

# Calling time on Fannie and Freddie

*Exploiting their perceived government subsidy, America's huge housing finance "government-sponsored enterprises" have outgrown their original role and the US mortgage market. The solution, argues Bert Ely, is genuine privatisation.*

The US mortgage market is enormous, with over \$5 trillion of residential mortgage debt outstanding, mostly on owner-occupied homes. Major participants in the residential mortgage market are Fannie Mae and Freddie Mac, the two largest of several congressionally chartered "government-sponsored enterprises," or GSEs. Since their privatisation (Fannie in 1968, Freddie in 1989) both have pursued an aggressive growth strategy so that they now rank among America's largest corporations. However, aided by the markets' perception that they enjoy an implicit government guarantee, they now threaten to squeeze out their private sector competitors and, should they face financial difficulty, to fall back on American taxpayers.

## A little history

Until the Great Depression (1930-33), US home mortgages generally had a three to five-year term, with large balloon payments upon maturity. The inability of many homeowners to roll over their mortgages during the Depression, due to job losses and declining home prices, triggered over one million foreclosures. From that experience came a strong political desire to shift housing finance to long-term (20-year), fixed-rate, fully amortising mortgages. As part of Franklin Roosevelt's New Deal, federally chartered savings-and-loans (S&Ls) were authorised to make such mortgages. Fannie's predecessor was chartered as a federal corporation to provide a secondary market for home mortgages.

S&Ls played a key role in financing the

US housing stock after World War II, with Fannie playing a supporting role by buying mortgages that S&Ls could not fund with locally gathered deposits. However, both the S&Ls and Fannie contained a fundamental financial flaw — they borrowed short-term from depositors and, in the case of Fannie, from the financial markets, to fund a long-term asset, the long-term fixed-rate home mortgage. This financial structure made them extremely vulnerable to interest rate spikes, which occurred with increasing severity in the 1960s and 1970s. The great interest rate crisis of 1980-82 rendered the entire S&L industry, as well as Fannie, technically insolvent as the market value of the mortgages they owned plunged. Hundreds of S&Ls actually failed and were either liquidated or sold to other S&Ls in a disaster that eventually cost \$160 billion, measured on a present value basis.

Driven by necessity as much as anything else, Fannie began securitising some of its mortgages in 1981, emulating a practice Freddie started when Congress created it in 1970 as an adjunct of the S&L industry. Together, these GSEs created the market for mortgage-backed securities, or MBS. At the end of 1999, the two GSEs combined had \$1.7 trillion of MBS outstanding. As Fannie and Freddie have grown, the S&L industry has shrunk through the S&L failures of the 1980s and early 1990s, its continuing absorption into the US commercial banking industry, and the growing marketplace dominance of Fannie and Freddie.

Fannie and Freddie argue that their growth, at the expense of their competitors, is justified because they reduce the cost of

home ownership by lowering mortgage interest rates by one-quarter to three-eighths of one percent. However, that claim is dubious given that lower rates are partially, if not fully, capitalised in housing prices. Further, as a 1996 congressional study showed, Fannie and Freddie are not particularly efficient in delivering the housing finance subsidy — they retain for their stockholders and employees approximately one dollar for every two dollars of subsidy they deliver to home owners.

Another CSE, the federal home loan bank system, also was created in the 1930s and now provides \$300 billion of mortgage-backed funding to US banks and S&Ls; a discussion of its activities lies beyond the scope of this article.

### **Fannie and Freddie**

Fannie and Freddie are unique, and increasingly controversial creatures, on the US financial scene. Although both started life in one form (government-owned in the case of Fannie and S&L-owned in the case of Freddie), Congress transformed both of them into stockholder-owned corporations. All other CSEs continue as cooperatives or government-owned. Today, while Fannie is 50 percent larger than Freddie, both are among the larger corporations listed on the New York Stock Exchange, in terms of market capitalization. However, they have retained many CSE attributes that give them a valuable competitive edge over their private-sector competitors.

These attributes include: an implicit government backing of their debt and the MBS they issue (more about this backing later), lines of credit with the US Treasury totalling \$4.5 billion, an exemption from state and local corporate income taxes, a reduced risk-weighting under the Basel risk-based capital standards, an exemption from bank and S&L loan-to-one-borrower limits, and an exemption from SEC registration fees and disclosure requirements. In addition, their debt securities and MBS are eligible for Federal Reserve open-market transactions and are eligible collateral for government bank deposits. Finally, the US President

### **About Fannie and Freddie**

Fannie Mae and Freddie Mac are government-chartered and government-sponsored corporations that have been assigned the statutory mission of improving liquidity in the middle-class residential mortgage market by buying and selling residential mortgages. Fannie Mae and Freddie Mac carry on their functions in two ways by purchasing and holding mortgages originated by mortgage lenders and by placing their guarantee on securities (mortgage-backed securities, or MBSs) that represent an interest in pools of mortgages they have assembled. Whether they are holding mortgage loans or MBSs in their portfolio or are guaranteeing MBSs that are then sold to investors, they have assumed the credit risk associated with those loans. Fannie Mae and Freddie Mac are today among the largest financial institutions in the United States. Many economic studies, including one in 1996 by the Congressional Budget Office (CBO), have concluded that these government-sponsored enterprises (GSEs) receive an implicit government subsidy arising out of the statutory benefits they retained at the time they were "privatised".

appoints up to five members (a minority) of their boards of directors. Little wonder, then, that Fannie and Freddie are correctly perceived by the financial markets as favoured pets of Congress. Fannie and Freddie fight vigorously to maintain their special political status, with Fannie particularly engaged in extremely aggressive lobbying reinforced by substantial political contributions.

### **Terrible twins**

Although Fannie and Freddie have different roots, today they are Siamese twins — vigorously competing against other and yet

marching arm-in-arm to protect their many competitive advantages. Each also is driven to enhance the value of its stock. While they promote themselves in Washington as the facilitators of the great American dream, home ownership, in reality they are incessantly driven to produce for Wall Street 15 percent annual per-share earnings growth in a mortgage market that is growing 7-10 percent annually. Fannie is one of the few companies in the S&P 500 stock index which has delivered double-digit earnings growth for thirteen straight years. Despite their frequent touting of the public mission they supposedly serve, boosting home ownership, no one can truly understand what motivates these GSEs unless one views them from an earnings growth perspective.

### **The risks they pose**

Fannie and Freddie pose two fundamental risks — a financial risk to US taxpayers and a competitive risk to private-sector firms serving the US mortgage market. The financial risk stems from their GSE status as well as their large, and growing size. There is an intense debate over whether or not their debt obligations are implicitly backed by the federal government. The financial markets clearly believe they are, as do the bond ratings agencies, which have awarded Fannie and Freddie AAA status by virtue of being GSEs. On a free-standing basis, they would be much less than AAA-rated due to their high leverage; based on their on-balance-sheet assets alone, they are more twice as leveraged as well-capitalised banks. Consequently, Fannie and Freddie debt yields less than high-grade corporate debt. Whenever their implicit backing is questioned, yields on their debt jump. That was the effect when US Treasury Undersecretary Gary Gensler stated in March that Fannie and Freddie debt was not government-backed.

History reinforces the market's belief that should Fannie or Freddie experience financial difficulty, such as problems in rolling over their debt, Congress will unequivocally protect their creditors against any loss. In January 1988, Congress bailed out another

GSE, the Farm Credit System (FCS), by extending it a \$4 billion line of credit. The FCS, a major provider of US agricultural credit, had been rendered nearly insolvent by the collapse of US farmland values during the early and mid-1980s.

In 1996, Congress ensured that there would be no default on bonds issued in the late 1980s by another GSE, the Financing Corporation. Those bonds funded the initial phase in cleaning up the S&L mess. Initially, the interest on those bonds was to be paid by the remaining S&Ls. However, a shrinking S&L industry raised the spectre of default. Congress solved that problem by extending the interest burden to banks.

Fannie and Freddie are implicitly backed by US taxpayers for another reason — they are simply too-big-to-fail (TBTF). Further, if one is in trouble, the other one will surely be seen as troubled also, which is why they should be viewed as one, from a TBTF perspective. At the end of 1999, their combined on-balance-sheet debt of \$908 billion was approximately seven times the debt of Long Term Capital Management when it was saved in 1998 in a rescue engineered by the New York Fed. While there are numerous TBTF banks in the US, in 1991 Congress enacted what it called the "systemic risk" exception which provides that any cost incurred in protecting depositors and creditors in an insolvent bank deemed TBTF by the US Treasury Secretary will be assessed on banks, not taxpayers generally. No similar provision shields taxpayers from protecting Fannie and Freddie's creditors against loss, yet another competitive advantage they enjoy.

### **Their competitive threat**

Driven by their earnings growth imperative, Fannie and Freddie have become like two giant gorillas growing faster than their cage. At the end of 1999, they had assumed almost one-quarter of the interest rate risk posed by the types of mortgages they presently are authorised to buy and over half of the credit risk these mortgages pose. If the growth Fannie and Freddie project occurs, by the end of 2003, they will have

assumed over one-third of this interest rate risk and over three-fifths of the credit risk.

Fannie and Freddie's interest rate risk is growing faster than their credit risk as they increasingly hold mortgages they buy instead of securitising them. They also are buying back a growing amount of the MBS they previously issued. Instead of merely earning a credit guarantee fee on the mortgages they securitise, Fannie and Freddie feel compelled to capture the higher net interest income earned on mortgages and MBS they hold in portfolio in order to grow their earnings per share faster than the overall mortgage market is growing.

As they gain mortgage market share, Fannie and Freddie effectively are crowding out their private-sector, taxpaying competitors. However, as these competitors overcome their political fear of Fannie and Freddie, they are complaining with increasing ferocity to Congress, which is why the political risk to Fannie and Freddie's earnings growth rates is rapidly rising. Not surprisingly, the stock market has responded by holding Fannie and Freddie's share prices below recent highs despite steadily higher earnings.

These Siamese twins are increasingly constrained by limits on the types of mortgages they can buy or other activities in which they can engage. In particular, they are barred from buying "jumbo" or large mortgages, presently mortgages exceeding \$252,700. Also, they cannot purchase mortgages on non-residential commercial property, such as office and factory buildings. Equally important, they cannot originate mortgages by dealing directly with the homebuyer. Instead, they are restricted to buying mortgages from banks, S&Ls, and other companies that originate mortgages. Although Fannie and Freddie are trying to lessen the impact of these restraints through "mission creep," such as buying second mortgages and the sub-prime mortgages they traditionally shunned, they are rapidly running out of growing room.

While Fannie and Freddie would like to shed some of their product shackles, something they publicly deny, they face a political dilemma. In America it is far easier to block

than pass legislation. Hence, while Fannie and Freddie have had a relatively easy time, albeit an expensive one, defeating efforts to restrain their growth, they soon will face the much tougher task of legislatively easing their present restraints.

### A final resolution

Two political options exist for resolving the Fannie/Freddie problem — containment or genuine privatisation. Fannie and Freddie will strongly fight any effort to limit their market share growth because it would slow their earnings growth rate. That slowing would trigger a drop in Fannie and Freddie's share prices, severely impacting their very generous executive compensation packages which are heavily reliant on stock options and earnings-related bonuses. Hence, while containment is seen by many as the easier way politically to lessen the escalating conflict between Fannie and Freddie and their competitors, that is unacceptable to either GSE.

As radical as it may seem today, full privatisation of Fannie and Freddie is the only practical solution to their growing systemic and competitive risks. This has a precedent - the recent privatisation of the Student Loan Marketing Corporation (Sallie Mae). Sallie actually opted for privatisation as congressional enactments lessened the desirability of its GSE status. If Congress denies Fannie and Freddie the growing room they need to appease Wall Street, soon they may find privatisation an increasingly enticing option.



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