Fannie Mae Alchemy

Both Fannie Mae and Freddie Mac lost lots of money last quarter and last year—and we mean *lots.* If they continue losing money at current rates, in fact, they could find themselves below their mandatory capital requirements in another six months or so.

The mortgage giants try to turn losses into gold.

Fannie and Freddie think that the best way to deal with this problem is to allow them to leverage up even further by reducing those same capital requirements. Some on Capitol Hill, notably New York Democrat Chuck Schumer, agree. Like maxed-out consumers who were about to reach their credit limit, Fannie and Freddie already hit up investors for a cool $13.8 billion in additional capital last quarter. But as they continue to lose money, their capital position remains tenuous.

So now, with the help of Senator Schumer and other friends on the Hill, they're trying to get their credit limits raised. Like political alchemists, they want to turn their losses into the gold of more profit-making opportunities. James Lockhart, the regulator responsible for Fannie and Freddie, gave them a bit of relief this week by eliminating caps on the size of their investment portfolios, and their stock prices jumped. Now the pressure is also on Mr. Lockhart to lower their capital requirements, but nothing about their results suggests that Fannie and Freddie need more risk in their lives—or ours.

The two government-sponsored mortgage giants lost $6.1 billion between them in the fourth quarter. In both cases, the lion's share of the reported losses came from losses on derivatives that the companies use to hedge their huge portfolios of mortgage-backed securities, or MBSs. Supposedly, we are to take some comfort from this. The companies contend that these are paper losses and that the price of derivatives can fluctuate from quarter to quarter or year to year. That's true.

But bear in mind why Fan and Fred buy these derivatives in the first place. Each of them has an MBS portfolio worth more than $700 billion on its books. These portfolios are entirely separate from their original mandate, which was to buy mortgages from banks, package them into securities and sell them to investors with a guarantee. Both companies still do this too, of course, and the recent turmoil in the housing market has allowed them to greatly expand their market share in that business. But these days they make more money (on an "operating basis," at least) by holding mortgages or MBSs for their own account, or by buying MBSs on the open market and holding them.

To do that, they borrow. A lot. In fact, almost every dollar they invest in MBSs is a dollar they borrow by issuing bonds. This they can do cheaply because of a market perception that, if loss comes to shove, Uncle Sam will make their creditors whole. The two companies then make money off the spread between their borrowing rates and the interest paid by the mortgage holder or the mortgage-backed security.

To make sure that spread stays positive, and hence profitable, they then purchase interest-rate swaps and other derivatives to hedge their exposure to changes in interest rates. And in the fourth quarter in particular, Fannie and Freddie saw huge declines in the value of those derivatives as interest rates fell. It may be that those losses will never get realized or that the value of the derivatives will recover.

But in the meantime, Fannie and Freddie continue to bleed capital. In the fourth quarter, Freddie raised $6 billion and Fannie $7.8 billion in preferred-stock offerings. And it's a good thing they did, because without that capital last quarter's losses would have put both companies below the minimum capital levels required by their regulator. Fannie's capital base stands $3.9 billion above the minimum, while Freddie has a cushion of $3.5 billion.

That doesn't sound too, too bad, maybe. Except that Freddie is holding $100 billion in subprime asset-backed securities in its portfolio while Fannie has $74 billion or so. It wouldn't take too much in the way of portfolio losses to wipe out those capital cushions. How likely are further write-downs? Well, 21% of Freddie's $100 billion in subprime assets are 60 days delinquent or more, and 40% of those securities on watch for downgrade.

So, what in the world is Congress doing? Mr. Schumer cheered Wednesday when Mr. Lockhart lifted the caps on the companies's portfolios. We guess he thinks that what we really need is *more* taxpayer exposure to the risk of a meltdown at Fan and Fred. Meanwhile, the reform bill passed by the House last year is stalled in the Senate Banking Committee, thanks in part to Democrats like Mr. Schumer. This is the bill that would strengthen the regulator's power to make sure the two giants stay solvent.

What Fannie and Freddie really need is a regulator with the clout to cut up their credit cards before they get into even deeper trouble—and take the rest of us along with them.