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## **How Paulson Would Save Fannie Mae**

By Peter J. Wallison  
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The most astonishing thing about Treasury Secretary Henry Paulson's plan for Fannie Mae and Freddie Mac is that he intends to use taxpayer funds to resuscitate the companies and return them to profitability.

This after 20 years, during which Fannie and Freddie used government backing to enrich their shareholders, managements, lobbyists, former government officials and Washington insiders; after they rigged the political process with campaign contributions; and after their Congressional supporters resisted every effort at reform until the two companies were on the verge of collapse. Now a Treasury secretary in a Republican administration aims to put them back in the same business, and get the taxpayers to finance it.

It is difficult to believe, yet that is where we are headed.

Mr. Paulson has correctly noted that Fannie and Freddie operate on flawed business models -- as government-sponsored enterprises they have conflicting missions, and force the taxpayers to subsidize the risk-taking of for-profit managements. But he argued that, after they have been re-established as operating companies, Congress can decide their future.

This is stunningly naive. Recent statements by Barney Frank (D., Mass.), the chairman of the House Financial Services Committee, and Chuck Schumer (D., N.Y.), a powerful member of the Senate Banking Committee, make clear that Congress will never let them be privatized, broken up, slimmed down, nationalized or any of the other options hopeful reformers are putting forth today. Fannie and Freddie in their current form are just what Congress wants: an inexhaustible source of campaign contributions and funds for favored groups.

Here's how it works. Fannie and Freddie are backed by the federal government, which allows them to borrow money at interest rates lower than any other shareholder-owned company. With these cheap funds, they buy and hold mortgages and mortgage-backed securities with considerably higher yields.

But the huge profits from this government-subsidized arbitrage do not mean lower mortgage rates for the American homebuyers. Studies by the Federal Reserve have shown that Fannie and Freddie have essentially no effect on mortgage rates. The profits instead go to shareholders and managements, lobbyists, favored community groups, and of course to members of Congress through campaign contributions.

The Paulson plan, regrettably, will restore these two companies to their positions as poster children for corporate welfare. The Federal Housing Finance Agency (Fannie and Freddie's new regulator) has been appointed as a conservator for both companies. But while a conservator can keep the companies running, it does not have the power to change the business model, break them up or liquidate them. When the conservatorship ends, the shareholders will regain control.

The Treasury Department also has allocated up to \$100 billion for equity investment in the companies. Yet if Mr. Paulson simply wanted to keep Fannie and Freddie functioning, no capital investment by the U.S. Treasury would be required (although the taxpayers will have to bear the losses incurred thus far). Capital is necessary for a business corporation mostly to reassure lenders about the organization's ability to meet its financial obligations. Since Fannie and Freddie's debt will now be backstopped by the Treasury, such reassurance is unnecessary.

Instead, the taxpayer-funded capital injection contemplated in the Paulson plan seems to be a down payment on what will be required to return the companies to profitable operations. The Treasury Department has received preferred stock and warrants for the purchase up to 79.1% of Fannie and Freddie's common shares at a low price. Both would be worthless unless the companies become profitable. But any gains to taxpayers should be of little consolation; we will once again be saddled with two companies that create enormous risks for the financial system and deliver little or nothing for taxpayers or homeowners.

What should have been done? A receiver, not a conservator, should have been put in charge of Fannie and Freddie. A receiver could have wiped out the common and preferred shares, repudiated unfavorable contracts, created a good bank/bad bank structure for isolating the bad assets, and otherwise taken steps to reduce the losses to taxpayers.

The two companies could be operated indefinitely under government control, continuing their role in the housing finance system until private sector alternatives develop. Then, gradually, the receiver could whittle them down, preparing them for one of three possible outcomes -- nationalization, privatization or liquidation. The decision about which course to adopt would be in the hands of the next administration -- which could consult with Congress, but not have to wait for a congressional assent that will never come.

Accordingly, as it stands today, the Paulson plan is an historic missed opportunity to eliminate Fannie and Freddie as government-sponsored enterprises, the form which has put us at such risk. Nevertheless, the Housing and Economic Recovery Act of 2008, which authorized the conservatorship, also contemplated its conversion into a receivership. It is not too late to take this essential step.

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