the weekly Standard

The Fannie and Freddie Follies
Spare the rod, spoil the child.
by Lawrence B. Lindsey
07/28/2008, Volume 013, Issue 43

Should the United States drop into a historically memorable economic downturn in the near future--a clearly possible if far from certain event--economic historians will likely cite July 11, 2008, as a critical date. It will be not unlike October 28, 1929, which we know today as Black Monday. I propose that future historians call it "Fickle Friday" for the confusing signals out of Washington whipsawed the market and led to a diminution of confidence in the government's ability to right the financial system.

Dawn broke on the East Coast that Friday with our two biggest Government Sponsored Enterprises (GSEs), Fannie Mae and Freddie Mac, trading down 50 percent from their close the day before. These two are the main conduit through which home mortgages pass in the marketplace. The proximate cause of their problems was a *New York Times* story saying that the Bush administration had plans to nationalize them and wipe out their equity value in the process. After the story broke, a mildly positive day in the European markets turned to one of major losses, and New York markets were set to open sharply lower. Nearly everyone associated with the money markets was talking about how the government would have to do something and soon.

The Bush administration began the day of confusing signals by announcing a presidential event at 11 o'clock--which turned out to be about gas prices--and a National Economic Council "Administration announcement" at 4 P.M., which turned out to be about an EPA issue. There was also to be a 10 A.M. statement by Treasury secretary Henry Paulson, which was widely hyped. It ended up being delayed by 25 minutes and turned the hopes of a rally based on great expectations into a midday fizzle. The secretary did not appear, and a written statement was released saying, "Today our primary focus is supporting Fannie Mae and Freddie Mac in their current form as they carry out their important mission." The markets viewed the phrase "in their current form" as showing some real detachment between policymakers and the facts on the ground. Equities were rapidly sold off, hitting lows not seen for two years.

But Senate Democrats improved on the administration's record for confusion. The Senate had been working on a Federal Housing Administration reform bill, sponsored by banking committee chairman Christopher Dodd, all week. One of the key provisions was a tax on all of Fannie's and Freddie's lending, amounting to about $300 to $400 on each mortgage. No sensible person could think that imposing heavier taxes on institutions whose stocks were in a death spiral was a good idea. But the taxes were dedicated to a new housing slush fund that would go to (largely Democratic) governors, mayors, and left-leaning community groups like ACORN. (The last--the Association of Community Organizations for Reform Now--would be a leading recipient of the bill's largesse despite, or perhaps because of, its being one of the few institutions in the country to have seven of its members convicted of voter fraud for generating fictitious voter lists.)

Then at 2 o'clock in the afternoon Senator Dodd went in front of the television cameras to defend Fannie and Freddie. He said that they were sound institutions, had access to capital, and had significantly tightened their lending standards. Then he mentioned that he had been in conversations with the Treasury and the Fed about the possibility of providing a new liquidity facility to Fannie and Freddie. Markets began to turn. Reuters piled on with a story that Federal Reserve chairman Ben Bernanke had told Freddie Mac CEO Dick Syron that they would have access to the discount window to cover any short-term liquidity crises. The Dow, which had been down nearly 200 points skyrocketed to positive territory. It turned out the Reuters story was false, but the Dodd statement had given them sufficient grounds to run it, and the Fed did not deny it until after the markets closed. Still, equities were turning back down at the close as cooler heads realized there was enormous uncertainty about the soundness of the housing giants and about the size or form of any government bailout.

But the day was not over as far as senatorial input was concerned. In the oddest moment, Senate majority leader Harry Reid issued a statement saying that all Senate Democrats had confidence in the GSEs. Then at 5 P.M., the Office of Thrift Supervision (OTS) closed IndyMac, a California mortgage lender. In a written statement, the OTS said that the "immediate cause" of the failure was Senator Chuck Schumer, a New York Democrat. Back in June, Schumer had sent a letter to the OTS questioning the bank's condition, a letter he then released to the press. A bank run followed with depositors withdrawing $1.3 billion in 11 days. It is the second largest bank failure in American history. According to the *Wall Street Journal* it will ultimately cost the bank insurance fund between $4 and $8 billion. Schumer shot back saying the OTS should concentrate on doing its job rather than pointing fingers.

These Washington follies exposed two big weaknesses in the governmental underpinnings of the American financial system. First, the government's backing of Freddie and Fannie puts them in a box. The chaos around the GSEs indicated to the markets that the authorities would have to offer some kind of bailout. So, on Saturday, when Paulson called around to various investment banks urging them to buy debt that was going to be issued by Freddie Mac on Monday, he was met with a very cool response. Why should private institutions put their money at risk if the government already believed that it would have to be the investor of last resort? If the nation's finance minister was reduced to playing bond salesman for a private company, moreover, it would stand to reason that things must be pretty bad.

Second, the Schumer-inspired collapse of IndyMac will, over the coming few weeks, remind people that not all deposits in banks are insured; in fact, roughly one third are not. The FDIC only insures deposits up to $100,000 in each account. IndyMac had a fairly wealthy clientele, and, when they find that they may not get all their money back, it will become national news. This is how bank runs start. People with large accounts tend to be quite sophisticated and will rapidly move their deposits to Treasury bills or other investments. In the last banking crisis in the late 1980s, FDIC chairman Bill Seidman was able to protect nearly all of these uninsured depositors by merging institutions. But in 1991, Congress in its infinite wisdom, made this far more difficult to do the next time--i.e. this time. (This is a story that will unfold in coming weeks.)

The more immediate crisis for Washington was what to do that would help Freddie Mac raise money Monday morning. Goldman Sachs, Paulson's old firm, had been charged with trying to place the debt issue and was failing. Late Sunday afternoon, before markets opened in Tokyo 13 time zones away, Paulson announced a three-point plan, which amounted to a request for Congress to issue a blank check to the Treasury Department to both extend loans and purchase the equities of Fannie and Freddie. The reaction in each of the world's markets was initially positive, but was quickly followed by a sell-off as investors considered the plan. Having the GSEs fail was unthinkable, but putting their losses on the books of the federal government wasn't a great idea either.

There are three important concerns that continue to weigh on markets. First, Fannie and Freddie--despite the protestations of their champions in the Democratic caucus on Capitol Hill--are not well capitalized. Why else would Paulson be requesting a blank check for the government to inject equity capital? Unlike what Paulson said in his formal statement, there really is no way that Fannie and Freddie can come through this "in their current form."

A look at Freddie Mac's own accounting statements shows that using the "fair value" method that includes some of their off balance sheet positions, the firm's net worth is *negative* $5 billion. Freddie has set aside a total of $14 billion to guarantee a total of $1.8 trillion in loans, enough for a loss rate of just 0.8 percent. Should their loss rate rise to 5 percent, which is conceivable in this housing market, they would be nearly $80 billion under water.

The problem at Fannie seems less acute on the surface. It would take a 1.5 percent swing in either their assets or their liabilities to make them insolvent under fair value accounting. But, they have $112 billion in exposure to mortgage insurance companies, like PMI and Radian, whose share prices have been rapidly dropping. These potential losses would require a level of capital injection from the Treasury so high as to be politically impossible. But, if the government is unwilling to pony up the huge sums that might be needed in the extreme, then any money put in now would simply be lost.

The second problem plaguing the Paulson plan is that despite open-ended commitments, there was no explicit sacrifice being asked of the existing management or shareholders. The plan appeared to be so generous that the share prices of these supposedly failed enterprises actually rose as markets opened. The smart money on Wall Street, moreover, had already bet on some form of government bailout by buying the preferred stock and subordinated debt of these two companies at a steep discount. Paulson's announcement produced billions of dollars in windfall profits for those who placed a bet that the government would indeed blink. This money did nothing to improve the access to mortgages for America's homebuyers; it was a direct transfer to Wall Street's investment banks and hedge funds.

Third, the Paulson plan undermined confidence in other financial institutions. There are plenty of ordinary commercial banks in the country that need to raise capital to restore their balance sheets. But Paulson signaled that even institutions that had the implicit backing of Uncle Sam like Fannie and Freddie could now effectively raise capital only from the Treasury and not from private markets. The stocks of many troubled banks--Washington Mutual, Wachovia, and National City for just three examples--plunged steeply in Monday's trading. The bank stock index had its worst fall in more than 10 years, dropping 8 percent at one point.

This leaves the question of what to do now. I do not share the view of some conservatives that we should just let the market handle it, though they are right that we should never have gotten ourselves into this mess by creating a for-profit company that comes to the government whenever it needs money. But, we are where we are and need to learn from our mistakes.

The key to repairing the GSEs is to make sure that existing shareholders and management pay a price if they get bailed out. Ideally common shareholders should see the values of their shares reduced to zero, or close to zero. Investors in other parts of the capital structure who knew they were taking risks should have their investments written down--taking a "haircut" in Wall Street parlance. But the bondholders, who supply the capital to homeowners, should be largely protected.

Government investment in the capital structure gives government control. We should avail ourselves of this opportunity to wind down the scale and scope of the government's involvement in the mortgage market. While mortgage securitization might at one time have been a specialized "high tech" financial innovation needing the government, it is not today. Homeowners, investors, and taxpayers would all benefit from having a more competitive mortgage securitization market with many well-capitalized private participants who are responsive to market discipline. The market share of Fannie and Freddie needs to be reduced.

Finally, we need to put financial regulation out of the reach of politicians seeking time before the television cameras. Bank supervision works only when it is done quietly, letting the regulator and the bank solve problems out of the glare of the limelight. Senators should not be spreading panic for political gain. Market discipline, by contrast, is done under the glare of publicity and full disclosure. The lessons of Fickle Friday should remind us that we need discipline in Washington, as well as in the financial markets, if we are to come through this crisis in good stead.

Lawrence B. Lindsey is the author of What a President Should Know . . . but Most Learn Too Late *(Rowman and Littlefield).*