Financial Times, February 24, 2004

Keeping Fannie and Freddie's houses in order

By GREGORY **MANKIW**

Congressional moves to reform the supervision of the US home mortgage market are gathering pace. Alan Greenspan, Federal Reserve chairman, is scheduled to testify before the Senate Banking Committee today on the regulation of Fannie Mae, Freddie Mac and the Federal Home Loan Bank system, the government-sponsored enterprises (GSEs) that underpin the market. Further hearings are to be held tomorrow.

The issue of GSE reform goes well beyond the role of housing in the economy. It has far-reaching implications for the entire US financial system.

The GSEs were created decades ago to ensure adequate supply of funds for mortgages. Although designed to serve a public purpose, they are private enterprises. Fannie and Freddie are owned by their private shareholders and the Federal Home Loan Banks are owned by their members, mainly financial institutions. Since their creation, their activities - notably their portfolio investments - have expanded greatly.

By charter, the housing GSEs enjoy privileges including exemption from state and local income taxes and from Securities and Exchange Commission registration and disclosure requirements. The US Treasury is authorised to extend limited credit to them and some of their directors are appointed by the president. The direct monetary benefit from these privileges is modest but their symbolic value is significant.

The privileges feed a market perception that GSE debt is backed by the US government. This is inaccurate - the charters do not require the federal government to bail out a troubled GSE. Yet, given the perception, investors are willing to accept a lower yield on GSE debt than on that of other private companies. A recent study by Fed staff estimated that the interest rate on the debt of Fannie and Freddie averaged 40 basis points below that on comparable securities. In financial markets, such a funding advantage is enormous.

Most observers believe the GSEs pass some of their implicit subsidy along to homeowners through lower mortgage interest rates. The Fed study estimated that the subsidy lowers mortgage rates by 7 basis points, with the rest of the subsidy going to executive compensation and shareholder profits.

This situation raises concerns over fairness, because the subsidy puts other financial institutions at a disadvantage, but the larger issue is that the subsidy creates a source of systemic risk for the US financial system. The risk arises because the subsidy has allowed the GSEs to become gigantic. Since 1996, the debt issued by the housing GSEs has more than tripled, reaching a reported Dollars 2,400bn by September 2003. To put this in perspective, the privately held debt of the federal government is Dollars 3,300bn.

The housing GSEs have used the proceeds from issuing debt to amass enormous portfolios of mortgages and mortgage-backed securities. The value of such assets is highly sensitive to swings in interest rates or refinancing activity. The GSEs engage in a variety of hedging activities to reduce this sensitivity, but even the best minds in financial management cannot entirely eliminate risk. Further, the belief in a government bailout if things go wrong creates an incentive for a company to take on risk and enjoy the associated increase in return. The savings and loan crisis of the 1980s illustrates the dangers of government guarantees.

Because the housing GSEs are so large, the risk they face is important for the entire financial system. GSE debt is widely held by other financial institutions. Even a small mistake in GSE risk management could have ripple effects throughout the economy.

Although there is no way to eliminate the underlying risk, it is possible to reduce it by ensuring that the housing GSEs are overseen by an effective regulator. This should have authority to set both risk-based and minimum capital standards for GSEs; to review and, if appropriate, reject new GSE activities; and to wind down the affairs of a troubled GSE through receivership. Instead of relying on the congressional appropriations process, it should be granted a permanent funding mechanism by allowing it to assess the GSEs under its purview.

The reform effort should also re-evaluate GSEs' privileges. A useful step would be to remove presidential directors from the boards of Fannie and Freddie.

The US financial system has been a source of strength throughout the recent recession and recovery. But we must not take this strength for granted. To protect its long-term health, we must provide our world-class housing finance sector with a world-class regulator.

The writer is chairman of President George W. Bush's Council of Economic Advisers