Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

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For information contact:

Charles W. Calomiris
212-854-8748
Peter J. Wallison
202-862-5864

Statement of the Shadow Financial Regulatory Committee

On

Fannie Mae's Duration Gap

September 23, 2002

Last week Fannie Mae reported that its duration gap – a simple measure of the mismatch between the maturity of its assets and the maturity of its liabilities – fell to negative 14 months. The Office of Federal Housing Enterprise Oversight (OFHEO) stated last Monday that Fannie's interest rate risk exposure was unacceptably high, that it had instructed Fannie Mae to decrease its interest rate risk exposure, and that OFHEO would increase its scrutiny of Fannie Mae.

The increase in the duration gap to negative 14 months appears to imply a significant increase in the risk of loss to Fannie Mae, and thus is a matter of concern to taxpayers in light of the implied guarantee from taxpayers enjoyed by Fannie Mae and other Government Sponsored Enterprises (GSEs). Given Fannie Mae's highly leveraged position, a duration gap of negative 14 months implies that a one-percentage point decline in interest rates could result in about a 40% decline in its capital. Fannie Mae currently holds only slightly more than its minimum required capital. Such a decline in capital could result in Fannie Mae falling substantially below its minimum required capital, which is already low relative to that of any private financial institution.

It is possible that more complicated measures of interest rate risk exposure would imply a lesser exposure to loss. The Committee, however – like investors and taxpayers – is unable accurately to measure the true interest rate risk exposure of the GSEs because they do not disclose detailed information on their derivatives hedging practices.

Fannie Mae's bet that interest rates will rise places taxpayers at risk. It reinforces the Committee's longstanding view (see Statements 131, 134, 159, 164 171, and 178) that these entities should be fully privatized, which would entail the elimination of implicit government guarantees, the reform of corporate governance, and the enhancement of public disclosure. In the meantime, alternative measures – including proposals to prohibit GSE purchases of mortgage backed securities, which are a primary means for undertaking interest rate risk – may be advisable as a means of limiting taxpayers' exposure to risk.