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Fannie today, Citigroup tomorrow?

By James C. Miller III
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Conservatives and others have expressed outrage over the recent Supreme Court ruling giving government power to take private property from one owner and give it to another to promote economic development.

Right now Congress is considering doing something similar, and there's hardly a peep of protest. In the name of enhancing stability in financial markets, Congress might "downsize" two major private companies and transfer stockholder value to someone else.

The companies are Fannie Mae and Freddie Mac, financial institutions created by Congress to support home mortgage lending. Contrary to popular belief, neither is a government agency. Both are federally chartered private companies — profitmaking, owned by stockholders and publicly traded.

The two companies have been extremely successful in both their public and private goals, having lowered mortgage costs by billions of dollars each year and built mortgage investment portfolios totaling some \$1.5 trillion.

Their critics argue that, because the companies are so large, any problems they encounter could endanger the broader financial system. But there is no evidence the two companies are uniquely prone to failure.

Mortgages are extremely safe investments, and Fannie and Freddie employ extensive and sophisticated hedging to reduce interest rate risk to a minimum. A recent study by CapAnalysis found Freddie survives stress tests (inflation, interest and

default scenarios) far better than other financial institutions. Nevertheless, Congress may force Fannie and Freddie to reduce their mortgage portfolios substantially. Earlier this year Fed Chairman Alan Greenspan, who supports the proposal, suggested capping their portfolios at \$100 billion to \$200 billion each, implying a forced divestiture of up to \$1.3 trillion to other companies.

Forcing financially sound companies to divest the bulk of their assets would be unprecedented. If this were proposed for any other company, conservatives would argue it would amount to confiscating stockholders' property on a flimsy pretext. But Fannie and Freddie are unpopular with many conservatives because of their special charters and the benefits they receive.

Ironically, some conservatives object to another proposal — requiring Fannie and Freddie to pay 5 percent of their profits into an affordable housing fund — as a government-mandated transfer of stockholder wealth. Yet the amount taken by the tax would be minuscule compared to the wealth that would be taken under the portfolio proposal.

Conservatives should be alarmed at the precedent this proposal would set. Once government grants itself this power, why couldn't it eventually be applied to other companies and industries? For example, many banks and other financial companies operate under federal and state charters. Banks receive subsidies in the form of federal deposit insurance — taxpayer support that makes deposits a cheap source of funding — and access to low-cost funds from the Federal Reserve. Large banks receive preferential treatment in capital markets, because investors

believe they too are too big to fail. Large banks also pose at least as much risk as Fannie or Freddie. If government can force Fannie and Freddie to sell most of their assets, what's to keep government from later doing the same to Citigroup or Bank of America?

Moreover, if government can force the sale of assets because the owner used a subsidy to acquire them — which seems to be an implicit justification for doing this to Fannie and Freddie — no one's property is safe. Subsidies are widespread and used by almost everyone. Homeowners get them through tax deductions for mortgage interest and local real estate taxes. Virtually all businesses benefit from a direct or indirect subsidy. Once government uses a new power, it always seeks to use it again more broadly. Fannie and Freddie could be the first targets of this power, but they would not be the last.

Given Fannie and Freddie's size and their key role in our system of housing finance, concerns about the potential risks of their mortgage investments are not out of place.

But the best way to address the issue is to ensure they operate safely and soundly and cover their risks through adequate hedges and capital. This is far better than taking wealth from stockholders under a misguided theory that the companies are simply too successful and too big.

A precedent of this sort could lead to unintended — and very dangerous — consequences.

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