

No Exit in Sight for U.S. As Fannie, Freddie Flail

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MCLEAN, Va.—When Charles E. Haldeman Jr. became Freddie Mac's chief executive officer in August, the ailing housing-finance giant had already consumed \$51 billion of government money to stay afloat. It's likely to need even more.

Freddie's federal overseers nevertheless have instructed Mr. Haldeman to focus on something that isn't likely to make the bleak balance sheet look any better: carrying out the Obama administration plan to allow defaulted borrowers to hang onto their homes.

On a recent afternoon, employees at Freddie's headquarters here peppered Mr. Haldeman with concerns about the company's future. He responded that they were "fortunate" to have such a clear mission—the government's foreclosure-prevention drive. "We're doing what's best for the country," he told them.

Freddie and its larger rival, Fannie Mae, were among the first big financial institutions to receive massive federal bailouts after the financial crisis hit in 2008. Government officials have been racing to fix bailed-out car makers and banks and are pushing to reshape the financial-services industry. But Fannie and Freddie remain troubled wards of the state, with no blueprints for the future and no clear exit strategy for the government.

Nearly a year and a half after the outbreak of the global economic crisis, many of the problems that contributed to it haven't yet been tamed. The U.S. has no system in place to tackle a failure of its largest financial institutions. Derivatives contracts of the kind that crippled American International Group Inc. still trade in the shadows. And investors remain heavily reliant on the same credit-ratings firms that gave AAA ratings to lousy mortgage securities.

Fannie and Freddie, for their part, remain at the core of a housing-finance system that inflated a dangerous housing bubble. After prices collapsed, sending shock waves around the world, the federal government put America's housing-finance system on life support. It has yet to decide how that troubled system should be rebuilt.

On Dec. 24, Treasury said there would be no limit to the taxpayer money it was willing to deploy over the next three years to keep the two companies afloat, doing away with the previous limit of \$200 billion per company. So far, the government has handed the two companies a total of about \$111 billion.

The government is willing to tolerate such open-ended exposure for two reasons. First, it sees the companies as essential cogs in the fragile housing market. Fannie and Freddie buy mortgages originated by others, holding some as investments and repackaging others for sale to investors as securities. Together with the Federal Housing Administration, they fund nine in 10 American mortgages. Worries about potential insolvency would cripple their ability to fund home loans, which would hamstring the market.

Second, the companies are a convenient tool for the administration to use in its campaign to clean up the housing mess.

"We're making decisions on [loan modifications] and other issues, without being guided solely by profitability, that no purely private bank ever could," Mr. Haldeman said in late January in a speech to the Detroit Economic Club.

Besides playing a key role in the loan-modification program, Fannie and Freddie have jump-started lending by state and local housing-finance agencies by helping to guarantee \$24 billion in debt. They also are lending support to the apartment sector by becoming the main funders of loans to builders and buyers of apartment buildings.

By using Fannie and Freddie for such initiatives, the White House doesn't have to go to Congress for funding. The Treasury and White House can simply issue instructions to Fannie and Freddie via their federal regulator, the Federal Housing Finance Agency, or FHFA.

The government is "running Fannie and Freddie as an instrument of national economic policy, not as a business," says Daniel Mudd, who was forced out as Fannie Mae's chief executive in September 2008 when the government took control.

Assistant Treasury Secretary Michael Barr says that because Fannie and Freddie are "owned by the taxpayers in the middle of the biggest housing crisis in 80 years," it would be unrealistic to expect the companies wouldn't be used to help stabilize the market. He says the administration's actions have been "prudent" and "consistent with taxpayer protection."

The companies are political lightning rods. The government's decision to absorb unlimited losses followed the Treasury's approval of multimillion-dollar pay packages for senior executives at each company. Republican critics have blasted those decisions, demanding investigations and pay cuts. Massachusetts Democratic Rep. Barney Frank, a longtime supporter of the companies, said last month that ultimately they should be abolished and replaced with an entirely new housing-finance system. Last Thursday, he said he would convene a hearing next month to review the future of housing finance and the federal government's role in it

Some housing experts contend that prolonged government intervention will make it more difficult and costly to eventually wean the companies off government support.

"The more aggressively we continue kicking the can down the road, the larger the losses become and the harder it becomes" to address the companies' future, says Joshua Rosner, managing director at investment-research firm Graham Fisher & Co.

Edward DeMarco, acting director of Fannie and Freddie's regulator, the FHFA, says efforts to modify loans and to stabilize the housing market ultimately will help the two companies' bottom lines. "The businesses are trying to mitigate the losses and remediate the problems that led to conservatorship in the first place," he says.

As mortgage delinquencies rise, Fannie and Freddie are required to set aside more capital to cover anticipated losses. Each quarter, if their revenues are insufficient to meet those financial needs, the Treasury has to kick in more money.

With delinquencies still rising, the outlook is grim. At Freddie, 3.87% of single-family mortgages were at least 90 days past due at the end of December, up from 1.72% a year earlier. Fannie is worse: 5.29% were 90 days past due in November, up from 2.13% a year earlier.

For decades, both Fannie and Freddie were highly profitable. The housing bust hit both hard, sharply reducing the values of the mortgages they guaranteed, along with their investment portfolios, which were stuffed with riskier loans.

By September 2008, their capital reserves were so depleted that the government seized control of both companies, using a legal process known as conservatorship. In exchange for injecting money, the government has received preferred shares that pay a 10% dividend, along with warrants to purchase up to 79.9% of the common stock of each company.

The Obama administration had said it would weigh in on how to revamp the companies when it released its proposed budget earlier this month. Instead, the budget contained only a single line about the companies' future, promising to "monitor the situation" and to "provide updates...as appropriate." That stance reflects policy makers' uncertainty about how to proceed and a lack of urgency about resolving the problem.

Lawrence Summers, the president's chief economic adviser, has said the companies shouldn't be run permanently by the U.S. or be allowed to "return to the failed model of the past, where Fannie and Freddie relied on an implicit government [debt] guarantee to borrow cheaply."

Some Republicans have said the government should play no role whatsoever in the companies in the future, meaning no implied debt guarantee and no government directives to support affordable housing. The other end of the spectrum would be to turn the companies into government agencies. Many housing-industry leaders believe the eventual plan will fall somewhere in between. Housing-policy experts assembled by the Center for American Progress, a think tank that has provided the White House input on past policy and personnel decisions, recently proposed that Fannie and Freddie be transformed into two or more companies whose profits would be capped like those of public utilities. There would be explicit federal guarantees on certain mortgage-backed securities. The new entities would be required to ensure that mortgages are available to low-income borrowers. Others have proposed turning the companies into cooperatives owned by lenders, but subject to strict regulation.

With the fate of the two companies now largely in the hands of the government, employees have shifted their attention to the administration's loan-modification effort, called Home Affordable Modification Program, or HAMP. It provides financial incentives for banks and other owners of mortgages to reduce monthly loan payments for at-risk borrowers. Fannie and Freddie's job is to oversee how loan servicers—the firms that collect monthly payments on mortgages—are working with homeowners on the front lines.

The program is off to a slow start. The administration said it would offer three million to four million borrowers the chance to modify loans. Through December, loan servicers have signed up 903,000 borrowers for trial modifications. Just 66,000 have received a permanent fix so far. Both Fannie and Freddie have struggled at times to adjust to the new marching orders. Fannie has warned in financial filings that the modification program had shifted "significant levels of internal resources and management attention" from other parts of the business, which could lead to a "material adverse effect" on the business.

At Freddie, David Moffett, the chief executive who took over when the federal government assumed control, left last March after only six months, partly because it became clear that regulators would be calling the shots.

He says he and others warned administration officials that the loan-modification goals were unrealistic, that borrowers whose homes weren't worth what they owed were unlikely to take part, and that many participants would be likely to re-default within months. "They really didn't want our views," Mr. Moffett says.

Treasury's Mr. Barr says that isn't true. The Fannie and Freddie officials he worked with, he says, "were quite supportive of the program, of the structure and the basic design," and "were integral to the formulation."

Since then, Freddie has taken some heat for problems with part of the loan-modification drive. In an October report, the government said Freddie failed in its job as the program's auditor. Its task is to make sure loan servicers deal correctly with applications from borrowers for payment relief. Freddie says it has reassigned the vice president responsible for the effort.

Freddie's current chief executive, Mr. Haldeman, 61 years old, says it was immediately "very clear" to him that the loan-modification program was a top priority of the Obama administration. But the program isn't his only headache. As foreclosures mount, Freddie finds itself with title to more and more homes. The company wants to price them to sell, but doesn't want to put downward pressure on overall housing prices.

"Imagine having to keep the lawns mowed, the lights on, and the property secured for one house, let alone more than 40,000 homes all over the country," says Mr. Haldeman. "It's not an easy process." John A. Koskinen, a turnaround specialist who became chairman of Freddie's board when the government stepped in, says that in all his years working for government agencies and troubled companies, "I've never been in one with as many challenges."

Last spring and summer, as interim CEO, he had to recruit executives to fill the top three jobs. Filling those jobs has put the company on firmer ground, he says, and having a clear mission—even a government-mandated one—is helping morale. "At least the getting yelled at by your neighbor in the grocery store is behind us," he says.

Loan standards today are tighter than they have been in decades. That means the default risk on loans guaranteed recently by Fannie and Freddie is much lower than it was a few years ago. But their mistakes during the housing boom are expected to continue burning holes in their balance sheets. The Mortgage Bankers Association estimates that mortgage delinquencies won't peak any sooner than the middle of this year. At the current pace, around 6% of Fannie's loans and 4.9% of Freddie's are expected to go into default over the next 18 to 24 months, producing losses that would raise the price tag on Treasury's bailout to \$175 billion, according to October estimates by investment bank Keefe, Bruyette & Woods Inc. The bank has since said that even that dire forecast is too optimistic. Former FHFA head James Lockhart, the companies' top regulator until last August, says the U.S. is unlikely to ever fully recoup its investment in the two companies.

—Bob Davis contributed to this article.