Lawmakers wary of Fannie and Freddie reform

By Suzanne Kapner in New York

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As President Barack Obama signed sweeping financial reform legislation into law on Wednesday, one important area in dire need of an overhaul has been largely ignored by lawmakers.

The way that Americans finance the purchase of homes is in such disarray that **Fannie Mae** and **Freddie Mac**, the two large government-sponsored mortgage finance companies, are expected to end up costing taxpayers more than the bail-out of banks and motor companies combined. Fixing the companies is becoming a priority among lawmakers and administration officials as losses pile up. Fannie and Freddie have absorbed $145bn (€113bn, £95bn) of taxpayer aid so far, and the final tally is expected to be far higher.

The new financial reform legislation requires the administration to submit proposals for overhauling Fannie and Freddie no later than early January. Barney Frank, chairman of the House financial services committee, has said he plans to start tackling the issue in earnest when Congress returns from its August recess. Comments from the public on how to fix the system were due to be submitted to the Treasury on Wednesday.

“It’s amazing that we passed financial reform legislation and still have this big, glaring hole,” said Fred Cannon, co-director of research for Keefe, Bruyette & Woods, an investment bank that is urging the Treasury to take action. “The real question is: are the GSEs some kind of third rail of the financial industry that Congress is afraid to touch?” Mr Cannon said.

Lawmakers have good reason to tread slowly. With the Federal Housing Administration, Fannie and Freddie are propping up the fragile housing market by guaranteeing nine out of 10 new loans. Their portfolios include guarantees for $5,000bn in mortgages, or about half of the $10,000bn in home loans outstanding. The administration has said it does not want to rush to overhaul the system until the housing market is on a stronger footing.

The so-called government-sponsored enterprises have been widely criticised by politicians in both parties for a hybrid structure that allowed them to operate as private companies with debt that was implicitly guaranteed by the federal government, a framework that potentially encouraged them to take unnecessary risks. Both companies were seized by the government in 2008 and their publicly traded shares have since been delisted from the New York Stock Exchange.

Republicans have advocated breaking up Fannie and Freddie and privatising them fully, a strategy the administration appears to be resisting. Tim Geithner, Treasury secretary, told the House of Representatives’ financial services committee in March: “There is a quite strong economic case, quite a strong public policy case, for preserving some form of guarantee by the government to facilitate a stable housing market.” However, Mr Geithner and other administration officials seem to be in favour of separating that government support from private interests.

One way to do that, according to Keefe, Bruyette & Woods, would be to carve the government-sponsored enterprises into “old” and “new” entities. The “old” entities would continue to hold the money-losing mortgages that would run off over time. The “new” entities would operate as co-operatives of bank mortgage lenders, similar to the 12 regional Federal Home Loan Banks. These lenders would put their own capital at risk.

In a letter to the Treasury, John Duffy, KBW’s chief executive, stopped short of calling for a full privatisation, saying that such a solution was not a “viable option”.

Another issue is the extent to which the government should support home ownership. Critics have argued that an over-emphasis on home ownership by the Clinton and Bush administrations helped create the housing bubble by encouraging people to buy homes they could not afford. Now some housing experts say the pendulum needs to swing back in the other direction.

“The emphasis needs to be on other forms of affordable housing, such as rentals,” said David Minn, associate director for financial markets policy at the Center for American Progress, a left-leaning think-tank.

Much of the coming debate will depend on which party controls Congress after the November elections. Even if the Democrats retain control, they will need to be careful in how they frame the conversation. “Frannie and Freddie is a loser issue for Democrats,” said Mark Calabria, a director of financial regulation studies at the Cato Institute, a libertarian think-tank. “They need to make the debate more about the overall future of our mortgage finance system, including the FHA and the Federal Home Loan Banks.”

Like Fannie and Freddie, the Federal Home Loan Banks, known as “flubs,” are considered government-sponsored entities because their loans are implicitly guaranteed by the US Treasury. Although some lost money on mortgage-backed securities, as a group they remained profitable and continued lending at a time when other credit sources were scarce.

FHLB officials have been lobbying Treasury to preserve their status quo.