Editorial

One Doesn't Mention Rope . . .

In a case of recognition of the dangers of the deepening depression, which is more than rare in Washington, a Federal oversight agency on Feb. 4 asked Congress for receivership authority in case of a near-term failure, because of derivatives losses, of one of the giant Federal mortgage companies, known as Fannie Mae and Freddie Mac. A failure could trigger a "systemic event" threatening the collapse of the housing financial system and a "major disruption" of global financial markets, reported the agency, the Office of Federal Housing Enterprise Oversight (OFHEO)—exactly the conclusion drawn in the June 21, 2002 *EIR* by economic researcher Richard Freeman. OFHEO is supposed to regulate these two government-sponsored enterprises creating the secondary mortgage market—the last financial bubble still left standing as of now.

OFHEO sent a report to the Senate Banking Committee and the House Financial Services Committee, calling on Congress "to allow the agency to close and appoint a receiver to manage the affairs of an insolvent Enterprise," by amending the Federal Housing Enterprises Financial Safety and Soundness Act of 1992. If an Enterprise is not viable, the report states, then OFHEO should have the authority to "place it into receivership and wind down the business of the company."

Major global securities firms and commercial banks that serve as counterparties to the financial derivatives contracts that the Enterprises use, OFHEO warns, would face "serious [credit] exposures" and "solvency or liquidity problems," were one of the Enterprises to fail. More than 30% of commercial banks with assets above $1 billion, OFHEO estimates, hold debt of Fannie or Freddie exceeding 10% of their equity—while one with more than $50 billion in assets (unnamed but unmistakably J.P. Morgan Chase) held Fannie Mae debt in excess of 25% of its equity. "Changes in market conditions in securities or derivatives markets, could impose losses on, and increase the risk of, Fannie Mae and Freddie Mac and other financial institutions that participate in those markets." The interdependencies are so large that, "if either Enterprise became insolvent or il-liquid, investors in its debt and, potentially, its derivatives counterparties could incur losses."

OFHEO considers three "hypothetical" scenarios of deteriorating financial conditions. In the third scenario, Enterprise A suffers large losses and becomes illiquid—resulting in a "systemic event." Investors "are uncertain about whether it will default, about the size of any credit losses they may incur, and about the future liquidity of its debt." As a result, there is widespread selling of the Enterprise's debt as well as a large decline in the market prices of its mortgage-backed securities (MBS).

Under some circumstances, the sell-off becomes a panic; the resulting bank problems "increase the risk of contagious il-liquidity spreading through the banking system, the markets for the obligations of other GSEs, and the financial sector as a whole, adversely affecting the U.S. and the global economy." For example, foreign investors would sell dollar-denominated assets. Mortgage rates would skyrocket, GDP and employment would plummet; pension funds would be hit hard. In this case, OFHEO states, "the Federal government faces difficult choices." Without government action, "the potential decline in aggregate economic activity may be very large."

The potential for an Enterprise failure is much greater now than it was in 1992—when Fannie Mae and Freddie Mac outstanding debt was much lower, and they were just beginning to use financial derivatives. The mortgage corporations had $1.7 trillion in derivatives outstanding at the end of 2001, according to OFHEO Director Armando Falcon, up from $72 billion at the end of 1993. Fannie Mae's debt has increased five-fold, and that of Freddie Mac by 20 times.

Most serious was the result of OFHEO director Falcon's report. He was fired immediately on Feb. 5, and replaced by a total-deregulation advocate who is a friend of former Sen. Phil Gramm and his wife Wendy. If the Bush Administration cannot tolerate listening to warnings of what is coming, that is more dangerous than the collapse threat itself.