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## Fixing Fannie and Freddie

### A “Buy-in” for Taxpayers rather than “Bail-out” for Shareholders

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To understand the dilemma and respond to the crisis posed by the erosion in market confidence in Fannie Mae and Freddie Mac requires an understanding of their unique histories.

Briefly, both institutions began as government entities to provide a deeper secondary market for home mortgages. Congress eventually allowed each to become privatized with implicit and explicit market privileges enabling them to become federally licensed duopolies owning or guaranteeing approximately half the mortgages made in the United States.

The privileges granted these two Government Sponsored Enterprises (GSEs) are extraordinary, ranging from a right not to pay state income taxes, to less rigorous regulatory oversight than that imposed on purely private sector competitors, to a Treasury extension of a \$2.25 billion line of credit. This line of credit, while modest in relation to current liabilities, is designed to imply that the full faith and credit of the United States stands behind institutional assets, thereby allowing each to borrow from the public at near Treasury rates.

The legislated perks granted Fannie Mae and Freddie Mac are of a multi-billion dollar yearly magnitude and the regulatory advantages they enjoy magnify the capacity of each to grow. It is no accident that no commercial companies in the past generation have had as muscular a lobbying operation on Capitol Hill. When, for instance, I once introduced a battery of constraining amendments, including a doubling of capital requirements, to legislation favorable to Fannie and Freddie, it took each less than 48 hours to orchestrate both parties' leadership to weigh in against trimming their wings of privilege.

It therefore came as no surprise after a steamroll of the committee of jurisdiction that Congress dismissed Don Quixote-like observations I made on the House floor. With few dissenting votes, it acquiesced to Fannie and Freddie and established a regulatory regime which called for inadequate capital ratios and unprecedented constraints on the regulators rather than the regulated. The effect of this 1992 lobbying blitz was an eight-fold growth in mortgages owned by these two GSEs in less than two decades. Heavily leveraged growth transformed both from principally being secondary market actors facilitating tertiary markets to the dominant owners of American mortgage products, increasingly competing with rather than servicing local financial institutions.

At issue today is the financial viability of these two uniquely chartered institutions which have privatized profit and socialized risk. The combined regulatory capital of both is defined to be in the \$90 billion range although GAAP shareholder equity is substantially less and traditional book value an even sparser fraction of regulatory capital. However one defines capital, it has been leveraged with borrowings to allow these two GSEs to hold in their own portfolios over \$1.5 trillion in home mortgages and to package and

market approximately \$3.7 trillion in additional home loans with guarantees of payment streams to investors.

In good times it is doubtful that a \$90 billion regulatory capital cushion is adequate to backstop this magnitude of investments. In bad times it is woefully inadequate. And given the decline in home values over the past several years and the sluggishness of the American economy today, the public has become apprehensive that liabilities relative to assets of all mortgage holders are growing rapidly. In the case of Fannie and Freddie, even when factoring in the \$2.25 billion line of credit with the Treasury, a 2% loss on \$5.2 trillion in held and guaranteed loans would exceed the regulatory capital available to both institutions. Hence a concern for financial strength has led to more than an 80% plummet in their stock values from market peaks reached several years ago and calls for government intervention.

While established as American institutions serving American home owners, the fate of these two financial behemoths has international implications because over a trillion dollars of their packaged mortgage products are held abroad. If either institution were to fail, the remarkable American secondary market in many kinds of financial products would come into disrepute and mortgage rates would substantially increase in the U.S. Cascading failures of financial institutions could be precipitated, as could recessionary pressures at home and abroad.

The American public has become increasingly aware that the judgment surrounding the decision to go to war in Iraq has tarnished the American brand in the eyes of many around the world. Yet at the same time our political maturity has been widely critiqued, our financial system maintained an envious position of respect. Now with problems becoming increasingly evident at some of our larger institutions from Bear Sterns to Fannie Mae and Freddie Mac, the twin pillars of our society – our politics and our finance – are coming into question. This is one of the reasons Congress has little credible choice except to back the Treasury's call to act swiftly and powerfully. But it is an insufficient reason to accept the exclusive parameters of the Treasury's proposed methodology.

What is missing is comprehensive regulatory reform and any management or shareholder accountability. In refusing to prescribe such accountability, the Treasury is giving the shareholders of Fannie Mae and Freddie Mac a free ride and has put itself and Congress in the philosophically untenable position of presenting taxpayers vast new liabilities without a quid-pro-quo from those who have and will continue to benefit financially.

This dilemma is reflected in the question Congress is reviewing this week: whether to authorize an open or a constrained line of credit at Treasury. If a precise figure is inscribed in statute -- \$300 billion, for instance, was on the table at one point -- budget ramifications automatically develop which neither the Treasury nor Congressional leaders want to face. Hence the view of insiders has been to proceed with an ambiguous open-ended commitment which could disguise both the depth of the problem and obfuscate Congressional as well as industrial accountability.

This judgmental quandary involving Congressional budgeting rules underscores the case for adding a new dimension to the policy mix. In this context, aspects of two precedents -- the Chrysler "bail-out" of the late 1970's and the Mexican "bail-out" of the early 1990's -- demand review. In the first, Congress straightforwardly agreed to guarantee Chrysler debt in exchange for warrants -- options to buy Chrysler stock at a fixed price with an advanced commitment to resell immediately any stock purchased back to the public; in the second, fees were charged in exchange for providing U.S. guarantees for certain Mexican debt issuances.

Despite simmering controversy which remains on both decisions, the Treasury in each instance followed a direction pressed by several of us in Congress. The Department was statutorily required in the Chrysler case and determined without legislated guidance in the Mexican circumstance to follow a "win-win" profit model and serve as a quasi-investment bank for the American public. Debt was guaranteed, but the Treasury made hundreds of millions of dollars in both cases without any public funds ever being gifted to the parties assisted.

If the Treasury is to increase its line of credit or the Federal Reserve provide access to the discount window, this "investment-bank-for-the-public" model – a "buy-in" for taxpayers rather than "bail-out" for shareholders -- should be followed. One methodology for Fannie Mae and Freddie Mac, and conceivably

others in the event of an economic melt-down, could be to require that the Treasury — i.e., the public — be granted warrants exercisable over a 10 year period, ala the Chrysler model, to buy Fannie Mae and Freddie Mac stock at today's share prices. Depending on the gravity of solvency concerns, such warrants in the case of GSEs might, illustratively, amount to 10% of corporate equity for every \$100 billion line of credit authorized by the Treasury or Federal Reserve. To stabilize the companies and lessen the likelihood that these credit lines will be called upon, a whopping \$500 billion authorization could, for instance, be immediately adopted with the understanding that any funds actually borrowed through government lines of credit would also include, ala the Mexican model, a profit premium above Treasury's cost of funds.

The problem with the current plan on the table is that these two overleveraged institutions are transferring significant liabilities to the public and at the same time are manipulating governmental power to not only preserve current benefits but expand future market reach. In proposing to expand significantly the scope of housing eligible for GSE investment beyond the original mandate to serve only low and moderate income home owners, Congress appears bent on treating them as part of a solution to all our housing traumas while in ironic tandem the Executive is implicitly suggesting solvency is in question without the extension of a government line of credit.

In the background, the governing public interest proposition should be that privileged government support is doubtful in general, but even if socially advisable, should never be painlessly cost-free to those given market advantages. Hence the case for an "investment-bank-for-the-public" approach which could, if the housing market stabilizes, allow Congress to treat the program as a working asset rather than taxpayer liability.

Such a quid-pro-quo approach might have to be approved by the Boards of Fannie Mae and Freddie Mac. To insure agreement Congress could put in statute the prospect of removal of the panoply of special privileges the two institutions now enjoy and make it clear they will come under full Federal Reserve supervision if they choose not to proceed with a plan of the nature outlined above. As for the long run, Congress is obligated to continuously review the competitive equity as well as taxpayer liability implications of giving unprecedented financial powers to a privileged few.

A federal back-stop may be necessary today to protect against an international financial debacle, but the lesson for the future should be that no private institution should be provided a governmental umbrella unavailable to others. Government Sponsored Enterprises are simply an anachronism in a market economy.

Fannie and Freddie must be understood as spoiled siblings requiring reconciliation with public parents who must themselves prove they can wean themselves from a special interest culture.

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