fred clearly understood that these mortgages were risky, thought many homeowners didn't understand them and that they were putting their business at risk by buying up Alt-A and subprime mortgage-backed securities.

One Fannie Mae document from March 2005 notes dryly, "Although we invest almost exclusively in AAA-rated securities, there is a concern that the rating agencies may not be properly assessing the risk in these securities." But they bought them anyway, both to maintain their market share and to show people like Democrat Barney Frank that they were promoting affordable housing.

By April 2008, according to a document prepared for then-Fannie Mae CEO Daniel Mudd and marked "Confidential—Highly Restricted," Fannie's $312 billion in Alt-A mortgages represented "12% of single-family credit exposure." This book of business, the document notes, "was originated to maintain relevance in market with customers—main originators were Countrywide, Lehman, Indymac, Washington Mutual, Amtrust." The first four need no introduction; regulators ordered Ohio-based Amtrust to stop lending two weeks ago.

Remember that one of Fannie's roles was supposed to be to buy up mortgage-backed securities in the secondary market and keep that market "liquid." This was, they always argued, the rationale for their $1 trillion-plus MBS portfolios. By becoming buyers of private-label subprime and Alt-A-backed MBS, they did just that—they liquified and helped legitimize products that they now claim others irresponsibly sold.

Mr. Raines even suggested that Fan and Fred's regulator was to blame for allowing them to get into trouble. "It is remarkable," he told the committee, "that during the period that Fannie Mae substantially increased its exposure to credit risk its regulator made no visible effort to enforce any limits."

What Mr. Raines failed to mention was that, all along, Fannie and Freddie were spending millions on lobbying to ensure that regulators did not get in their way. As the AP reported Sunday night, Freddie spent $11.7 million in lobbying in 2006 alone, with Newt Gingrich, for example, getting $300,000 that year for talking up the benefits of Freddie's business model. (Apologies welcome, Newt.)

Other Republicans on Freddie's payroll included former Senator Al D'Amato and Congressman Vin Weber, and then House Majority Leader Tom DeLay's former chief of staff, Susan Hirschmann. As we know by now, Fan and Fred tried to buy everybody in town from both political parties, and the companies did it well enough to make themselves immune from regulatory scrutiny.

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Mr. Waxman calls it a "myth" that Fannie and Freddie were the originators of the crisis. That's a red herring. Mr. Waxman's documents prove beyond doubt that Fan and Fred turbocharged the housing mania with a taxpayer-backed, Congressionally protected business model that has cost America dearly.