Fannie/Freddie Blowout Debate Reaches the Fed

by Richard Freeman and Lothar Komp

In a surprising speech on March 10, St. Louis Federal Reserve Bank President William Poole intensified the debate over whether the overleveraged American housing debt bubble generated by the Fannie Mae and Freddie Mac mortgage corporations, threatens to set off a systemic meltdown in the U.S. financial system. Poole's remarks came one month after the White House had abruptly "shot the messenger" of such a warning, firing the director of the Office of Federal Housing Enterprise Oversight (OFHEO). The St. Louis Fed chief delivered his remarks at a Washington symposium sponsored by OFHEO, which regulates the large Fannie and Freddie "enterprises."An unexpected financial shock at either Fannie Mae or Freddie Mac, which dominate the speculative housing bubble in North America, could inflict tremendous damage on the U.S. financial system and economy, Poole said.

On Feb. 4, OFHEO Director Armando Falcon had released a strong 115-page report, entitled, "Systemic Risk: Fannie Mae, Freddie Mac and the Role of OFHEO," which convincingly presented a worst-case scenario of Fannie and Freddie defaulting on their debt, whence a chain of shocks would create a systemic crisis. On Feb. 5, reflecting the pressure of the top banks dealing in derivatives and housing financial paper, the Bush Administration fired Falcon, and replaced him with Mark Brickell, for 15 years head of derivatives trading at J.P. Morgan Bank, the largest derivatives-trading bank in the world. In 1993-95 Brickell operated a SWAT team at Morgan which mobilized to attempt to crush the effort of Lyndon LaRouche to surgically puncture the deadly derivatives bubble through a tax on transactions (see "Official Axed, Exposed Threat of Housing Bubble Crash," *EIR*, March 14).

At the symposium on March 10, Poole threw oil onto the fire by beginning his speech, "I especially want to commend OFHEO for its [Feb. 4] report." He came back to the report several times in his presentation. Poole warned about "unquantifiable risks," which cannot be "studied and modeled," but have been all too frequent over the last 30 years. "I want to concentrate on the non-quantifiable risks," Poole said. "It helps to make this issue concrete by listing . . . examples. The failure or near failure of Penn Central [railroad], Continental Illinois [bank], Long Term Capital Management [hedge-fund], Enron and WorldCom may not have been complete surprises to knowledgeable insiders, but the shocks were certainly 'news' to market participants, regulators, and the general public. No one predicted the timing of the stock market crash of 1987. . . . It is well known that the great Yale economist Irving Fisher was caught completely off guard by the crash of 1929."

These were strong words from within the Fed; and they got stronger when Poole raised the enormous vulnerability of Fannie Mae and Freddie Mac, which are major liquidity-generating "props" integrated into the U.S. financial system. These huge, now-private corporations are known as government-sponsored enterprises (GSEs), and reportedly are the two most highly indebted companies in the world. Poole stated, "Should either firm be rocked by a mistake or an unforecastable shock, in the absence of robust contingency arrangements, the result could be a crisis in U.S. financial markets that would inflict considerable damange on the housing industry and the U.S. economy. In the case of GSEs, the enormous scale of their liabilities could create a massive problem in the credit markets. If the market value of GSE debt were to fall sharply . . . what would happen? I do not know, and neither does anyone else." But Poole was clear that "a market crisis could become acute in a matter of days, or even hours."

What motivated his remarks, as it did the firing of Falcon and the deployment of Morgan banker Brickell, is that such a crisis at Fannie and Freddie is not a future event but can emerge right now—from either their debt obligations, their large derivatives holdings, or their mortgage-backed securities. In early 2003, Fannie announced that it had suffered a \$4.54 billion derivatives loss in 2002, which cut its 2002 profits in half. And after Poole's remarks, the two GSEs' stock prices each fell 6% on March 10; both are at their lowest level since the Fall of 2000. The OFHEO report had shown that more than half the banks operating in the United States, and several large banks in the world, have a gargantuan exposure to Fannie and Freddie debt. Were these two to fail, many banks would also go under.

Europe Also Prepares for 'Emergency'

In an evidently related crisis development on the same day, European Central banks and regulators prepared for financial emergencies. On March 10, the central banks and financial supervisory agencies of Western and Eastern European countries adopted a "Memorandum of Understanding" (MoU) on "high-level principles" of cooperation in "crisis-management situations." The European Central Bank (ECB) stressed that the MoU "is not a public document." It specifies principles and procedures for cross-border cooperation to ensure the "stability of the financial system" during financial emergencies. The ECB said that "the integration of financial markets and market infrastructures in the EU, the growing number of large and complex financial institutions and the diversification of financial activities" have increased "the likelihood of systemic disturbances affecting more than one Member State," and have possibly also increased "the scope for cross-border contagion."