Can We Avert the Next Financial Crisis?*

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In America, we like to feel good -- happy, not sad. We have a number of products that deliver this to us. Indeed, two advertisements stand out as marketing how their product is essential to our happiness. Both advertisement campaigns have soft lighting, happy huggy couples, while the voice over reminds us that there is no substitute for their product. They make us feel so good that it's hard to tell them apart. But there is one major difference. The advertisement for Viagra comes with a medical warning. In contrast, the advertisement for Fannie Mae should come with a financial warning for all of us, but it doesn't.

Fannie Mae and Freddie Mac, two enormous Government Sponsored Enterprises (GSE's), are intertwined into the core fabric of the U.S. housing market. These institutions were designed to be intermediaries in the housing market. In theory, they would purchase mortgage loans, bundle them up and sell them off – in doing so they would sell of the interest rate risk but still hold the credit risk. Given the illiquidity of the mortgage market at that time, Fannie Mae's and Freddie Mac's provided the mortgage market with the benefits of securitization and savers with the benefits of a diversified saving's vehicle.

In turn, however, Fannie Mae and Freddie Mac have received a number of important benefits. First, their securities receive both an official and unofficial preference in comparison to identical securities provided by other firms. For instance, their securities receive a higher weighting in the Basel Accords capital standards. As well, they themselves have lower capital standards as compared to other Second, based on a number of Treasury Department provisions, there is a presumption in the market that the securities issued by Fannie Mae and Freddie Mac have an implicit backing by the U.S. Federal Government. Accordingly, these securities command a higher price (and, by implication, can offer a lower return) by savers due to their nature of being a safe asset. The ability for these GSE to have access to a lower cost of funding is a big advantage in the world of financial markets.

Of course, to receive these benefits, Fannie Mae and Freddie Mac were also expected to provide a service to those with mortgages. Initially they did so indirectly by

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providing financial institutions a channel for securitization and by establishing an exceptionally liquid market that might otherwise have taken much longer to emerge.

While there is no doubt that these GSE's helped establish the market they now dominate, the fundamental question remains as to whether they still provide a benefit to the housing market by passing along their access to a lower cost of funding. If the answer is no, these GSE's could be fully privatized, remove the Government's implicit guarantee, and then treat these organizations like any other financial institution by standard regulation, supervision and oversight.

Federal Reserve Economist Wayne Passmore attempted to answer just this question: and in December 2003 his answer came back a resounding NO of whether homeowners benefit from the subsidy to Fannie and Freddie! [1] He concludes that based on Fannie and Freddie's unofficial Government backing, they are the recipients of funding advantage of 40 basis points from 1998 through the middle of 2003. In contrast, they estimate that the reduction in mortgage rates is about 7 basis points. So the difference between the implicit benefit they receive from the government less the benefit they deliver to household, 33 basis points, is a huge advantage when you think about the size of the mortgage market. And the work suggests that Fannie and Freddie have not contributed much to the American Dream of homeownership through reduced mortgage rates – certainly nothing compared to the tax treatment of interest payments on mortgages.[2]

But now a second front has emerged on recognizing the burden that Fannie and Freddie could impose on our economy -- and that risk is interest rate risk. For some time now, Fannie Mae and Freddie Mac have taken the rather unusual step of buying back their own securities and issuing long term debt. This fact has been established by Professor Dwight Jaffee of the University of California, Berkeley, who calculates that Fannie and Freddie have been annually repurchasing approximately 50% of their newly issued mortgage backed securities. So they purchase mortgages, repackage them into bundled securities and then buy back their own created securities, which seems strange until you look at the evidence of how much money this has made Fannie and Freddie.

This unusual portfolio strategy, though profitable, has exposed them to interest rate and pre-payment risk. And the strategy seems unusual since doesn't it re-introduce the exact type of risk that the GSE's were supposed to sell-off? However, given the size and nature of their portfolio, and the likely forthcoming change in interest rate policy by the Federal Open Market Committee, these risks are large. Now financial institutions are in the business of balancing risks, and Fannie and Freddie have some talented individuals who can help them hedge this risk, but they don't play by the same rules as everyone else. Indeed, private financial institutions are regulated and supervised to hold a sufficient amount of capital (i.e. safe assets to cover liabilities in case of a deterioration in their risk

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[1] http://www.federalreserve.gov/pubs/feds/2003/200364/200364pap.pdf

[2] But Fannie and Freddie are no shrinking violets, and they retained a number of top academic economists to discredit the Passmore study. Not surprisingly, their experts found the study wanting, which in turn solicited a response by Passmore and a colleague.

assets), but Fannie and Freddie are not required to satisfy these high capital standards. Instead, they have a remarkably reduced level of capital *viv-a-vis* their regulated competitors, and Fannie and Freddie use their presumed implicit guarantee to offset whatever penalty the market would place in terms of a higher cost of raising funds on their risky behavior.

In very recent speeches, Federal Reserve Chairman Alan Greenspan, Federal Reserve Board Governors Ben Bernanke and Susan Bies, and Federal Reserve Bank of New York President Tim Geithner have all pointed to these critical issues in reigning in Fannie Mae and Freddie Mac. The Federal Reserve has also instituted some changes ontheir own. For instance, as of July 2006, these GSE's will stop receiving interest free advances on their payments from the Federal Reserve. And while legislative efforts to tighten and strengthen the supervision over Fannie and Freddie have somewhat stalled, the Office of Federal Housing Enterprise Oversight, or OFHEO, the GSE's financial regulator, is drafting a rule that would outline how the agency could take over the companies' operations in case they get into financial trouble.

So the general policy thrust towards these GSE's has been to recognize the risks, and to help avert a financial crisis that could impact the entire housing market. What is the GSE's response? The first is to lobby harder. In the past few years Fannie Mae has donated 1 million dollars to both the Congressional Hispanic and Black Caucuses to launch campaigns for more home ownership by Blacks and Hispanics. Of course, this probably had nothing to do with Congressional Hispanic Caucus subsequently trying to pressure the Federal Reserve Board to not release the Passmore study. The second is to engage in accounting misdeeds. In 2003 Freddie Mac was rocked by an accounting scandal that forced the restatement of earnings from 2000-2002 and led to the exit of the CEO, CFO and COO. Not to be outdone, the OFHEO reported in early April 2004 that its examination of Fannie Mae suggests that they may to restate past earnings. The third is to pay the CEO more. Franklin Raines, chairman and CEO of Fannie Mae, received $17.1 million dollars of compensation last year, up 46% from the year before. Not a bad chunk of change for a firm that feeds off the public trough.

Hmm. Excessive lobbying, accounting scandals and excessive pay. Sound familiar? Let me connect the dots for you. These are the three pillars of a looming financial crisis, a combination we have grown too familiar with during the days of Enron, WorldCom, etc… But in those cases we learned to late. But not so in this case! Fannie and Freddie can be brought under stricter oversight and regulation as well as improved capital standards. And the implicit backing by the Federal government they receive can be explicitly removed. Let's hope that our Government can deliver these key policy ingredients, and avert the financial crisis that awaits us if they don't.