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Teaching Fannie and Freddie to Act Like Grown-Ups

By DANIEL AKST

MY uncle called the other day, the one in Washington.

"Oh, everything's O.K.," he said uneasily. "But I'm worried about the kids."

"Fannie and Freddie? I thought they were thriving. Home prices are still sky high, and interest rates are low."

"I know, but something about what they're up to makes me nervous, and I can't put my finger on it. Listen, do you happen to recall whether I ever agreed to pick up the check for those two if things went wrong?"

"Well, people sure act like it. That's the whole point. Fannie and Freddie can borrow at something like Treasury rates because everyone knows Sam's always good for it. You never really promised. But you never really didn't."

"Hmm, so am I good for it?"

I had to laugh. Uncle Sam has never been any good with money.

"Sure you're good for it. I mean, you can always print some more dough, right? Just how much are you on the hook for?"

"When you count what they owe and what they insure? Probably around \$3 trillion." He sounded worried, but then brightened: "Look, it can't all go sour at once, can it? There's all those houses behind it. And the kids do have some money of their own."

"Yeah? How much?"

"Oh, \$40 billion."

"Look, Sam, now you're scaring me. Don't those kids do any saving? This kind of leverage is unbelievable."

"What worries me," Sam went on, "is how they do so much short-term borrowing to keep themselves going. I mean, what happens if suddenly the cash window closes for a bit? The law says I can lend them \$2.25 billion each, but these days that's chicken feed."

"Sam, this is the kind of thing that always happens to you. You're on the hook, but Fannie and Freddie give their profits to investors. Because everyone thinks you back the kids, they borrow for less than anyone else and get bigger and bigger — which convinces everyone all the more that you'd never let them fail. Plus, the whole system encourages undue risk-taking."

"They are awful big, aren't they?" There was a nostalgic tone in his voice; Sam was always strongly sentimental.

"Sam, pay attention. Remember what I told you last time around? Don't guarantee anybody's debt unless you know how much it is and can't see any alternative. So maybe Chrysler or Mexico or something. But not a blank check like last time."

"Last time?"

"Don't you remember the savings and loan crisis? You tried to save the thrifts by letting them run wild, but you never pulled back your deposit guarantee. So depositors flocked to the nuttiest institutions with the highest rates, secure in the knowledge that Uncle Sam would bail them out in the end."

"See, I knew there was something bothering me! That darned thing cost a couple hundred billion."

"But Sam, remember when we looked and found that fraud played only a small role? That's the scary part. Fannie and Freddie are good kids, just doing what comes naturally under the circumstances. But if the markets get spooked, or home prices crash, we could be in a lot of trouble here."

"So I can't cut them loose, but if I let things go on, they might get worse. Help your uncle out here! If I get in trouble, remember, I'm going to ask you for money."

"Sam, the ideal thing would be to cut them off. Let them fend for themselves in the marketplace."

"Tough love, eh?"

"But if you cut them off, their cost of capital will soar, and capital is what they need most. Tough love might bring on the kind of panic we've got to avoid here."

"So what else can I do?"

"Take them back, Sam. They're your kids; it's never too late. You'd still be on the hook, but let's be realistic, you're on the hook anyway — these two are just too big to be allowed to fail. Give both kids the capital they need in exchange for a controlling interest in their businesses. You'd get profits instead of just worries. And when Fannie and Freddie are back on their feet, send them out into the world again — this time, with no guarantees. Meanwhile, you make them an offer they can't refuse."

"What are you saying? That sometimes an uncle has to act like a godfather?"

"Maybe. But just because you're not a don doesn't mean you need to be a dunce."

