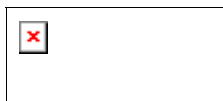

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By JIM MCTAGUE

Big Ben's Dumb Idea for Fannie and Freddie

BEING THE FEDERAL RESERVE BANK CHAIRMAN may make you feel like a know-it-all, but it doesn't actually make you one.


Ben Bernanke demonstrated the truth of this axiom on Capitol Hill recently when he suggested that secondary mortgage-market giants Fannie Mae and Freddie Mac temporarily be granted the authority to buy jumbo home-mortgages of up to \$1 million -- more than double the companies' current limit on loan sizes. Though Bernanke said this would help the beleaguered housing sector, James Lockhart, the man who regulates Fannie and Freddie, was totally surprised by the suggestion and told us it would do more harm than good.

"We're talking to the Fed about this," says Lockhart, who is director of the Office of Federal Housing Enterprise Oversight, an agency that is supposed to prevent Freddie and Fannie from doing anything unsafe and unsound. "Given the moment," Lockhart points out wisely, "Fannie and Freddie have enough to do in their own space -- the conforming-loan area. They don't have any particular expertise with jumbos. They don't buy them, they don't have systems, models or risk-management tools for them. It would take a lot of implementation."

The two congressionally chartered companies buy mortgages from banks and mortgage companies, which, in turn, use the proceeds to make even more loans, providing liquidity to the marketplace. The size limit on loans eligible for sale to Fannie and Freddie, currently \$417,000, is revised annually to reflect changes in an index of housing prices.

Right now, thousands of struggling homeowners in expensive markets like California and parts of Florida are burdened with adjustable-rate jumbo loans -- mortgages larger than the Fannie-Freddie limit -- with introductory "teaser" rates that will reset to much higher levels this year and next. Those homeowners would like to convert to more manageable fixed-rate loans. But Wall Street, pension funds and other buyers of jumbos have all but stopped their purchases, lest they get caught holding the bag if conditions worsen.

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For this reason, Bernanke also suggested that the U.S. Treasury explicitly guarantee the repayment of such jumbos if purchased by Freddie and Fannie. (Markets already treat the two mortgage titans as if their actions carry "implicit" guarantees, despite annual denials from Treasury.)

We asked the White House and Treasury what they thought of Ben's brainstorm and, not surprisingly, were put off with "No comment."

Lockhart wasn't so bashful. This reliable Bush school-chum was placed at the helm of OFHEO in 2006 to make sure that Fannie and Freddie fulfilled the terms of consent agreements signed earlier when they were caught cooking their books to make earnings appear more robust than in reality. The firms promised to strengthen accounting and management systems, to begin reporting their financial results to the Securities and Exchange Commission, and to limit growth and maintain capital levels 30% higher than required by law -- until they got their houses in order.

Those restrictions, says Lockhart, prevented the current mortgage crisis from being even larger, by keeping Fannie and Freddie in good shape to buy loans. But he might have to lift the capital and portfolio-growth restrictions sometime after February 2008, if the two giants meet the terms of their earlier agreements and are operating safely. He certainly wouldn't want to do that now: "It would be a major mistake to lower capital requirements in this market -- almost like repeating the mistakes of the S&L days."

LOCKHART HAS LIMITED POWERS as a regulator -- he is a lion tamer with neither chair nor lash. His agency was able to impose consent agreements on the two corporations three years ago because they were weakened politically at the time. Fannie and Freddie have since regained influence on the Hill. Lockhart has been urging the Senate to enact legislation, already passed in the House, that would create a new regulatory agency with more teeth. Otherwise, Freddie and Fannie, which already are leveraged about 50 to 1, would be allowed to leverage themselves even higher. Banks have far more rigorous capital standards.

Fannie Mae is closer to complying with the consent agreements than is Freddie Mac, because the latter has proved slower at rebuilding itself. When Richard Syron replaced Leland Brendsel as CEO at Freddie Mac, he brought a new management team with him -- one that didn't know the company. "There was a learning period," says Lockhart, "and Syron made some unfortunate choices. He lost a CFO and a COO, which has made it tough; and he still has a thin management team."

Even with the growth restriction, Freddie and Fannie have been buying more than 60% of the nation's new mortgages, up from 40% last year. That could put them at greater risk in a recession, possibly even requiring a federal bailout. That, says Lockhart, is the ultimate reason why a more powerful regulatory office is needed. "Congress," he says, "really does have to act." We couldn't agree more.

E-mail comments to editors@barrons.com¹

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