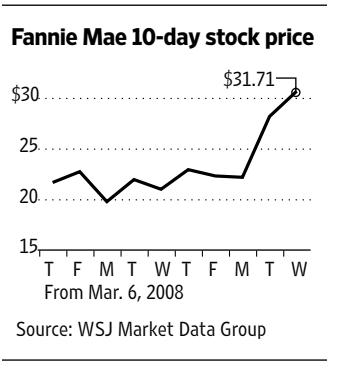
A More Honest Socialism

How do you turn $5.9 billion into $200 billion overnight? By magic. Political magic in the case of Fannie Mae and Freddie Mac—due to their status as publicly traded private companies back-stopped by taxpayer guarantees.

Yesterday, Fannie and Freddie announced, alongside their chief regulator Jim Lockhart, that they would be leveraging up their businesses in the name of riding to the rescue of the mortgage-backed securities market. Here's how the wizardry works: Mr. Lockhart, the Director of the Office of Federal Housing Enterprise Oversight, agreed to cut the amount of capital Fannie and Freddie are required to maintain by a combined $5.9 billion and to allow them to increase their leverage to 33-1 from about 30-1. That means Fan and Fred can borrow up to $33 for every dollar in freed-up capital, and presto—the two mortgage giants get $200 billion or so to spend buying up mortgages or mortgage-backed securities.



There is a catch. In exchange for this freedom, Fan and Fred have promised to raise "significant" new capital over the next year. We're told it's on the order of $10 billion each. That's the good news. The bad news is that the companies can leverage any new capital right alongside the old, meaning that the total increase in business—and risk—could be well above the $200 billion set by Mr. Lockhart.

Let's put some of these numbers into context. J.P. Morgan Chase is leveraged about 12-1 against its Tier 1 capital base. Investment banks are usually more highly leveraged than commercial banks, and Bear Stearns, formerly the industry leader in this category, was leveraged at 34-1 at the end of 2007. You know how that turned out.

The oddest argument is that Fan and Fred need to be unleashed to help the mortgage market. That's what they were supposed to be doing all along, yet so far in this crisis they have themselves become sources of systemic financial fear. After taking big losses in last year's fourth quarter, investors and counterparties have become nervous that Fan and Fred might face solvency problems similar to those of other mortgage players. Their refinancing "spreads"—the price of their paper—have periodically blown out nearly as far as everybody else's on Wall Street.

This isn't supposed to happen. The two companies are chartered to liquify the mortgage market, especially at the lower-income end. But of course the low end isn't where the money is if you are a publicly traded company whose executives need to enhance shareholder value. Thus in this crisis, Fan and Fred have both so far been hunkering down, often not even buying back their own mortgage-backed paper. What good are quasi-socialists if they won't act like socialists in a capitalist crisis?

Yesterday's capital expansion merely lets the companies continue their double lives as profit-making companies backed by taxpayer guarantees—and to do so by taking even greater risk at a very risky time. No wonder their stock prices are up by more than a third in a week (see nearby). If the politicians really want to double-down on Fan and Fred, the honest way to do it is to provide them the taxpayer money up front.

Here's one idea: How about issuing the companies some subordinated debt, with an option to convert that paper into Fannie and Freddie stock down the road? Fan and Fred would get the money to return to the mortgage markets, but once the crisis ends at least the taxpayers would get some upside from the risk they are taking now.

Yes, this amounts to a form of nationalization, but at least it's honest socialism. As it stands now, Fannie and Freddie get to gear back up, and if they get into deeper trouble because housing prices keep falling, the taxpayers pick up the tab. If the crisis ends, Fan and Fred's private shareholders get all the upside and their executives get even richer than they are. If Washington wants to socialize the housing market—as it seems eager to do—let's do it in the open and put Fannie's debt on the federal budget so taxpayers can see what they're buying.

Of course, the last thing Congress wants is all of this to be transparent. The Members benefit from the current private-public confidence game because the two companies ladle them with campaign contributions to protect their privileged status. That's why Congress continues to dither over reforms that might actually provide a regulator capable of staring down Fan and Fred.

With a couple of brave exceptions (Mr. Lockhart, Alabama Senator Richard Shelby), Fannie and Freddie own Washington. It'd be better for the housing markets and taxpayers if Washington finally admitted it and bought Fannie and Freddie.