

FINANCIAL TIMES

Fannie and Freddie must not get a free lunch

By Joseph Stiglitz

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Much has been made in recent years of private/public partnerships. The US government is about to embark on another example of such a partnership, in which the private sector takes the profits and the public sector bears the risk. The proposed bail-out of Fannie Mae and Freddie Mac entails the socialisation of risk - with all the adverse implications for moral hazard - from an administration supposedly committed to the free market.

Defenders of the bail-out argue that these institutions are too big to be allowed to fail. If that is the case, the government had a responsibility to regulate them so that they would not fail. No insurance company would provide fire insurance without demanding adequate sprinklers. But that is what we have done with the financial system.

Even if they are too big to fail, they are not too big to be reorganised. In effect, the administration is indeed proposing a form of financial reorganisation, but one that does not meet the basic tenets of what should constitute such a publicly sponsored scheme.

First, it should be fully transparent, with taxpayers knowing the risks they have assumed and how much has been given to the shareholders and bondholders being bailed out.

Second, there should be full accountability. Those who are responsible for the mistakes - management, shareholders and bondholders - should all bear the consequences. Taxpayers should not be asked to pony up a penny while shareholders are being protected.

Finally, taxpayers should be compensated for the risks they face. The greater the risks, the greater the compensation.

All of these principles were violated in the Bear Stearns bail-out. Shareholders walked away with more than \$1bn (£500m), while taxpayers still do not know the size of the risks they bear. But the proposed bail-out of Fannie Mae and Freddie Mac makes that of Bear Stearns look like a model of good governance. The same administration that failed to regulate, then seemed enthusiastic about the Bear Stearns bail-out, is now asking the American people to write a blank cheque.

Everyone agrees that something must be done. We should begin with the core of the problem: that millions of Americans were made loans beyond their ability to pay. We need to help them stay in their homes, including by converting the home mortgage deduction into a cashable tax credit and creating a homeowners' Chapter 11, an expedited

way to restructure their liabilities. This will bring clarity to the capital markets - reducing uncertainty about the size of the hole in Fannie and Freddie balance sheets.

The government should set a limit to the size of the bail-out, at the same time making it clear that, while it will not allow Fannie and Freddie to fail, neither will it extend a blank cheque. There may need to be a drastic reorganisation. There should be a charge for the "credit line" and it should be at a higher than normal rate.

As long as the credit line is extended, no dividends should be paid. At least, say, 25 per cent of any notes, loans or bonds coming due that are not lent again should be set aside in an escrow account, to be paid only after it is clear that taxpayers are not at risk. Any government loans should be cumulative preferred debt: the taxpayers get paid before any other creditors receive a dime. To discourage moral hazard the interest rate should be at a penalty rate and increase with the amount borrowed. Finally, the government should participate in the upside potential as well as the downside risk: for instance, by taking shares or warrants.

We should not be worried about shareholders losing their investments. In earlier years, they were amply rewarded. The management remuneration packages that they approved were designed to encourage excessive risk-taking. They got what they asked for. Nor should we be worried about creditors losing their money. Their lack of supervision fuelled the housing bubble and we are now all paying the price. We should worry about whether there is a supply of liquidity to the housing market, so that those who wish to buy a home can get a loan. This proposal provides the necessary liquidity.

A basic law of economics holds that there is no such thing as a free lunch. Those in the financial market have had a sumptuous feast and the administration is asking the taxpayer to pick up a part of the tab. We should say No.

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