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REVIEW & OUTLOOK

Fannie Takes the Hill

Sober analysts have been saying for years that Fannie Mae and Freddie Mac are dangerous. And so they have always seemed to us -- on paper. But this week, when it became clear that the House of Representatives couldn't get even a modest regulatory bill out of committee, the dangers became clear in reality.

Congress, which has ultimate oversight over these two government-sponsored hedge funds, was moved to act after a year in which Fan and Fred experienced some financial and corporate governance blowups. Earnings surprises and accounting scandals have demonstrated that Fan and Fred's current regulator, the Office of Federal Housing Enterprise Oversight, was utterly clueless. Obviously stronger regulatory oversight was needed. The Bush Administration and House Financial Services Committee Member Richard Baker (R., Louisiana) proposed that Fan and Fred be brought under Treasury's authority.

And then the fun began. At first, Fannie Mae took her usual magisterial tone and welcomed stronger regulation. Franklin Raines, Fan's boss, testified that he supported the move to Treasury and intoned that he "looked forward to working with Congress and the Administration to adopt the proposal into law this year."

Behind the scenes, however, Fan has been lobbying her head off against the bill. Fan's chief objection is to a provision moving the power to approve new products from the Department of Housing and Urban Development to Treasury. But in a three-page paper, widely circulated on Capitol Hill, Fan has also raised major objections to other parts of the legislation. Fannie is nothing if not a bossy and effective lobbyist, and various Congress people started caving in, right and left.

No surprise then that the bill was gutted, leaving Treasury with a limp carcass. But Treasury refused to take delivery, arguing that the gutted bill would cripple its ability to provide significant oversight. Quite sensibly, Treasury does not want the responsibility for Fan and Fred without the authority to police them.

The House Financial Services Committee has now postponed a vote indefinitely. And Representative Baker,

who had been working in good faith with Fan and Fred to achieve reform, has pretty much thrown in the towel. After the effort fell apart, he put out a statement blaming them for "obstructionism and mendacity."

Of course it's all very good theater. Fan and Fred need to find a credible regulator soon, so they can assure investors that the political risk that has been weighing on their stock prices is at an end. This goal, however, is complicated by a Catch-22. They need a credible regulator to convince the markets that they aren't risky propositions, but a credible regulator might wring some risk out of their operations and make their returns less attractive to the market. Their too-clever-by-half solution has been to welcome Treasury as a strong regulator but to make sure that Treasury didn't have any real authority.

Fan and Fred have grown fat on the public purse. Their implicit backing from the federal government has subsidized their speedy growth into two of the largest financial institutions in the country. They are now so big and powerful that they can, apparently, dictate the terms of their existence to Congress.

Lack of accountability in any government-connected enterprise is dangerous. And we are now witnessing that danger firsthand in the fight over regulatory authority. What makes this particularly dangerous is that Fan and Fred's current regulatory setup has allowed them to indulge in all sorts of risky practices. And the taxpayers are on the hook for risks that go sour.

Simply put, Fan and Fred enjoy private profits at great public risk. There are two ultimate remedies for this problem. Either privatize or nationalize. We have always favored privatization. But if the pair can defeat any serious public financial accountability, privatization is even less likely to make it through Congress. So perhaps the Members ought to consider calling these fundamentally public entities what they truly are, government protectorates that taxpayers are guaranteeing even if they don't realize it. At least nationalizing Fan and Fred would be more honest about who is really on the hook.

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