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Hillary Clinton Advisers' Mortgage Plan Would Tap Investors for Billions

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A closely watched proposal to replace Fannie Mae and Freddie Mac would require raising more than $100 billion from private investors, according to its authors who include advisers to Hillary Clinton.

Left unstated is how to deal with current shareholders, who include hedge funds and money managers who are locked in a bitter legal battle with the government over profits generated by the mortgage-finance giants.

At issue is a paper that advises Congress to wind down Fannie Mae and Freddie Mac and replace them with a government-owned company dubbed the National Mortgage Reinsurance Corporation. While the authors first proposed the new company in March, they provided details Tuesday on how it would be governed and capitalized.

Notably, NMRC would create a new class of securities paying a fixed dividend to erect a buffer against possible downturns. As the company ramped up, the securities would build capital amounting to 2.5 percent of the company's guarantees — or about $125 billion, assuming that the firm backed about $5 trillion of mortgages.

The proposal could be a starting point for housing-finance reform if presumptive Democratic nominee Clinton is elected president. Two of the papers' authors, former White House officials Gene Sperling and Jim Parrott, have advised her campaign on housing policy.

"We wanted to take part of a system that works and put it on a foundation that's sustainable," Parrott, who has no formal ties to the Clinton campaign and is a former top housing adviser in the Obama White House and current consultant for financial firms, said in an interview.

Fannie Mae and Freddie Mac don't make mortgages. They buy them from lenders, wrap them into securities and provide guarantees to investors in case of default. That process is the backbone of America's mortgage market, making some wary of replacing it with an untested system.

Eight years after the financial crisis, the companies' fate is still undecided and likely to be passed from President Barack Obama to the next administration. The government took them over in 2008, eventually providing a $187.5 billion bailout.

Investor Lawsuits

Since then, Fannie Mae and Freddie Mac have become profitable, but the current terms of their bailout require them to send nearly all earnings to the U.S. Treasury. The companies rely almost wholly on about $258 billion in remaining credit from Treasury in case of losses.

Investors including the Fairholme Funds and Perry Capital LLC have sued over the 2012 decision to sweep Fannie Mae and Freddie Mac profits to the government. The NMRC proposal doesn't address what should happen to current shareholders. A federal appeals court in Washington is expected to issue a ruling on the investor lawsuit later this year.

In addition to Sperling and Parrott, other authors of the paper include Lewis Ranieri, who co-invented the mortgage-backed security, Moody's Analytics chief economist Mark Zandi and Barry Zigas, who is director of housing policy at the Consumer Federation of America.

Their idea to raise money from investors hinges on issuing fixed-dividend securities that would only pay out when the company makes a profit. Private shareholders also would be represented on NMRC's board, a move that the authors say would discourage the company from taking excessive risk.

Government Inefficiencies

The governance structure, which is meant to mirror that of a private company, will prevent the NMRC from being bogged down by inefficiencies that plague government agencies, Parrott said.

The arrangement could be met with skepticism from Fannie Mae and Freddie Mac investors as some shareholders have said that if the profit sweep stands, it would be more difficult to raise private capital for a future system.

"If the government's allowed to take 100 percent of the profits forever, no one's going to put a dollar of capital in a rescue situation and it's going to cause people a real question whether they're willing to put a dollar of capital into any financial institution," Pershing Square Capital Management Founder William Ackman said last year during an event at Columbia University.

In addition to the new fixed-dividend securities, the NMRC would lay off most of the risk of mortgage defaults to private investors. A separate "mortgage insurance fund" first held at Treasury and later transferred to the NMRC would provide a final cushion, bringing the total capital standing in front of taxpayers to 8.5 percent. The authors say a buffer that size could withstand a housing downturn almost twice as severe as the last one.

'Nothing Changed'

A potential hurdle to the NMRC proposal gaining traction in Congress is that Republicans may oppose a plan that still leaves taxpayers backing mortgages.

"My biggest knock on it is that you haven't actually changed all that much," said Mark Calabria, director of financial regulation studies at the libertarian Cato Institute. "They've come up with a slightly different version of the status quo."