President's Message

William Poole

President and CEO,
Federal Reserve Bank of St. Louis

To Sustain Financial Stability

We're on our way to fixing some of the problems that led to the Enron, WorldCom and Arthur Andersen debacles. An oversight board for corporate auditors has been set up. CEOs must now vouch for their companies' financial statements. The SEC is getting a long-overdue budget increase to help pay for enforcers.

Let's keep the ball rolling.

Other obvious problems that could threaten our nation's financial stability need to be fixed. If we do not address potential weaknesses, we could find ourselves in the same situation as after the S&L catastrophe, wondering why no one stepped in to remedy the all-too-clear problems before it was too late.

Social Security and Medicare are two well-known problems that need attention. For decades, the government has wrangled with ways to balance future costs and revenues. Now, there's a stalemate. Our leaders need to muster the energy to tackle these issues. The longer the wait, the greater will be the pain.

Another problem is the federal tax law that allows corporations to deduct interest paid on debt but not dividends paid. This provision encourages business to issue debt instead of equity to finance expansion and acquisitions. What happens when a company can't pay its debts? If it had issued more stock to finance a purchase or expansion, it would still have the option of reducing or eliminating dividends to save money. The tax law could be changed in a revenue-neutral way to eliminate this problem.

A little-known crisis-in-waiting involves Fannie Mae and Freddie Mac, the mortgage-market giants. These private companies were established by the government and enjoy special advantages as government sponsored enterprises (GSEs). Fannie and Freddie dominate the mortgage industry, either owning or guaranteeing nearly half of all existing home mortgages. The direct and guaranteed debt of all the GSEs taken together is 40 percent larger today than the entire national debt! If Fannie and/or Freddie were to stumble, the entire housing market would be thrown into chaos.

Many who buy Fannie's and Freddie's direct and guaranteed securities mistakenly believe that the federal government guarantees these obligations. Some investors figure Fannie and Freddie enjoy "too big to fail" status. Others simply do not realize that there is no such guarantee; the false impression may arise in part because the government continues to give breaks to Fannie and Freddie that it doesn't give to other lenders—such as a line of credit at the Treasury, very low capital requirements and an exemption from state and local taxes.

There is no indication that Fannie and Freddie are unstable, but to assume that there is no potential for instability is unreasonable. To eliminate this potential —and any expectation of a taxpayer bailout—the federal government might, for starters, withdraw the Treasury's line of credit, which is relatively small and has never been tapped. The government could also raise Fannie's and Freddie's capital requirements so that they are more in line with those of federally regulated banks.

We should act on these and other vulnerabilities now before some event or mistake turns today's potential problems into tomorrow's financial crises. We can deal with these challenges if only we will.

"Fannie and Freddie dominate the mortgage industry, either owning or guaranteeing nearly half of all existing home mortgages. ...If Fannie and/or Freddie were to stumble, the entire housing market would be thrown into chaos."