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A Plan to Alter Fannie, Freddie

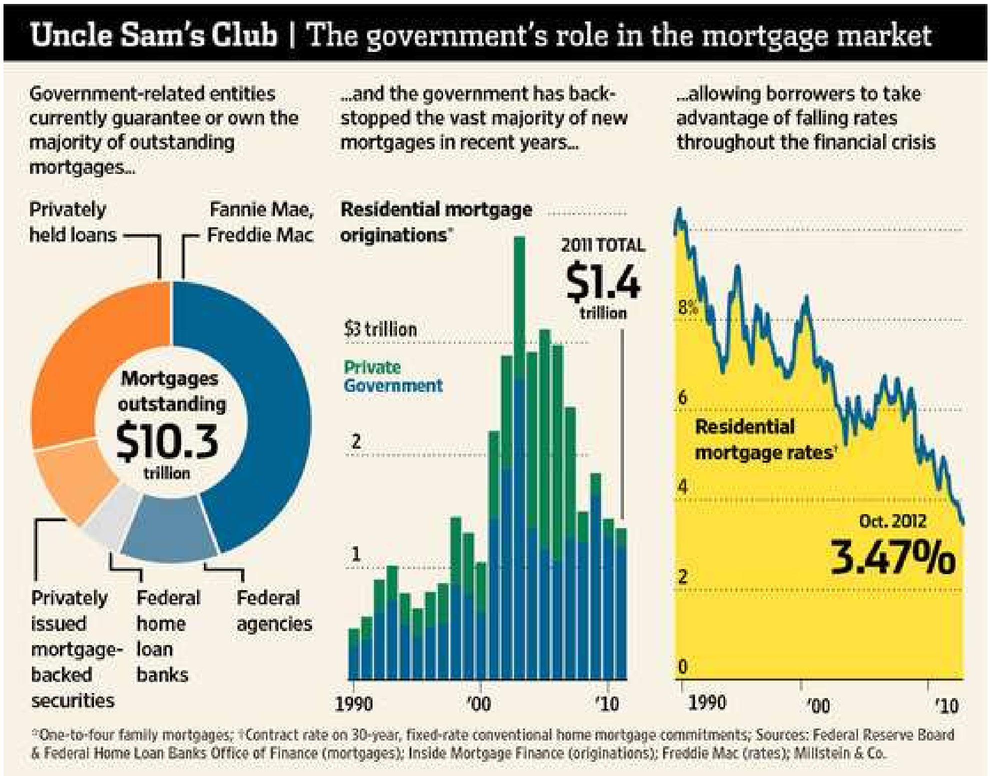
By NICK TIMIRAOS - October 21, 2012

As the housing market awakens, policy makers will have to decide what to do with Fannie Mae and Freddie Mac. In the past four years, the firms, together with federal agencies, have backed about nine in 10 new loans. Without them, many of today's home sales and refinances wouldn't have happened.

Conventional wisdom in Washington says the mortgage giants, which effectively were nationalized in 2008 to keep credit flowing, should be wound down. But neither the White House nor Congress has proposed a serious plan for what should take their place or how to recoup the $142 billion taxpayers have put into the two companies.

In the meantime, talent has streamed out of both firms, and long-term systems upgrades have been deferred. What remains is an indefinite, government-run conservatorship of two companies with $5 trillion in liabilities.

"It's been in a holding pattern and that's ultimately death to a business," says Jim Millstein, the corporate restructurer who oversaw the Treasury Department's recapitalization and sale of American International Group Inc.



Mr. Millstein, who left the government last year to start his own company, is circulating a plan that he says can do for Fannie, Freddie and its government owner what the Treasury did for AIG: recoup the taxpayer's investment while using Fannie and Freddie to create a competitive mortgage market.

His proposal has three main steps:

First, restructure the firms. Hive off and ultimately liquidate their investment portfolios, which capitalized on the lower cost of the companies' funding conferred by their government ties. That would leave their core business: guaranteeing investors against default on mortgages that the firms bundle into securities.

Next, strip the companies of their government guarantee and special charters. The U.S. would instead explicitly guarantee the mortgage-backed securities issued by the firms, much the way the Federal Deposit Insurance Corp. insures bank deposits. Fannie and Freddie would pay a fee for the insurance and hold more capital, with both serving as a buffer against taxpayer losses before the government guarantee would ever be called upon.

A new regulator would determine which mortgages would be eligible for inclusion in these government-guaranteed securities. It also would approve charters to any newcomers, such as banks or insurance companies, that want to compete with Fannie and Freddie.

Finally, recapitalize Fannie and Freddie by allowing them to keep their profits, rather than having them swept away by the Treasury as repayment for the government's bailout. The companies would gradually raise the fees they charge to lenders to build capital reserves.

Within a few years, Mr. Millstein predicts, the firms would have enough capital for the government to begin selling stock in the companies back to private shareholders—and eventually repay all taxpayer funds.

Reconfiguring Fannie and Freddie is a hard sell, particularly among critics who say the companies' past practices are among the reasons why they should be wound down. For years, Fannie and Freddie enlisted lobbyists to duck tougher regulation and higher capital standards. Spinning the companies back into public markets also would renew the conflict between providing returns to shareholders and stability to financial markets. Some say that tension contributed to bad management decisions in the run-up to the firms' collapse.

"In order to recapitalize them, you'd have to keep them large or grow their business," says Andrew Davidson, a mortgage-industry consultant.

Not everyone is convinced that government loan guarantees outweigh potential costs. If federal insurance is underpriced, "taxpayers eventually may foot the bill again," said Edward DeMarco, acting director of Fannie and Freddie's federal regulator, in congressional testimony two years ago.

Politicians might also direct the firms to ease credit rules once memories of the recent crisis have faded. "There will always be a political push to lower standards," says Mark Calabria, director of financial-regulation studies at the Cato Institute.

Political firewalls could help reduce such interference. If loan guarantees are explicit and on the government's books, for example, any changes to credit standards or pricing would require Washington to pay for them upfront.

Any overhaul would have to take into account how today's mortgage market works.

The U.S. hasn't had a truly private mortgage market since before the Great Depression. For at least the past two decades, Fannie, Freddie and federal agencies have backed more than half of all mortgage originations in any year, with the exception of 2004-06—the peak of the housing bubble.

"Even if your eventual goal is to have no [government] guarantee you first have to make explicit that there is a guarantee today, and then shrink it," says Phillip Swagel, a Treasury economist in the Bush administration who supports Mr. Millstein's proposal.

Banks don't hold on to most mortgages they make and haven't for decades. Unless banks enlarge their balance sheets, securitization is likely to remain a key source of funding loans. Fannie and Freddie, meanwhile, developed deep, liquid markets that function much like a national electricity grid for buying and selling mortgage-backed securities.

Their loan-guarantee business attracts capital from pension funds, sovereign-wealth funds and central banks that wouldn't otherwise invest in American mortgages. That market functioned throughout the financial crisis solely due to effective government backing.

Private capital to fund mortgages—even at today's more conservative lending standards—remains scarce. Banks have reduced their holdings due both to losses suffered during the bust and to meet new capital standards. Private mortgage insurers are weak, buried under bad loans from the boom years. And the market for "private label" mortgage-backed securities, or those issued without a government guarantee, dried up in 2007. Only the safest loans are being securitized today.

Mechanically reducing the government's guarantee to lure back private capital is a "very risky assumption" in the current climate, says Mr. Millstein. "And this is too important a market to engage in wishful thinking."

Most Americans count their home as their largest asset. Policy makers looking to revamp how home sales are financed will have to tread carefully.