After years of muscling and/or seducing, Fannie and Freddie face some challenges bigger than they ever expected.

Ominous Signs

BY PETER J. WALLISON

After years of success in terrifying the political world and seducing the financial community, the government-sponsored enterprises—and particularly Fannie Mae—are now threatened with real change. The precipitating cause is a tough and determined stand by the Bush Administration for stronger regulation. This has inspired the GSEs' previously torpid regulator—the gracefully named Office of Federal Housing Enterprises Oversight—to fight for its life with aggressive regulation, and apparently persuaded at least one rating agency that it may actually be sensible to take no for an answer. In this two-front war, Fannie is in an unaccustomed position—it is no longer in full control of the outcome. As a result, it has been required to call its usual allies into the open for whatever support they can provide.

For almost the last full year, Fannie and Freddie have been buffeted with actions and statements by the Administration and others—including OFHEO—that call into question whether the two powerful GSEs still have control of their political risk.

■ The Treasury Department, insisting on tough minimum requirements for new regulatory legislation for the GSEs, showed its determination by opposing and ultimately dismembering a House Banking Committee bill that the Treasury considered too weak. This was the first sign that Fannie and Freddie, despite their massive network of lobbyists, would not have their usual way with the legislative process.

Peter J. Wallison is a resident fellow at the American Enterprise Institute. He was formerly General Counsel of the Treasury and White House counsel in the Reagan Administration.

THE INTERNATIONAL ECONOMY

THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

■ The Office of Management and Budget, in an analysis that accompanied the President's 2005 budget, declared that Fannie and Freddie were undercapitalized, in need of serious new regulation, and failing to perform an important part of their mission: providing affordable housing, especially for the minority community

■ At the request of OFHEO, the GSEs' regulator, Congress voted $7.5 million to do a forensic audit of Fannie's accounting.

■ With that audit underway, OFHEO suggested that it had already turned up accounting problems, warning the market that Fannie might have to restate its financial reports for previous years. When Fannie's spokesman denied that the company knew anything about this, OFHEO's director issued a statement calling Fannie's denial false and misleading.

■ OFHEO proposed new corporate governance regulations that, among other things, would require Fannie and Freddie to split the offices of chairman and CEO, and limit the terms of their directors. OFHEO also announced that it was considering whether it had the power to institute a receivership for either of the GSEs, even without specific legislation.

■ The White House let it be known that the President would no longer appoint the five directors of Fannie and Freddie that he is authorized to appoint, a clear effort to eliminate one of the links to the government that underpin Fannie and Freddie's privileged GSE status.

■ The Department of Housing and Urban Development (HUD), the GSEs' mission regulator, requested authority to levy $6.5 million in fees on the GSEs so it could better enforce its affordable and low-income housing regulations.

■ HUD proposed significantly tougher affordable and low-income housing regulations, which if ultimately adopted will force Fannie and Freddie to devote more resources to the less profitable and riskier underserved market. An OMB spokesman said that the OMB toughened the requirements after HUD submitted the regulations for review.

■ The Federal Reserve Board announced that it would no longer permit Fannie and Freddie to incur daylight overdrafts in the course of making payments on their securities, a benefit some calculated at about $10 million per year.

■ A Fed economic study concluded that the value of Fannie and Freddie's government subsidy was between $119 billion and $164 billion, far higher than earlier estimates by the Congressional Budget Office (CBO); that between 42 percent and 81 percent of the companies' market value is attributable to their government subsidy; and that the benefit homebuyers derived from this subsidy was only seven basis points—less than a third of previous estimates.

■ CBO announced that it had updated its 2001 study of Fannie and Freddie's subsidy and, using the same methodology, concluded that the subsidy had grown from $11 billion in 2000 to almost $20 billion in 2003. Of this amount, Fannie and Freddie retained about one-third and passed the balance through to homebuyers. CBO also noted that its conclusions, although using a different methodology, were consistent with the Fed study.

After many successful years of avoiding serious scrutiny, reality seems now to be finally closing in on Fannie and Freddie.

■ Greg Mankiw, Chairman of the President's Council of Economic Advisers, declared in a speech that Fannie and Freddie posed risks to the economy and needed to be reined in by stronger capital regulation and other restrictions. Speeches and testimony by Treasury officials also emphasized these concerns, and a Treasury official declared that if Congress wanted to eliminate the GSEs' $2.25 billion "line of credit" at the Treasury—another of the links that confer GSE status—that is something that Treasury would be willing to discuss.

■ The Organization for Economic Cooperation and Development (OECD), in a report on the U.S. economy, recommended that limits be placed on the growth of Fannie and Freddie.

■ The Senate Banking Committee, in an action openly and strongly opposed by Fannie and Freddie, adopted a bill that provided a strong new regulatory structure for Fannie and Freddie. The bill gave a new regulator control over the GSEs' capital and mission, and authorized the regulator to exercise receivership powers (subject to action by Congress within forty-five days). All the Democrats on the committee voted against the bill, virtually assuring that it would not come to a vote in the full Senate this year, but to get this Democratic support, Fannie and Freddie had to agree to much stronger rules on affordable housing, and to a 5 percent pre-tax charge to earnings for an affordable housing fund.

■ The Department of Justice concluded that the Treasury Department had authority under Fannie and

Freddie's charters to limit their issuances of debt. This is highly significant, since it provides Treasury with authority to slow or halt the growth of Fannie and Freddie if all other means fail.

■ Last, but far from least, in testimony before the Senate Banking Committee, Federal Reserve Chairman Alan Greenspan declared Fannie and Freddie a systemic danger to the economy and called for their privatization.

Perhaps the most ominous signs of long-term trouble for Fannie and Freddie were changes in the way they are viewed by the private sector.

WEAKENING INFLUENCE AND DECLINING INVESTOR SUPPORT

Perhaps the most ominous signs of long-term trouble for Fannie and Freddie were not government actions at all, but changes in the way they are viewed by the private sector. Several examples suggest that their control over events was beginning to weaken. Wells Fargo, one of the nation's largest banks and a major player in the mortgage market, publicly challenged Fannie and Freddie's commitment to affordable and low-income housing. Only a few years ago, a public complaint about the GSEs by a participant in the housing markets would have been unthinkable.

Major media outlets began to assign reporters to the Fannie and Freddie "beat." The *Wall Street Journal, Washington Post, Financial Times,* Dow Jones Newswire, and Bloomberg News all designated specific reporters to follow events at or involving Fannie and Freddie. To call this a death watch would be an exaggeration, but it indicated that Fannie and Freddie had been recognized as a potential source of important developments in the future, virtually guaranteeing a flow of unfavorable publicity for two companies that had successfully flown under the media radar for many years.

Finally, and perhaps most importantly, investors and analysts began to draw attention to the severe decline in the price/earnings ratios of the two companies. Listed on the New York Stock Exchange, Fannie and Freddie have been consistently among the most profitable public companies in the United States. Fannie boasts that it is only one of four or five companies in the S&P 500 (one of these is Freddie) that have had double-digit increases in profitability for fifteen straight years. Indeed, the company's profit has been doubling every five years since the beginning of the 1990s, and its return on equity has been consistently in the range of 23–26 percent. Freddie's results have been much the same.

With a success record like this, both companies should have price/earnings ratios well up into the 20s, but by early July 2004 Fannie's P/E was about 9.1 and Freddie's about 9.2. For comparison, the composite price/earnings ratio of the S&P 500 financials was close to 20. What this has meant for Fannie's shareholders is that the price of the stock has not participated at all in the recovery of the securities market since 2001. Indeed, an investor who bought the stock in 1999 paid $77 per share; in July 2004, the same shares were selling for about $70 each. Although the Dow Jones Industrial Average has climbed almost 2,000 points since September 2002, Fannie's stock price is today almost exactly where it was when the market began its upward move, and is lower than it was on January 4, 1999, the day that Franklin Raines became chairman and CEO.

Fannie's stock price is today almost exactly where it was when the market began its upward move, and is lower than it was on January 4, 1999, the day that **Franklin Raines** became chairman and CEO.

The significance of this fact should not be underestimated. What it means is that investors have built into Fannie's stock price an enormous risk premium, perhaps anticipating that there will be some event—probably government action—that will seriously diminish the company's value. From the perspective of investors, the many events listed above constitute what analysts call "headline risk"—the downward pressure on a stock price that follows upon the disclosure of bad news.

OFHEO's ongoing forensic investigation of Fannie's accounting promises to be a source of more headline risk during the balance of 2004. OFHEO has already demanded that Fannie restate a portion of its financial statements that deal with impaired loans for manufactured housing, arguing that Fannie did not write off a sufficient amount of the value of these assets. After trying and failing to get the SEC's support for its accounting treatment, Fannie agreed to change its method of accounting for impaired assets in future years.

Under pressure from the Administration and OFHEO, Fannie was compelled to call upon one of its congressional supporters, Democrat Barney Frank (MA), the ranking member of the House Financial Services Committee, to complain that OFHEO was being too tough. The sight of a liberal Democrat complaining about excessive regulation is unusual enough, but it follows the virtually unanimous Democratic opposition to a tough GSE regulatory bill that was adopted by the Senate Banking Committee.

Indeed, the spectacle of members of Congress complaining about excessive regulation of the two GSEs is exactly why many commentators are skeptical that Fannie and Freddie—with their extraordinary political power—can ever be effectively regulated.

But questions about Fannie's financial condition and the quality of its accounting assumed greater importance than ever in May, when Standard & Poor's announced that henceforth it would condition Fannie and Freddie's ratings on their financial condition—not their governmental support. "Historically…" the agency said in its statement, "a strong governmental consensus of support for the senior unsecured debt holders of GSEs had led to the highest degree of confidence that the government would ensure full and timely payment on these securities, even if the entities themselves got into financial difficulties. We no longer have the same degree of confidence that the Government would ensure full and timely payment on the senior unsecured debt of these GSEs." For several months, Treasury officials have been insisting that the government will not support Fannie or Freddie in the event that either of them has financial difficulties, and it appears that this message has finally gotten through. Standard & Poor's no longer believes it is prudent to treat as government-backed a security that the government itself was insisting it would not back.

The sight of a liberal Democrat complaining about excessive regulation is unusual enough, but it follows the virtually unanimous Democratic opposition to a tough GSE regulatory bill that was adopted by the Senate Banking Committee.

Investors and analysts began to draw attention to the severe decline in the price/earnings ratios of the two companies.

This brings the question back to the quality of Fannie and Freddie's financial statements. No matter how they are viewed, they do not inspire confidence. Whether or not OFHEO requires Fannie or Freddie to restate financial results for any past year, neither company's capital position is what one would expect of a triple-A rated financial institution. Fannie's capital position, in addition, is considerably weaker than Freddie's. By statute, Fannie and Freddie are required to hold only 2.5 percent capital against losses on balance sheet assets, but earlier this year the Office of Management and Budget calculated Fannie's equity—as distinct from its required capital—at 1.8 percent (the corresponding number for Freddie was 4.2 percent). Although Fannie and Freddie are hugely profitable, that profit comes from the enormous leverage they are able to obtain because of their perceived government backing. If Standard & Poor's no longer accepts the reality of this backing, both their profits and their triple-A ratings will be in jeopardy.

After many successful years of avoiding serious scrutiny, reality seems now to be finally closing in on Fannie and Freddie. ◆