Fannie Mae, Freddie Mac Live to Die Another Day: Caroline Baum
Commentary by Caroline Baum

July 30 (Bloomberg) -- Two weeks ago, with their stock prices plummeting and accusations of insolvency swirling through the marketplace, Fannie Mae and Freddie Mac, the two giant mortgage-finance companies, stared into the abyss.

What looked like a black hole turned out to be a blank check from the U.S. Treasury: an unspecified and unlimited credit line, borrowing privileges at the Federal Reserve's discount window, and a pledge of a capital injection from the government if needed.

The Securities and Exchange Commission coughed up additional protection, tightening the rules for short-selling of Fannie and Freddie, along with 17 other financial stocks.

Mission accomplished? With the government making explicit the implicit guarantee of the two government-sponsored enterprises, which together own or guarantee $5.2 trillion of the nation's $12 trillion of mortgage debt, the hope is that Fannie and Freddie won't have to tap the emergency backstops.

The fear is that the needed makeover will stop there.

If these public-private hybrid companies are too big to fail -- and everyone from the Bush administration to Congress to businesses and homeowners agrees that they are -- then by definition they are too big to survive in their current state, a paradox voiced by William Poole, former president of the Federal Reserve Bank of St. Louis, in a July 27 New York Times op-ed.

The lame-duck Bush administration, no fan of Fannie and Freddie until recently, has neither the clout nor the interest to refashion the companies. Treasury Secretary Hank Paulson has said repeatedly that Fannie and Freddie, which play ``a central role'' in the housing finance system, ``must continue to do so in their current form as shareholder-owned companies.''

Lobbying Ban

Congress, for its part, isn't interested in an extreme makeover. As part of the Federal Housing and Economic Recovery Act of 2008, awaiting presidential signature, lawmakers provided for a ``world class'' regulator for the GSEs, according to the Senate Banking Committee's summary of the legislation. (Quotation marks theirs.)

An interesting choice of words. Regulators get their mandate and powers from Congress. Lawmakers, by their own admission, seem to be saying the current GSE regulator, the Office of Federal Housing Enterprise Oversight, is a bantam weight. If Ofheo is, then it's of Congress's choosing: a choice heavily influenced by one of the most effective lobbying machines in Washington.

Earlier this month, Senator Jim DeMint, Republican of South Carolina, said that any federal bailout of Fannie and Freddie should include a ban on their ``lobbying and political activities.''

``Any legislation exposing taxpayers to this risk should include a serious debate on long-term reforms, and a ban on lobbying must be included,'' DeMint said. ``

Asymmetric Risk/Reward

DeMint tried to hold up Senate passage of the bill last week by forcing a vote on an amendment to curtail lobbying by the GSEs, the only government agencies to engage in such a practice. The Senate leadership rejected his request.

Congress isn't known for its long-term thinking. To the extent that the immediate crisis abates -- borrowing isn't a problem now that Fannie's and Freddie's debt carries the full faith and credit of the U.S. government -- it will reduce the impetus to seek a long-term solution, which is exactly what's needed.

A ``world class'' regulator isn't the solution. Eliminating the asymmetric risk/reward from Fannie and Freddie is.

If the taxpayer is going to shoulder the burden for bailing out Fannie and Freddie, the taxpayer should stand to benefit. It makes no sense to guarantee the debt of a private company, the benefit of which accrues to the shareholders, and not own the equity.

Mission Creep

And it isn't only a bunch of right-wing, free-marketeers pushing for a re-evaluation of the role of the GSEs in the 21st century. Former Treasury Secretary and Harvard University Professor Larry Summers, who is an economic adviser to Democratic presidential candidate Barack Obama, said the priority should be protecting the taxpayers and financial system, with the stockholders and subordinated-debt holders taking the hit.

Summers's idea is to run the GSEs as public corporations for a few years, after which their government and private functions could be divided, with the latter sold off.

Fannie Mae, created in 1938 and re-chartered as a shareholder-owned company in 1970, and Freddie Mac, chartered in 1970, have strayed far afield from their original mission, which was to provide liquidity, affordability and stability to the housing market.

Nothing in there about ``using its cost-of-funds advantage to lever its balance sheet,'' said Josh Rosner, managing director at Graham Fisher & Co. in New York. ``Buying manufactured housing, aircraft lease equipment, Alt-A mortgages: the taxpayers should not fund the non-corporate businesses.''

Insignificant Subsidy

What's more, only 7 basis points of the GSE subsidy benefited the home buyer, according to a study by Federal Reserve economists.

Now that Congress has passed a housing-rescue bill, which authorizes the Federal Housing Administration to insure as much as $300 billion of refinanced mortgages in addition to establishing a new GSE regulator, ``they think the problem is fixed,'' said Jim Bianco, president of Bianco Research in Chicago.

Bianco expects the other shoe to drop, perhaps in early August, when Freddie Mac reports quarterly earnings.

``Freddie announced its intentions to raise $10 billion of equity on July 18, filed a shelf offering on the 22nd, and the clock is still ticking,'' Bianco said. ``It took Merrill Lynch 12 hours to pull off an $8.55 billion stock sale.''

In this era of big government, it's good to know there are a few things the market still does better.

(Caroline Baum, author of ``Just What I Said,'' is a Bloomberg News columnist. The opinions expressed are her own.)

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