

Book Forum

Privatizing Fannie Mae, Freddie Mac and the Federal Home Loan Banks: Why and How

Introduction

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October 4, 2004

The publication of OFHEO's interim report on Fannie's accounting has the potential once again to alter the political landscape on how to deal with Fannie Mae and Freddie Mac. Although the media focused on various governance failures, the report goes much further than identifying errors in governance. It notes again and again that Fannie's officers took deliberate action to evade the requirements of GAAP. For example, Fannie:

- “deliberately developed and adopted accounting policies to spread estimate income or expense that exceeded predetermined thresholds over multiple reporting periods;”
- “made discretionary adjustments to the financial statements, for the sole purpose of minimizing volatility and achieving desired financial results;”
- “developed and implemented processes to generate multiple estimates of amortization with varying assumptions in order to select estimates that provided optimal accounting results.”

These charges are far more important than the references to weak governance, because they directly question whether regulation can ever work to limit the risks that Fannie and Freddie represent. More than that, they question whether improved, stronger, more competent regulation can ever work to limit these risks.

In the past I have argued that stricter regulation will not work because Fannie and Freddie are too politically powerful. In the failure of Fannie's management to abide by the rules, we have another example of why regulation cannot protect the taxpayers and the economy from the losses associated with the failure of either of these companies.

Relying on regulation assumes that regulated companies will obey the rules. Obviously, when a management refuses to do so, regulation is useless. In fact, it's worse than useless, because the existence of regulation can reduce market discipline by lulling investors into a false sense of security. We should keep in mind that the only industries to have suffered collapse in recent times were banks and S&Ls—both of which were heavily regulated.

Sometimes, we think and act as though regulators were all-seeing—that given enough staff and regulatory authority they can guarantee us against risk and loss. That is clearly the theory underlying the current interest in stronger regulation and a more competent regulator for Fannie and Freddie. But in reality it is impossible for a regulator—no matter how well funded, competent and endowed with authority—to oversee every decision that a management makes, and if management wants to evade the rules they will be able to do so. Fannie and Freddie have both now shown that they can keep their regulator from learning the most important information about their operations.

Indeed, it stands to reason that the most significant and risky decisions managements make are exactly the ones that are kept from the regulator until it is too late to deal with their ill effects. This is fully in accord with what we understand of human nature. Managements have objectives that are different from those of regulators, and to the extent possible they make decisions that pursue their own goals rather than those of the regulator. If these decisions come out well, no one ever hears about them and the company rocks along without interference. But if the decisions produce serious losses, the regulator is often the last to hear about it. The management uses accounting tricks and other devices to avoid regulatory suspicion and scrutiny, because they know that providing negative information to a regulator is the same as announcing it publicly.

Under this scenario, a desperate management then makes even more risky decisions in order to recover their losses before anyone—especially the regulator—should stumble upon them. In the case of the S&Ls, this was called “gambling for resurrection,” and is still the best explanation for why the S&L debacle was so costly.

As it happens, the Fannie case is virtually a textbook case of hiding the ball. It is important to note that this OFHEO report on Fannie would never have been written, or even attempted, if Freddie Mac’s board had not discovered that its own management was fudging the company’s financial reports. The resulting dismissals were a surprise not only to the market but to OFHEO as well. Despite the fact that OFHEO was regularly receiving reports from Freddie, and had supervisory staff regularly present in Freddie’s offices, it did not discover that Freddie was manipulating its numbers until the day before Freddie’s board fired its top management.

Only after OFHEO had been alerted in this embarrassing way did it draw the logical inference that if Freddie was not accurately reporting its financial results, Fannie might be doing the same. After seeking and receiving a special appropriation to pay for a forensic audit on this question, the outcome was the current interim report, with more to come. Does anyone doubt that if this chain of events had not occurred, we and OFHEO would still be unaware of what was happening in Fannie? More to the point, does anyone believe that a regulator with more staff and with the additional authorities that are currently being considered in Congress would have discovered on its own that Freddie and then Fannie were cooking the books?

The lesson we should draw from this is sobering and timely. It is that regulation alone is a very weak reed if we are hoping to prevent a financial disaster. Its success is wholly dependent on the willingness of managements to abide by the rules. While most

managements do so, there are cases where they do not, and Fannie and Freddie are now exhibits A and B for this phenomenon. While we can absorb the occasional bank failure, there are a few cases where a regulator's failure to discover what is going on would be costly to the taxpayers and have serious adverse effects on the economy as a whole. Where this danger exists, the risk becomes unacceptable.

Fannie and Freddie present exactly this case. There is simply too much risk concentrated in only two companies. If any one of them fails, the consequences could be dire. This is the point that Chairman Greenspan has been making, and the basis for his view that while limiting their growth would be desirable, privatization is the only realistic and viable solution to the risks they represent.

In these circumstances, it seems apparent that stricter regulation and a different regulator will not be sufficient. No matter how tight the supervision, a management that is willing to evade the rules will be able to do so. Accordingly, the only real protection for the taxpayers and the economy is privatization of Fannie and Freddie—and a form of privatization that reduces their size and significance to the mortgage markets. It would be poor policy indeed if Congress were to privatize Fannie and Freddie only to find that market discipline was still limited and competition impaired because they were now considered too big to fail.

A road map for achieving the right kind of privatization is Tom Stanton's plan—the plan we will discuss today. It achieves all the main objectives privatization should seek, by reducing the size and importance of Fannie and Freddie as privatized entities without disrupting the mortgage markets, and by allowing their shareholders to recover the principal values stored in the companies while creating a more efficient and competitive mortgage market. If Tom's plan were carried out fully, Fannie and Freddie as privatized companies would not be too big to fail, and would not be the dominant entities in the competitive secondary mortgage market that would result.

As an adjunct to Tom's plan, Bert Ely's deals with a familiar objection to privatization—that it will cause interest rates to rise. The Mortgage Holding Subsidiary that Bert developed is highly original has the potential to lower mortgage rates below those offered by Fannie and Freddie, and without any government backing.

Together, these plans will do what is necessary to protect the taxpayers and the economy. As shown by the case of Fannie Mae, stricter regulation cannot promise or guarantee this result.