Comment sent to WSJ Forum ''The Fannie Mae Gang, by Paul A. Gigot''

Dear Sir,

Congratulations for your article and the effort to keep vigilant on this kind of inefficient and costly business behavior from a private and also social viewpoint. The big question is what could be recommended to do now.

What if these GSE´s were already economically bankrupt? Then the issue from a public policy perspective would be who could in the short and long term horizon replace their role -if any efficiency market condition required it- in the mortgage and financial market.

Let us consider the following argument. Without taking into account the net economic value of guarantees GSE´s have given to financial assets, what we do know now is that around 4 to 2 years ago there was a huge incentive to prepayment in mortgages in the US market -GSE´s and non GSE´s mortgage holders equally affected-, at new financial spreads close to 50 basis points, whereas the spread since 1977 between comparable mortgages and US Treasury Bonds -according to Federal Reserve statistics- had been historically close to 150 basis points.

In other words, what had been under a long term perspective efficient mortgage financing at 150 basis points spread, came to a sudden "low cost" production function at 50 basis points spread -recent spreads have reversed and been close to 200 basis points-. The issue is that it was in this bubble period -given massive prepayments- that GSE´s had their present core business essentially defined at limiting conditions. With rising interest rates and more normal spread conditions, only marginal mortgages "well priced" have come into their balance sheets, while the previously bubble determined mortgage stock after massive prepayments remains being -and will remain in the future- an economic drag difficult to overcome.

Standard accounting practices will not recognize this structurally impaired economic condition of GSE´s unless mortgages are sold to third parties. Only time will month by month capture this "grand bargain" business.

However, given historical spreads and an extremely low capital base, these limiting conditions not financially recognized until now could imply that GSE´s are technically bankrupt. If we add to this economic core scenario the net value out of guarantees that seem to have been given under equivalent "bubble conditions", the global GSE equity picture gets only worse.

The basic problem then turns out to be one of solvency, not liquidity. A short term liquidity solution led by the FED and US Treasury would not solve the real long term problem.

If the above mentioned argument is correct, then how do we proceed, having in mind that we face economically bankrupt mortgage holder agencies? It seems to be the case that the US Treasury should calmly proceed with an ad hoc Chapter 7 long term liquidation plan with these GSE´s and that the Federal Reserve should come up with financing to commercial banks to revitalize mortgage markets, but from now on under more credible competitive conditions farther away from days of political and economic bubbles.

Is this solution now possible given recent Congress steps in the other direction? What seems to be happening is that politicians from both sides and government officials are just closing their eyes, sanctioning short term solutions, but preparing long term storms.

Regards,
Manuel Cruzat Valdes
MBA University of Chicago
Santiago, Chile

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