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Dismal Science: Fannie Deserves a Smack

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Abstract (Document Summary)

In the immediate post-Enron period, investors went on orange alert when increased scrutiny revealed that Fannie has serious problems with corporate governance, financial disclosure and reporting. More recently came revelations that Fannie was having trouble managing its huge portfolio of assets. A bad guess on the direction of interest rates exposed a giant mismatch between the maturities of its assets and liabilities, and demonstrated how vulnerable Fannie is to interest-rate risk.

The bizarre thing is that Fannie willingly (and happily) exposes itself to interest-rate risk. There is nothing in its government charter that even remotely requires Fannie to borrow great gobs of money to purchase and hold a huge portfolio of mortgages. Fannie does it because it is wildly profitable. Because of the implied government guarantee of its debt, Fannie can borrow at very low rates and then lend out that money at higher rates by retaining or repurchasing the mortgages it has securitized. This opportunity to borrow low and lend high is so seductive for profits, it's almost a form of entrapment.

Initially, Fannie fit into this scheme with its mission to supply liquidity to the secondary mortgage market. That need of course is long gone -- private companies offer ample liquidity. Thus Fannie now says that its mission is to provide affordable housing by reducing mortgage interest rates; specifically, Fannie argues that it lowers rates by 25-to-30 basis points, about a quarter of 1%. Fine, and a number of studies done in the past decade agree, though the evidence argues more toward 22 basis points. But just who benefits from this reduction?

Full Text (960 words)

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Fannie Mae, the mortgage company behemoth, is not having a good year. Shareholder equity has been evaporating -- down 27% at the end of the third quarter (or down 47% if one ignores Fannie's accounting shenanigan). Worse, there are more difficulties on the way. Aside from skating on thin ice with investors, there is political risk from politicians who are looking at its operations with growing crankiness.

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It's such a good deal, in fact, that Fannie has issued an amazing amount of debt. Currently its outstanding debt is around \$800 billion. Moreover, Fannie's debt relative to its small capital base gives it enormous leverage. Fannie's required core capital is 2.4% of on-balance sheet assets and 0.45% of outstanding mortgage-backed securities and other off-balance sheet obligations. This is well below levels necessary for FDIC-insured commercial banks; even government securities dealers carry capital around 5% of assets.

Fannie is running with this huge leverage (about 54-to-1) because it can -- shareholders, at least until this year, didn't seem to care.

What about its creditors? Well, considering taxpayers are the ultimate creditors, they should probably care more than they seem to. At the end of the third quarter, Fannie's combined debt and its mortgage-backed securities held by outside investors totaled \$1.8 trillion.

Taxpayers are stuck with this potential liability for what is, after all, a private company, for reasons that have their origins in the mists of conventional social wisdom. The argument is that a nation of homeowners is more stable politically and more civic-minded. Or, as economists would say, home ownership generates lots of positive externalities. So the government has developed policies to encourage home owning. In addition to substantial tax advantages, there are programs to provide mortgage insurance (FHA and VA) and a bunch of special considerations for banks and thrifts that invest in mortgages. The result is that home ownership is at an all-time high -- about two-thirds of households own homes.

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Well, check out a 1999 study by the Bureau of the Census using 1995 data (the most recently available). This looks at the impact of mortgage rate changes on the affordability of housing for blacks and Hispanics; it finds that decreases in rates of less than three percentage points has no significant effect on the number of renters who would qualify for a mortgage. Or how about a study published this year by the Federal Reserve Bank of Minneapolis, which finds that while reducing mortgage rates by 2% has a small but appreciable impact -- the percentage of all households who could buy homes increases around 50 basis points -- the increase for blacks is only 10 basis points. (Observers say that low income or first-time homeowners would be helped more by direct subsidies for down payments.)

The beneficiaries of Fannie's rate reductions are mostly middle- and high-income households. These are people who would own homes anyway, but are encouraged to buy larger and fancier homes or second homes. Economist Lawrence J. White at New York University's Stern School observes: "Positive externalities apply to incidence of home ownership, not to the quantity of housing consumed." Simply put, unless Fannie's mission is to allow bond traders to buy second homes in Jackson Hole, it isn't promoting positive externalities. But this discouraging failure doesn't have to be terminal. Fannie has a Gordian knot option -- one swift slice to sever its connection to the government and the demands of social policy.

The advantages of privatization should be enticing. Fannie would free itself from current regulatory constraints like being limited to the residential mortgage business, restrictions on the maximum size of mortgages, and oversight by the evil twins, HUD and OFHEO. Once liberated from its "special relationship" with the government, Fannie could expand into jumbo and subprime lending, and go into new businesses, like securitizing credit cards and auto loans.

Fannie has a well-known brand name and fairly seethes with experienced and skilled human capital. No doubt a free Fannie would continue to prosper. And taxpayers, having had a massive risk transferred to the private credit markets, would be free to breathe a little easier, too.

Ms. Lee is a member of the Journal's editorial board.