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Let's Use Fannie to Clean Up the Mess It Made

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Earlier this week, James Lockhart, the director of the Federal Housing Finance Agency and the government conservator of Fannie Mae and Freddie Mac, said that the two companies need to begin writing down the principal on mortgages they hold or acquire. This could be an important step in slowing the housing slump. It also suggests that while Fannie and Freddie are largely responsible for the current financial crisis, they might offer a way out.

The Treasury's use of the Troubled Assets Relief Program (TARP) to recapitalize banks will fail if foreclosures on subprime and other junk mortgages continue to default at their current rates. Bank capital will further decline, eating into the new capital the taxpayers provide. And if foreclosures spread significantly into the prime mortgage market because of the recession, bank solvency will be further undermined.

In other words, to solve the financial crisis, we must address the problem of falling housing values and mortgage defaults. It is imperative to get ahead of this destructive curve.

The outstanding, institutionally financed single-family mortgage debt in the U.S. is about $10 trillion (subprime and Alt-A loans comprise about $3 trillion). Through its backing of Fannie, Freddie, Ginnie Mae, the Federal Home Loan Banks and the FDIC, the U.S. Treasury is already directly or indirectly responsible for perhaps $8 trillion of this debt.

Up to now, all programs that have been advanced to address the problem of mortgage defaults have relied on renegotiation of mortgage loans, using the depleted value of the home as the measure of the lender's loss. The objective has been to convert the mortgage into a longer-term loan with a lower fixed interest rate. With millions of mortgages needing this relief, the renegotiation process will be painfully slow. We cannot wait for snail-paced remedial efforts to have their effect.

The problem can only be addressed with a standardized plan that must work both for whole mortgages held by banks, and mortgages that collateralize mortgage-backed securities (MBS). It must also address several obstacles and challenges: the refinancing agency must have the necessary legal authority now (there is no time to establish a new agency); funding for mortgage purchases must be immediately available; and the plan must be voluntary, so the rights of lenders and the holders of MBS are protected. The plan must also target the right group of homeowners--those already delinquent or in danger of default because of impending interest-rate resets or other factors, but who are otherwise willing and able to carry a fixed-rate, reasonably priced mortgage.

The legal authority and the funding for such a standardized plan are already in place. Fannie Mae and Freddie Mac, as government sponsored enterprises (GSEs), have the authority to renegotiate any mortgage they own or purchase from others. They also have the necessary funding, either from the sums they can themselves raise in the market or through borrowing by the Treasury, which is authorized under the Housing and Economic Recovery Act of 2008 to lend virtually unlimited amounts to both GSEs.

The banks that own whole mortgages will want to keep those that they assess as performing now and likely to perform in the future. They also know that if they have to foreclose on a mortgage, they will incur substantial costs. Accordingly, Fannie and Freddie should make a blanket offer to all banks or other mortgage lenders to buy any existing mortgage at a fixed discount--say, 20%--from the principal amount then due on the mortgage. This will induce the banks to sell their weaker mortgages (including those not now delinquent). This in itself will improve their financial condition. Fannie and Freddie would similarly identify the weaker loans in their own portfolios and write them down 20%.

The GSEs should then offer to modify or refinance these weak and defaulted loans under the following terms: The unpaid principal amount of the mortgage will be reduced 20%. If the loan has a fixed rate, the rate will be reduced by 2% (but not below 5%), and if it is an adjustable, it will be recast at a 5% fixed rate, over 20 years. The purpose of a 20-year (rather than a 30-year) amortization is to build up equity in the home more quickly and help protect taxpayers against loss, and to help stabilize home values. Monthly payments will end up being reduced about 20%, ultra-high loan-to-value (LTV) ratios will be eliminated, and the downward slide in housing markets will be mitigated.

Loans that are in pools of mortgage-backed securities present a more complex, but manageable, problem. Fannie and Freddie are authorized to modify the terms of defaulted mortgage loans in MBS pools, and they could offer to refinance loans that servicers of MBS pools deemed likely to fail. Banks that hold these MBSs are likely to accept an offer for these securities by the GSEs for the same reasons that they will sell whole mortgages that are troubled or in default.

There are two additional conditions that must be added to these new mortgages, to make them less of a windfall for borrowers. The house could not be further encumbered by a home-equity loan until the government mortgage is fully paid off; and the mortgage-holder would be fully liable for the loan, unlike almost all other mortgages, which are backed only by the house itself. Requiring the new mortgages to be "full recourse" loans will tend to screen out of the plan those homeowners who can currently make their mortgage payments, and will attract those homeowners who are willing to assume personal liability in preference to foreclosure.

This plan requires banks that are holders of MBS to accept a 20% "haircut" on the weak mortgages they hold. It also requires greater responsibility and risk for the homeowners who choose a modified GSE mortgage. True, if many of these mortgages ultimately go into default, the taxpayers will suffer losses--but this is a risk that was always implicit in the TARP, and the risk will only be greater if we fail to act and losses further weaken the banks.

It is in our national interest to clean up the mortgage mess as promptly as possible, return the banks to financial health, and arrest the rise in mortgage defaults. This plan has a chance to accomplish these objectives--quickly enough to slow the slide into recession.

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