Paulson's Fannie Test

We're about to find out why Hank Paulson left that lucrative job at Goldman Sachs to be President Bush's last Treasury Secretary. Was it merely to add a fancy title to his obituary, or does he want to leave the U.S. financial system better than he found it? That's his test in the wake of his Sunday commitment to use taxpayer money to rescue Fannie Mae and Freddie Mac.

The past week's market turmoil over the mortgage giants has certainly been instructive for most Americans, not least Mr. Paulson. For 18 months, the Treasury Secretary had been told by Fannie, Freddie and their friends on Capitol Hill that the companies were in good shape. He was told that Fannie's critics at the Federal Reserve, in the Senate (Richard Shelby) and in the media (us) were "ideologues" who should be ignored. Ease up on reform, they told him, cut a deal with House Financial Services Chairman Barney Frank to let the companies grow, and they'll help end the mortgage crisis. Mr. Paulson went with the Beltway flow.

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We hope he now realizes he was lied to. More pointedly, on Sunday he was left naked on Pennsylvania Avenue, with no recourse but to disavow his own prior statements about Fan and Fred's good health and to bail them out. Now we'll see if he has the fortitude to stand up to these "government-sponsored enterprises" and protect taxpayers going forward.

The issue isn't whether the government should rescue the companies. Congress made that decision when it created the duo with an implicit taxpayer guarantee. Everybody has long known that, as the owner or guarantor of half of America's mortgages, the companies are too big to fail. The question has been how to manage and regulate these monsters in a way that minimizes risks to the larger financial system and taxpayer. Had Treasury and Congress acted two years ago, or even three or six months, the current panic could have been avoided.

The good news is that the crisis gives Mr. Paulson new political leverage, if he's willing to use it. The companies are straining to raise capital, with their share prices falling yesterday even after the Treasury's commitment to keep them solvent. Thus they are more politically vulnerable than ever. Their main patrons in Congress—Mr. Frank, Chuck Schumer, Christopher Dodd—should also be on the defensive after shilling for the companies for so many years.

Mr. Paulson's Sunday statement at least began to show more leadership. The Treasury Secretary wants Congress to give the government more power to rein in the companies, including with a preferred stock capital injection if required. This is progress, but it's not aggressive enough given the risks. He could make more progress more rapidly toward a safer financial system by putting the companies into federal receivership. If current law doesn't give Treasury that power—and we hear conflicting legal claims—Mr. Paulson should seek it from Congress.

> The best way to protect taxpayers is receivership.

The Secretary could then appoint a prominent financial figure with bipartisan credibility as a receivership czar, with a mission to protect taxpayer interests. A czar would have the power to replace Fan and Fred's management and directors, as well as give priority to taxpayers above the current private shareholders if the government does inject capital.

It's true that this might well require a larger up-front taxpayer contribution. But after Sunday, the taxpayers know they are on the hook for big losses in any case. Putting the companies in federal receivership would insulate them from a political class that has shown itself unable or unwilling to control their risks. Without such a move, the companies could easily use the taxpayer cash as protection in the short run, emerging both larger and more dangerous. Mr. Paulson will have been stripped naked twice.

Receivership doesn't mean the companies will fold up overnight. They continue to hold trillions of dollars in mortgage assets, and they would continue to buy and package mortgages. But as a first priority, a receiver would be able to rein in their portfolios of mortgage-backed securities (about $1.5 trillion now) that are a major source of their risk. Down the road, as the mortgage crisis eases, the receiver could decide whether to wind the companies down, sell them in parts to the private sector, or let them continue in far more restricted form.

Keep in mind that these semi-socialist giants (private profit, public risk) were founded in an era when mortgages were sold and held by the same lender. The idea was that Fannie and Freddie, by buying and packaging those loans, could supply more liquidity to the mortgage market. Whether or not that taxpayer risk was worth it at the time, it clearly isn't now that the bill is coming due and private companies can do the same thing.

The receivership option would also help Mr. Paulson get out ahead of the many other looming financial problems. IndyMac Bank's failure (see below) is only the first of many more failures to come, and Treasury is going to have its hands full. The airline and car companies may follow. Putting Fan and Fred in firmer hands now will reassure investors that at least one risk is being well managed, reducing public fear that the government is overwhelmed.

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Fannie's friends on Capitol Hill and Wall Street will call receivership draconian and unnecessary, and they'll fight it ferociously behind the scenes. But Mr. Paulson now occupies the higher political ground as defender of the taxpayer. Some of us have been saying for six years that Fannie and Freddie posed a systemic financial threat, while most of Congress told everyone not to worry. Mr. Paulson should keep in mind who told him the truth, and who didn't.