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OPINION

Hank Paulson's Fannie Gamble

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Our housing finance system has been broken for quite some time, creating perverse incentives for borrowers and lenders. We have now reaped the consequences, and a major financial bailout of the system is probably inevitable.

Conservatives can rightly argue that had Congressional Democrats not blocked the various initiatives of the Bush administration to reform Fannie Mae and Freddie Mac for the past five years, we would not be sitting at the precipice like we are today. But that does not change the need for a government injection of funds to fill the financial hole in those two enterprises. The institutional arrangements in the American mortgage market cannot be changed overnight, and the risks of a breakdown in that market at some point over the next 18 months are still quite real.



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The trouble is, the legislation that just passed Congress indicates that Washington has learned nothing from our recent troubles. And, as this bailout bill is likely to be followed by at least one additional bill next year, the evident inability or unwillingness of Congress to move up the learning curve and abandon its past practices will make the ultimate cost to the taxpayer far higher than it might have been.

The 700 pages of legislation, which I doubt many members of Congress have even attempted to read, contains many egregious provisions, some of which are unrelated to the trouble at hand. But the pork designed to buy votes for the legislation pales before the blunders directly related to the problem at hand.

First, Congress rejected a proposal that Fannie and Freddie be barred from paying dividends if they are receiving injections of capital from the federal government. This idea would seem to be the first lesson in a course on Government Bailout 101. The government shouldn't be shoveling taxpayer money in the front door while the company is shoveling dividends to shareholders out the back door.

Freddie Mac paid \$1.6 billion in dividends last year while Fannie Mae paid \$2.5 billion. Both have dividend yields that are many times higher than the norm. Congress chose to protect the shareholders at the expense of the taxpayer.

Second, Congress did not give the taxpayer any of the upside from a potential recovery of Fannie and Freddie, leaving it all with existing management and existing shareholders. This breaks with past bailout or workout traditions in both the public sector and the private sector. In the Chrysler bailout of the 1980s, the government gave itself warrants that paid off when the company recovered. In most private-sector deals, existing common shareholders get virtually wiped out (Bear Stearns, for example) while preferred shareholders at least get a haircut. Fannie and Freddie shareholders were untouched by this bill. Congress bailed them out on the downside and preserved their upside potential.

Third, the legislation did not produce any substantive reforms in the home-lending area, particularly the problems which became endemic in the recent bubble. For example, President Bush asked for authority to allow for risk-based pricing in government-generated mortgages. That idea is based on the commonsense view that higher-risk customers should pay higher interest rates.

Congress rejected this, despite the lessons of the recent housing boom and bust associated with risky lending. And when it came to controlling risk through minimum down payments by homebuyers, the legislation set the required down payment for a government mortgage at only 3½%.

Fourth, the legislation included a special tax on mortgages originated by Fannie and Freddie to go into a fund for "affordable housing" run by politicians and community activists. It may seem natural for politicians to help out their colleagues and the people who turn out the votes on election day with newly dedicated taxes. But whatever logic there is in boosting taxes on entities that need public funds escapes me.

The list of such nonsensical provisions goes on and on. The examples mentioned above were not surprises snuck into the legislation in the dark of night. The president threatened to veto the bill in a formal Statement of Administration Policy issued on July 11 because it contained such objectionable items. The veto threat was reiterated by the White House just days before the House passed the legislation, but Treasury Secretary Henry Paulson reversed the veto threat in time for the vote.

The usual reason given for monstrosities such as this is that these provisions were needed to secure passage and that the need to pass the bill was pressing. But was it really that pressing? Fannie and Freddie declared during the congressional debate that they were both adequately capitalized and had no problem obtaining liquidity. If they were telling the truth, then certainly there was plenty of time for more serious deliberation.

If they were not telling the truth -- and the GSEs just got out of a five-year habit of issuing reports that were late or "qualified" by the auditors -- then Congress just created a blank check for a bailout of two institutions with dubious credibility. Either way, prudence would dictate a little more caution and time should have been taken.

The more plausible reason for the bill's structure is that the decades of coziness between politicians and Fannie and Freddie is paying off. Not only were there campaign contributions, but their "foundations" contributed huge sums to think tanks, and many political figures made the transition from government to the GSEs. The list of their connections reads like a combined Washington-New York phone book, and undoubtedly

gives the appearance that both Wall Street and politicians close to Fannie and Freddie had key seats at the bargaining table over this bill. The taxpayer was not adequately represented.

Nor was the homeowner an obvious beneficiary. Both conforming and jumbo mortgage rates have risen about a quarter point during July. The new law actually reduces the amount of competition in the mortgage securitization business going forward by solidifying the special position for the two leading players, Fannie and Freddie, while competitors scramble to get capital.

The legislation also creates long-term uncertainty with regard to the extent and form of government assistance. In effect, Treasury Secretary Paulson now has an open-ended mandate to bail out the nation's troubled housing finance market, the largest single capital market in the world.

If any other country announced that its finance minister could print unlimited debt to do something similar, financial markets around the world would dump both the country's debt and the country's currency. It may well be different because this is the United States of America. But certainly, to take such a risky and unprecedented step, a better crafted and considered piece of legislation should have been created.

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