

The *GSE* REPORT

Special Supplement

*American Enterprise Institute (AEI) Seminar
Fannie Mae and Freddie Mac: Public Purposes and Private
Interests
March 24, 1999*

The American Enterprise Institute (AEI) held the first in a series of seminars on the GSEs on March 24 entitled “Fannie Mae and Freddie Mac: Public Purposes and Private Interests.” The conference focused on the four issues:

- (1) How do Fannie and Freddie balance their profit-making objectives with their public purposes?;
- (2) If the GSEs indeed operate with no cost to the government, should more GSEs be created to achieve other public goals?;
- (3) If not costless, how much of their government subsidies flows to their private shareholders and management?; and
- (4) If they are subsidized, to what extent should they be permitted to compete with private-sector entities that have no subsidy? Besides discussing these issues, the seminar was also used to set an agenda for further studies about the GSEs. The following is a summary of the oral remarks and the papers that were presented at the conference.

Highlights

Near Unanimous Agreement at the Conference that –

- **Fannie and Freddie are the beneficiaries of an implied government guarantee, and**
- **that the government would not allow them to fail.**

- Peter Wallison, Resident Fellow at AEI, noted that that Fannie and Freddie have an implicit US government guarantee that has convinced the capital markets that the Federal Government stands behind their securities.
- John Weicher, Hudson Institute, noted that when Fannie and Freddie were “privatized” it must have been attractive for GSE management because, “It offered the opportunity to take advantage of an implicit guarantee from the federal government and, thereby, finance mortgage market activities at costs that competitors could not match. Agency status may have seemed like a license to make large amounts of money.”
- Adolfo Marzol, Fannie Mae, said that an implied government guarantee backing Fannie and Freddie was a “myth.” He stated that, “Every one of our debt securities clearly states, in plain English, that it is not backed by the full faith and credit of the government, and our investors know it.” Marzol stated that there had to be more than any implicit government guarantee to account for the success of Fannie Mae. “We have lower spreads than the banks. We’re profitable because of our efficiencies and constant lowering of costs. Since the 1980s we’ve fundamentally re-engineered our business.” (As noted at the Conference, however, Fannie Mae has, in the past, admitted that investors and rating agencies view their obligations as having an implied government guarantee.)
- Vern McKinley, policy contributor to CATO, noted that those who argued at the AEI conference that there was no implied government backing of Fannie and Freddie, “Coincidentally enough, all work within the ‘hallowed halls’ of either Fannie or Freddie.” Every other AEI panelist and the privatization reports published by Treasury, HUD, GAO, and CBO, recognize the existence of the implied government guarantee, which results in a lower cost of funding for Fannie and Freddie.
- Francis Cavanaugh, former Economist at the Treasury Department, noted that securities issued by Fannie and Freddie must legally contain a disclaimer that they are not implicitly guaranteed by the government, but investors generally believe that they are implicitly guaranteed and that Congress would never allow them to fail. Cavanaugh pointed out that a 1998 letter to the OCC by Fannie’s own Deputy General Counsel, Anthony Marra, noted that Fannie’s standard domestic obligations were viewed by the rating agencies and investors as having implied government backing. Without the implied government guarantee, the GSEs’ debt ratings would have varied substantially over the past 20 years.
- Robert Seiler, Jr., Congressional Budget Office, noted that investors infer an implicit federal guarantee of Fannie and Freddie obligations which “reduces the interest rates that investors require on the GSEs’ obligations and means that they are not subject to as much market discipline of their risk-taking as would be imposed in the absence of federal credit support. The perception of an implicit federal guarantee also allows Fannie Mae and Freddie Mac to issue larger volumes of securities, sell a larger proportion of debt that is callable, and enter into larger volumes of hedging transactions, more than private firms with comparable levels of capital.” (Seiler’s remarks were his personal remarks, not those of the CBO)
- Robert Van Order, an Economist with Freddie Mac, appeared to have accepted that Fannie and Freddie have an implied government guarantee. He noted that Fannie and Freddie borrow at lower rates than they would if they had the same portfolio but a different (nondepository) charter. Van Order stated that insured depository institutions were “GSEs” because the federal government chartered them. Both have missions, both have implied guarantee (deposit insurance) and both are regulated for safety and soundness. (Van Order’s comments were his personal comments, not those of Freddie Mac’s)

Are Fannie and Freddie actually “Private” Companies?

- Most conference participants shared the view that Fannie and Freddie are not truly “private” companies. Nearly all conferees contended that depository institutions pay money directly into a fund for this insurance benefit, and suggested that if Fannie and Freddie believe they are like depository institutions, then they should pay directly for their government provided benefits as do depository institutions.
- Andrew Marzol stated: “It’s too late to debate privatizing Fannie Mae.” “We’re already private, with \$70 billion in private capital. We have a government charter, but so does Norwest and Chase Manhattan.”
- Robert Van Order presented a “dueling charter” theory, arguing that banks were like GSEs and Freddie is at least as “private” as banks for the following reasons: (1) Both banks and GSEs have a government guarantee (Freddie – implied; banks - deposit insurance); (2) Both banks and GSEs have a federal charter; (3) Both banks and GSEs are regulated for safety and soundness; (4) Both banks and GSEs have mission requirements.
- Vern McKinley disputed Marzol’s statement. McKinley countered by pointing out that Marzol’s definition of privatization is narrow and noted that if the discussion of privatizing Fannie and Freddie was such a “fruitless exercise,” then why would Congress have passed a law in 1992 to direct the Treasury, GAO, HUD and CBO to prepare studies on the impact of privatizing the GSEs? The 1992 legislation defined privatization as “repealing the Federal charters of [Fannie Mae and Freddie Mac], eliminating any Federal sponsorship of the enterprises, and allowing the enterprises to continue to operate as fully private entities.” McKinley noted that Marzol’s comparison of Fannie and Freddie to national banks is a good comparison but he reminded Marzol that there are differences between national banks and Fannie and Freddie. National banks do have government charters and are backed by the credit standing of the federal government in the form of government deposit insurance. However, he noted that while Fannie has a government charter and is implicitly backed by the federal government – there is a major difference – Fannie doesn’t pay for its government sponsorship, which gives them a competitive advantage over those institutions that pay for their government backing. “If Mr. Marzol’s analogy to national banks is meant as an admission that Fannie Mae should be charged a ‘capitalization fee’ to recover some of the benefits retained by the government sponsored enterprises (GSEs), then progress has been made today.”
- Lawrence White, New York University, asked if there was really anybody who would say with a straight face that Fannie and Freddie are private. In his opinion, to say that Fannie and Freddie were “private” companies like Microsoft is not serving a purpose to advance the discussion.
- Robert Seiler, Jr. stated that unlike the GSEs’ government benefits, there is a question that depository institutions cannot shift their government subsidy as Fannie and Freddie are able to do. (Seiler’s remarks were his personal comments, not those of the CBO.)

Editorial Note:

By the “dueling charters” line of reasoning, the GSEs are attempting to advance an argument that a level playing field exists between insured depository institutions and the GSEs. The GSEs’ definition of a level playing field is lopsided.

- First, banks and GSEs do not operate in the same competitive environments. A new bank receives a federal charter with a satisfactory application and adequate capital. A GSE charter

requires an Act of Congress; consequently the GSEs have little competition in their primary markets.

- Second, the economic benefit of federal deposit insurance flows, for the most part, to depositors versus depositories. The GSEs, on the other hand, derive billions of dollars of benefits annually from their implied federal guarantee. Insured depository institutions pay for their deposit insurance, which benefits their customers. Further, the federal benefit of deposit insurance protects the “depositors” (i.e. the consumers) should a bank fail, and not the institution, while the government granted benefits provided to Fannie and Freddie protect the institution and shareholders of these entities. The GSEs do not pay for their implied federal guarantee, and it generously benefits shareholders as well as borrowers.
- Third, capital standards, even when adjusted for asset differences, are hardly equivalent. The GSEs are permitted to operate at capital levels that would be considered unsound by the regulators who oversee depository institutions. Finally, only the GSEs are granted a variety of exemptions that have substantial economic benefit, from not paying local taxes to avoiding the cost of SEC reporting and registration. There are also limitations on the number of GSEs that can be chartered but any number of banks can be chartered as long as they meet the regulatory requirements.

There are major differences between the GSEs and depository institutions that would make Fannie and Freddie’s newest argument appear moot, if not unsound.

Fannie and Freddie –

- **Only marginally contribute to promoting homeownership;**
- **Have mixed results at providing credit during recessions or stressful economic periods;**
- **In the past, significantly assisted in alleviating regional disparities of mortgage credit; and are**
- **Currently not particularly active at increasing the supply of mortgage credit to “underserved” groups.**
- John Weicher argued that Fannie and Freddie’s contribution to promoting homeownership was marginal; their contribution to providing credit during recessions or stressful periods was mixed; their contribution to alleviating regional disparities of credit was significant; and they were not particularly active in serving low- and moderate-income families and geographically targeted areas. Weicher further stated that Fannie and Freddie have “tried to minimize the bite of the various low- and moderate-income housing requirements,” noting that “the 1978 house value/income criterion, which proved to be an ineffective way of reaching lower-income families was suggested by Fannie Mae.”

Are Fannie and Freddie violating their charters by originating mortgages?

- Andrew Marzol reiterated that Fannie had no intention of originating mortgages.
- Vern McKinley noted that Fannie and Freddie’s technology, including Fannie and Freddie’s automated underwriting systems and their direct marketing to consumers, raised questions about whether Fannie and Freddie are violating their charters by originating mortgages. It all depends on your definition of “originate.” McKinley stated that, “originate could be narrowly defined to simply include the funding of a loan. It could also be defined much more broadly to also include steps involved in the underwriting process.”

Previous government studies estimating the value of the GSEs' subsidies at \$6.9 billion may have been underestimated.

- Though not speaking on behalf of the CBO, Robert Seiler, Jr. noted that the methods used by CBO and Treasury in their 1996 studies actually *understated* the value of the GSEs' federal subsidies because they assume that government sponsorship only benefits the enterprises by lowering their borrowing costs. The 1996 CBO study estimated that in 1995 Fannie and Freddie received \$6.9 billion in total federal subsidies, while the Treasury study estimated the total subsidies at between \$4.6 billion and \$6.9 billion. Both the CBO and Treasury privatization reports estimated that Fannie and Freddie retain about one-third of their federal subsidies.

What are Some of the Activities that Fannie and Freddie May Be Undertaking that Push Beyond the Narrow Mission of Providing a Secondary Market for Mortgages?

- John Weicher stated that since the GSEs were "privatized," the GSEs have used their agency status to move into new markets to maximize profit by taking advantage of their implicit federal guarantees. He said, "They are behaving as private firms would be expected to behave, but their agency status gives them opportunities not enjoyed by other firms."
- Vern McKinley noted that "The GSEs will continue to go into new areas in search of profitability because their secondary market business has matured . . . Fannie Mae and Freddie Mac want to maintain double-digit earnings growth, so they are going into new areas...because they can. Their charters are very broad." McKinley listed four areas of expansion: (1) non-mortgage investments, (2) subprime mortgages, (3) technology, and (4) insurance. The GSEs dominate the secondary market, and this "is almost entirely attributable to the special benefits that derive from their GSE status." He further noted that, "If the benefits of GSE status allow Fannie Mae and Freddie Mac to dominate the secondary mortgage market, then it is logical that they should try to dominate other markets that they are not clearly proscribed from entering by their charter." McKinley found no evidence of a market failure that would justify Fannie and Freddie's expansion into the mortgage insurance business, noting that the mortgage insurance industry is a well-established and competitive market. According to McKinley, there is no specific grant of authority in the GSEs' charter to enter into insurance activities. Freddie Mac attempted to solve this problem with a legislative amendment (ultimately failed) that would have revised its charter to allow it to self insure the loans it purchases, thereby taking the risk currently borne by a highly competitive mortgage insurance industry. McKinley noted that Fannie's involvement in mortgage insurance is termed by Fannie as an "alternative risk dispersion technique." McKinley wrote, "Whether this is insurance, a power not explicitly granted to the GSEs, or whether it is a mechanism of alternative risk dispersion techniques, as Fannie Mae has called it, is open to interpretation."
- Adolfo Marzol called concerns about Fannie's expansion into non-mortgage investments, subprime mortgages, technology and insurance as "snipe huntings" (non-existent issues of concern). The GSEs feel that these investments are crucial to their mission. Expansion into the subprime market is just another area where Fannie is meeting its charter. Expansion into technology is lowering costs for Fannie, lenders, and consumers. Expansion into mortgage insurance was likened to auto insurance: Fannie isn't trying to enter the mortgage insurance business, it's just trying to keep the costs lower by reducing their coverage, much like shopping around for lower priced car insurance.
- Lawrence White noted that the GSEs have recently been expanding, and he differentiated between "horizontal" and "vertical" expansion, with the former being closely related to the

original product, and the latter as a complimentary product that may be an input to or a downstream component of the original product. In the area of non-mortgage investments, to the extent that the investments add to liquidity, he considered it a vertical expansion and within the scope of the charters, however, to the extent that was considered an additional investment area for revenues/profits, he considered it a horizontal expansion and outside the scope of the charters. In his oral remarks, he asked “How you could tell this apart?” and then answered that “You can’t tell.” The GSEs’ expansion into subprime mortgages should be considered a horizontal expansion because it is an additional investment area and should be considered within the scope of their charters. Automated underwriting systems are vertical expansions that fall within the scope of the GSEs’ charters as they reduce the costs of underwriting. Mortgage insurance is a vertical expansion that will reduce the costs of the mortgage package, and is therefore within the scope of the charter. White noted, “expansions that reduce marginal costs are more likely to be passed through (at least partially) to home buyers; expansions that just add to revenues are more likely to just add profits and to benefit shareholders.” He doesn’t believe the proper definition for the GSEs’ charters is a “box” because the “box” is “porous” and there is lots of room for vertical and economic growth.

Tremendous Increase in GSE Borrowing has had a Significant Impact on Increasing Treasury’s Borrowing Costs

- Francis Cavanaugh noted that there is a “new era” where there was a shrinking role for Treasury debt and an expanding one for the securities of the GSEs. GSE debt has “exploded” relative to the total US economy. Cavanaugh observed that GSE borrowing clearly has a significant impact on increasing Treasury borrowing costs and the implicit government guarantee puts the government at risk to cover principal and interest payments on GSE debt. He noted a 1996 report to Congress by the Treasury Department stating: “...since GSE securities serve as substitutes for Treasury securities for many purposes, and since they benefit from investors’ perception that the federal government implicitly stands behind them, those securities compete directly with Treasury securities in the government securities markets. The considerable and growing supply of GSE securities (relative to the supply of Treasury securities) tends to lower prices in the government securities market and thereby increase the Treasury’s borrowing costs.”
- Robert Van Order was of the view that there was no need to worry about raising Treasury borrowing a few points. (Van Order’s remarks were his personal remarks and not those of Freddie Mac.)

Suggestions for Reform

- Vern McKinley concluded that the GSEs are correct in their criticism that HUD and OFHEO should not micromanage the investments of Fannie and Freddie and unnecessarily limit their activities. At the same time, the private mortgage industry is correct in claiming that the GSEs have an unfair competitive advantage. Congress is the place to settle these problems. Congress should review the GSEs’ activities to determine if there is evidence of market failure either for expanded activities or the core GSE activities. Ultimately, full privatization of the GSEs is the answer. McKinley’s advice to those in the mortgage industry was for the industry to refrain from legislative attempts to revise the GSEs’ charters. “You can learn a lesson from the Republicans during the impeachment of the president,” he said. “Instead of killing the king, they just attempted to strike him and missed,” he said. “It’s best to kill the GSEs than to strike them to keep them in the box. I think the GSEs will fight as hard against the tweaking of their charters as they would against full privatization.”

- Robert Seiler, Jr. recommended the following research avenues that could help improve and refine the estimates of federal subsidies to Fannie and Freddie:
 - (1) Size of the GSEs' cost advantage in issuing debt and equity;
 - (2) The relationship between the size of single family fixed-rate mortgages and the interest rates on those loans;
 - (3) Whether the GSEs are earning above-normal returns in setting their guarantee fees;
 - (4) Effect of the GSEs' purchases of mortgage securities on the interest rates on conforming fixed-rate mortgages. (Seiler's remarks were his personal remarks and not those of the CBO.)

- Francis Cavanaugh noted that federal subsidies, including the Fannie and Freddie's direct credit line to Treasury, might have been justified 30 years ago when Fannie and Freddie began to establish themselves in the market as wholly privately owned companies. Since the companies are now well established, they should be able to stand on their own feet without federal subsidies. "A gradual phasing out of the subsidies might reveal any institutional weaknesses and allow time to correct them to avoid serious disruptions in GSE operations," Cavanaugh stated. Short of limiting GSE activities, Cavanaugh suggested three ways Congress could reduce the net costs to Treasury of GSE borrowing:
 - (1) Reduce subsidies to GSEs, including their Treasury lines of credit, thus reducing GSE competition with Treasury;
 - (2) Assess a fee on the GSEs for federal benefits including the Treasury line of credit; or
 - (3) Provide an explicit full government guarantee of GSE issues, which would reduce further their borrowing costs, and charging a guarantee fee to offset the estimated costs to Treasury.

Cavanaugh explained that "if Congress wishes to continue the favored GSE status for Fannie Mae and Freddie Mac, guarantee fees equal to the estimated amount of subsidies retained by GSEs would probably cover both the estimated increase in Treasury borrowing costs and the cost of the GSE default risk. If Congress wishes to cover the total opportunity cost to the government of the free guarantees too, then the guarantee fee should equal the estimated total funding advantage, or subsidy, to the GSEs. This latter approach would also level the playing field for private competitors with the GSEs." Congress should request that the CBO and the Administration determine the estimates of federal subsidies.

- Robert Van Order stated that he did not see the need for other regulations and only advocated regulation for safety and soundness. "Mission issues" are "interesting and controversial" but were "beyond the scope" of his comments. Van Order stated, "Given the mission stuff and the charter, I think the main focus of regulation should be on safety and soundness with an eye on keeping embedded options under control and equal access charters. That is not likely to be easy. Once this is done regulation can focus on mission issues in a cost benefit sort of way." (Van Order's comments were his personal comments and were not necessarily those of Freddie Mac.)

Introduction

Speaker: Peter Wallison, Resident Fellow at AEI

- Fannie and Freddie argue that their activities do not cost taxpayers any money. However, Wallison points out that this isn't the same thing as saying that they don't receive subsidies from the federal government. Wallison notes that Fannie and Freddie receive a number of intangible benefits from the Federal Government, including an implicit US government guarantee, which have convinced the capital markets that the Federal Government stands behind their securities
- Fannie and Freddie claim that they reduce mortgage rates and increase rates of homeownership, especially for low- to moderate-income homebuyers, without any cost to taxpayers. However, the homeownership rates have not increased substantially since the early 1960s. While at the same time, Wallison noted that Fannie tells the investment community that "We're one of only eight companies in the Standard & Poor's 500 that has produced double digit increases in operating earnings per common share for the past 11 years."
- Fannie and Freddie have two different audiences with two roles they must play: the investment community (which is interested in their profitability) and the political community (which is interested in what they are doing for housing). As Wallison points out, "It is hard to see how Fannie and Freddie can be doing *both* – maximizing profits on the one hand and maximizing interest rate reductions for homeowners on the other." Wallison posed the following question: "If the government wants to pursue a policy of lowering and stabilizing interest rates in the home mortgage market, why do it through two companies that seem to use a portion of their government subsidies for the benefit of their investors rather than the homeowners these subsidies were intended to benefit?" Ultimately, Wallison inquired as to "whether it makes sense for the government to create companies that are private in structure but receive subsidies with which they are expected to perform public functions. In an era when even public utilities – once thought of as natural monopolies – are being required to compete with one another, and when whole government agencies have been eliminated for which they are responsible, is there a justification for companies that have the conflicting goals of maximizing both their profits and the financial support they pass along to the mortgage market?"
- Wallison noted that "we are dealing here with more than the ordinarily profitable company. Fannie Mae is among the most profitable public companies in the United States." Wallison noted that "there is a great deal of controversy concerning the expansion of Fannie and Freddie into new areas of activity. One of the questions raised by this controversy is whether Fannie and Freddie are being driven to this expansion by the need to maintain their high level of profitability as they exhaust the opportunities within their traditional markets."

(Source for Portions of this Section: *Real Estate Finance Today*, Marshall Taylor, 3/26/99)

Full Summary

Panel I

From Public Agencies to Private Companies

The development of the housing GSEs: Why were they created and have they accomplished their purposes?

Speaker: John Weicher, Hudson Institute

“The Development of the Housing GSEs”

John Weicher, Hudson Institute

- Weicher, a senior fellow of the Hudson Institute, divided his paper into two parts – first, a history of Fannie and Freddie -- and the second, a description of how the GSEs are serving a public purpose. Weicher explained that Fannie and Freddie can only be understood in historical context; he traced the companies from their inceptions in 1934 and 1970, respectively, to the present day. The second part of the paper outlined the basic public purposes of Fannie and Freddie and their contributions outlined as follows:
 - (1) **promoting homeownership**; - Weicher reported that the contribution of Fannie and Freddie in promoting homeownership is marginal. The most important determinants of homeownership are household income and demographic circumstances. The contribution of the GSEs is hard to disentangle from these broad, basic factors.
 - (2) **demonstrate the feasibility of a secondary market to private financial institutions**; - Weicher noted that in the 1970s and 1980s the GSEs were the leaders in securitization but he is not clear whether the GSEs are likely to have further demonstration effects in this area since there is currently a market for fully private securities, backed by “jumbo” mortgages above the conforming loan limit.
 - (3) **assist in countercyclical market support**; Weicher reported that Fannie and Freddie’s evidence in this area is mixed. He measured countercyclicality as whether Fannie or Freddie provided more mortgage support in recessions or other stressful periods than in periods of credit availability. Weicher wrote that “Fannie Mae may have behaved in a modestly countercyclical manner throughout the late 1970s, but not during the double recessions of 1980 and 1981-82. Freddie Mac ... did not behave in a particularly countercyclical manner over that period.”
 - (4) **assist in spatial allocation of credit**; - Weicher noted one of the purposes for Fannie was to reduce regional differences in mortgage rates after World War II. The GSEs contributed significantly to the elimination of regional interest rate spreads by the mid-1980s through mortgage-backed securities, “but other changes in the mortgage market pushed in the same direction.” (Note: Risk-based pricing will reimpose regional disparities.)
 - (5) **increase supply of mortgage credit to “underserved” groups**. – Weicher observed that the “GSEs are not particularly active in serving low- and moderate-income families and geographically targeted areas. Their market share is about 20 to 25 percent of mortgages

in the various categories for which goals have been established. Interestingly, the loans they buy in these categories are not particularly low down payment loans, which suggests that they are not particularly serving the family on the margin of homeownership.”

- Weicher concluded his paper by analyzing several consequences of Fannie and Freddie’s “privatizations.” Weicher wrote that “From the standpoint of GSE management, privatization must usually have looked attractive. It offered the opportunity to take advantage of an implicit guarantee from the federal government, and thereby to finance mortgage market activities at cost that competitors could not match. Agency status may have seemed like a license to make large amounts of money” Weicher identified the following areas that were effected by Fannie and Freddie’s privatization:
 - **Portfolio Lending** - The biggest consequence since Fannie and Freddie’s privatization is the considerable amount of portfolio lending that both GSEs do today. Before the 1980s, portfolio lending was not viewed as profitable; however, the cost advantage between the GSEs and the private sector made the difference between profit and loss in this area. Weicher explained that one of the reasons for the GSEs’ success as the largest portfolio lenders today versus the S&Ls’ unsuccessful track record as portfolio lenders two decades ago, are the GSEs’ federally subsidized cost of funds.
 - **Affordable Housing** - Another consequence of privatization is that Fannie and Freddie have “tried to minimize the bite of the various low- and moderate-income housing requirements.” Weicher noted that “the 1978 house value/income criterion, which proved to be an ineffective way of reaching lower-income families was suggested by Fannie Mae.”
 - **New Products** - A further consequence from the privatization of the GSEs is that that the GSEs have used their agency status to move into new markets to maximize profit by taking advantage of their implicit federal guarantees. “They are behaving as private firms would be expected to behave, but their agency status gives them opportunities not enjoyed by other private firms.”

Panel II

Defining the Mission

*What are the housing GSEs doing today, and
how do these activities serve their public purposes?*

Speakers:

Vern McKinley, Policy Contributor to Cato Institute
Lawrence White, New York University
Adolfo Marzol, Fannie Mae

“Expanding the Empires: What are the Housing GSEs Doing Today, and How Do These Activities Serve Their Public Purpose?”

Vern McKinley

- McKinley began his remarks by noting that the GSEs view their charter as a broad mandate to do anything that increases mortgage credit while the mortgage industry believes the GSEs have a limited charter and should be “kept in a box.” In his paper, McKinley summarized Fannie and Freddie’s charters, then reviewed many of the current activities of Fannie and Freddie that are pushing beyond the narrow mission of providing a secondary market for high quality mortgages, and provided suggestions on resolving some of the issues of GSE charter oversight.

Fannie & Freddie’s Charters

- Summarizing Fannie and Freddie’s “charters,” McKinley noted that the charters are not as broad as the GSEs like to see them, nor as narrow as some in the mortgage industry would like to believe. McKinley used two tables -- the first to illustrate the investment-related charter restrictions placed on the GSEs. The second table listed investment-related charter powers expressly given to the GSEs. McKinley notes that “This is an application of the canon of statutory construction – ‘inclusion of one thing indicates exclusion of the other.’ By granting specific powers to the GSEs, Congress, by implication, may be signaling that powers are limited to those specified in the legislative charter.”

Expansion Activities of Fannie and Freddie

- “The GSEs will continue to go into new areas in search of profitability because their main secondary market business has matured,” McKinley stated. “Fannie Mae and Freddie Mac want to maintain double-digit earnings growth, so they are going into new areas...because they can. Their charters are very broad” McKinley listed the four expansion areas as the following: (1) non-mortgage investments, (2) subprime mortgages, (3) technology, and (4) insurance. He noted that the GSEs have dominated the secondary market and their dominance “is almost entirely attributable to the special benefits that derive from GSE status.” He further noted that, “If the benefits of GSE status allow Fannie Mae and Freddie Mac to dominate the secondary mortgage market, then it is logical that they should try to dominate other markets that they are not clearly proscribed from entering by their charter.”

Non-Mortgage Investments

- McKinley defined non-mortgage investments as the act of borrowing at preferred rates accorded to the GSEs because of their special status and investing in non-mortgage investments. The GAO found that Fannie now invests around 15% of its on-balance sheet assets in non-mortgage investments, and Freddie invests 9%. The

GSEs claim that these investments are necessary for liquidity purposes to meet their mission. McKinley noted, however, that shareholders of the GSEs clearly benefit from the profit derived from these investments. Many have called these investments arbitrage activities; McKinley doesn't believe the investments meet the classic definition of arbitrage and refers to them instead as "financial intermediation." McKinley commented that these investments probably pose little credit risk, but they are not zero risk. In the end, McKinley deemed non-mortgage investments as probably not a violation of the Fannie and Freddie charters, but noted that there was no real proof of a market failure in the area of "financial intermediation" that would warrant the necessity for the entrance of the GSEs in this area.

Subprime Mortgages

- In the subprime field, the GSEs have been moving into the area of subprime mortgages, with Freddie moving more aggressively into this market than Fannie. It is estimated that Fannie and Freddie will issue between \$10 - \$20 billion of nonconforming subprime securities in 1999. McKinley noted, however, this market is already established and competitive, and that there is no market failure in the subprime market that would justify the entrance of the GSEs. There is some question as to whether the GSEs' charters allow entry into the subprime area since Freddie's operations are required by its charter to be confined to mortgages "of such quality, type, and class as to meet generally the purchase standards imposed by private institutional mortgage investors," and Freddie has had to heavily credit enhance these subprime deals to securitize them. But, McKinley noted, the burden of proof to challenge the GSEs would fall to the challenging party, as Congress explicitly delegated the GSEs the power to determine the "quality, type and class" of their purchases, and hence it would be hard to determine whether the GSEs were overstepping their charters.

Technology

- McKinley also touched on the GSEs' entrance into the automated underwriting systems, and their virtual control over this market, which many view as entrance into mortgage origination (expressly prohibited in the GSEs' charters). He noted that the GSEs' technology has flip-flopped the relationship of the GSEs and the lenders to consumers. For many years, a consumer went to a primary mortgage market lender and the GSEs were an afterthought, but now consumers can go directly to the GSE's automated underwriting systems and the lender is the afterthought. He cited the iqualify.com and openclose.com websites that borrowers go directly to the GSEs' automated underwriting systems and noted that "It is only after the AUS [GSEs' automated underwriting systems] has approved a borrower's application that a primary lender is then sought out to fund the loan." Whether or not you believe that the GSEs' technology ventures are violating the restrictions in their charters against origination depends on your definition of what "originate" is. "Originate could be narrowly defined to simply include the funding of a loan. It could also be defined much more broadly to also include steps involved in the underwriting process." McKinley further noted that there was little evidence that any type of market failure is occurring that would cause the GSEs to enter into the loan origination market.

Insurance

- McKinley found no evidence of a market failure that would justify Fannie and Freddie's expansion into the mortgage insurance business over the past few years, noting that the mortgage insurance industry is a well-established and competitive market. According to McKinley, there is no specific grant of authority in the GSEs' charter to enter into insurance activities. Freddie Mac, to solve this problem, attempted to enter the industry with a legislative amendment (ultimately failed) that would have revised its charter to allow it to enter the mortgage insurance industry by self-insuring loans it purchases, thereby assuming the risk currently borne by private mortgage insurers. McKinley noted that Freddie ultimately failed in its attempt to revise its charter but Freddie's actions resulted in a "Trifecta," angering Congress, the industry, and the Treasury Department. Fannie didn't take part in Freddie's legislative attempt to enter the mortgage insurance business, however, as McKinley noted – under the "Jim Johnson (Former Chairman of Fannie Mae) model" – the motto is "just do it." McKinley noted that Fannie's involvement in mortgage insurance is termed by Fannie as an "alternative risk dispersion technique." A specific example of this risk dispersion technique is Fannie's Alt 97 program which reduced the mortgage insurance coverage for low-downpayment mortgage programs which has some of the characteristics of insurance (Freddie also has a similar program). McKinley wrote, "Whether this is insurance, a power not explicitly granted to the GSEs, or whether it is a mechanism of alternative risk dispersion techniques, as Fannie Mae has called it, is open to interpretation. From the standpoint of the GSEs, the credit risk analysis required is almost identical between this activity and the analysis performed for a purchased mortgage. The only difference is the loss position involved. From the standpoint of MI companies, the activity clearly reduces their role in carving out and taking on risk from such mortgages."

"Regulators"

- McKinley reviewed the parties that could enforce the charter limitations on Fannie and Freddie – HUD; OFHEO; Private Parties; and Congress and their limited abilities to enforce the activities of the GSEs.

Conclusion

- How to solve these problems? McKinley concluded that the GSEs are correct in their criticism that HUD and OFHEO should not micromanage the investments of Fannie and Freddie and unnecessarily limit their activities. While at the same time, the private mortgage industry is also correct in that the GSEs have an unfair competitive advantage. McKinley asserted that Congress is the place to settle these problems and suggests that the standard by which Congress review the activities of the GSEs is whether there is evidence of market failure - using this standard to review expanded activities as well as the core GSE activities "in the box." Ultimately, he believed full privatization of the GSEs is the answer. His advice to those in the mortgage industry that want to contain the GSEs was to refrain from legislative attempts to revise the GSEs' charters. "You can learn a lesson from the Republicans during the impeachment of the president," he said. "Instead of killing the king, they just attempted to strike him and missed," he said. "It's best to kill the GSEs than to strike them to keep them in the box. I think the GSEs will fight as hard against the tweaking of their charters as they would against full privatization."

- In his written remarks, McKinley concluded: “There is absolutely no reason that the Congress should not open up the activities in the box – the secondary market for conforming mortgages under \$240,000 – to competition. Let the GE Capitals, the Norwests, and the Countrywides of the industry, as well as smaller players, go head to head with Fannie Mae and Freddie Mac in this sector. The proper route to achieve this competition would be full privatization of Fannie Mae and Freddie Mac. When fully implemented, this would allow the two GSEs to engage in nonmortgage investments and mortgage insurance alike. It would also allow members of the mortgage industry to go about their business without fear of having a GSE as a competitor.”

(Source for Portions of this Section: *Real Estate Finance Today*, Marshall Taylor, 3/26/99)

“Fannie/Freddie: What’s It All About?”

Lawrence White, New York University

- White presented a basic outline on the status of the GSEs, noting that despite explicit disclaimers, the capital markets believe that the Congress would not allow the GSEs to default on their obligations. Evident in his presentation was that the implied government guarantee serves the GSEs well in that they can sell securities at better rates, which can be passed to home buyers via lower interest rates, and to the extent that the benefit is not passed through to home buyers, the benefits are passed to the GSE’s shareholders. Also, White outlined the new “channel” of mortgage finance -- mortgage originators to mortgage servicers to the GSEs, to investors -- which has displaced the traditional portfolio lenders (e.g. S&Ls). This he claimed is both due to superior innovation and efficiency and to the GSEs’ financing advantage. White also noted that the GSEs are just one way that Congress tries to encourage homeownership and in the view of Congress in the area of homeownership – “Too much is never enough!”
- The GSEs have recently been expanding, according to White. He first differentiated between “horizontal” and “vertical” expansion, with the former being closely related to the original product (conforming mortgages), and the latter as a complimentary product that may be an input to or a downstream component of the original product. He compared horizontal expansion to Ford Motor Co.’s entry into the production of tractors (which is closely related to car manufacturing) and compared vertical expansion to “self supplying.” In the area of non-mortgage investments, to the extent that the investments add to liquidity, it is considered a vertical expansion and within the scope of the charters, however, to the extent that is considered an additional investment area for revenues/profits, it is considered a horizontal expansion and outside the scope of the charters. In his oral remarks, he asked “How you could tell this apart?” and then answered that “You can’t tell.” He suggested that the GSEs’ expansion into subprime mortgages should be considered a horizontal expansion because it is an additional investment area and should be considered within the scope of their charters. He categorized the automated underwriting systems as vertical expansions and within the scope of the GSEs’ charters as it reduces the costs of

underwriting. He also claimed that insurance such as mortgage insurance is a vertical expansion that will reduce the costs of the mortgage package, and is therefore within the scope of the charter. White noted, “expansions that reduce marginal costs are more likely to be passed through (at least partially) to home buyers; expansions that just add to revenues are more likely to just add profits and to benefit shareholders.” He did not believe the proper definition for the GSEs’ charters is a “box” because the “box” is “porous” and there is lots of room for vertical and economic growth.

- White concluded by noting that the GSEs have a clear advantage, which Congress intended. However, determining the degree of this advantage is difficult, and more importantly, *why* they have this advantage is an important political, not economic, question.

Adolfo Marzol, Executive Vice President and Chief Credit Officer of Fannie Mae

- Marzol effectively discounted concerns that have been raised about the GSEs’ expansion efforts, and began his remarks by recounting a childhood story of his days as a Boy Scout when he was required to search for a bird that did not exist – a snipe. Marzol cautioned that “some participants” are sending people off on a “snipe hunt.” He noted that those participants “would send us searching for problems that most objective observers know don’t exist,” warning that “misguided hunting for snipes in the secondary mortgage market could threaten real working families and their desire to become homeowners.”
- Marzol focused most of his remarks by responding to McKinley’s paper, which he felt had many inaccuracies and it was “at odds with the spirit of the AEI.”
- His first point was to discount McKinley’s view that the GSE’s sole existence was to prevent temporary market failure. If this was true, Marzol stressed, then the same case could be made against national banks that were created in his opinion to ensure the flow of credit to all regions of the country. He stated that, “There is no point searching for market failures, current or supposed from long ago, when Fannie Mae is bringing significant benefits to the housing finance market today.”
- Marzol also found fault with McKinley’s view that the GSEs should be privatized because in his opinion, Fannie and Freddie are already “privatized.” The GSEs are privately held companies. He believed McKinley’s vision of “privatization” is relieving Fannie of the means by which Fannie carries out its public mission. Marzol notes that McKinley has argued previously that the country is over-invested in homeownership. “Perhaps that is his real problem with Fannie Mae and Freddie Mac.” Marzol stated in his remarks, “Our critics ought to be honest here. They just want to relieve us of our public mission. They just feel that there is too much housing credit out there.” In his opinion, “It’s too late to debate privatizing Fannie Mae,” Marzol stated. “We’re already private, with \$70 billion in private capital. We have a government charter, but so does Norwest and Chase Manhattan.”

- Thirdly, Marzol wished to discard the myth that Fannie “thrives because of an implied government guarantee.” Marzol stated that “Every one of our debt securities clearly states, in plain English, that it is not backed by the full faith and credit of the government, and our investors know it.” He noted further that Fannie’s “cost of funds is significantly higher than the US Treasury’s, and national banks earn far more from funds they lend than we do. Their net interest margin – the spread between cost of funds and interest and fees earned – averages over 400 basis points. Ours average under 125 basis points.” Marzol stated that there had to be more than any implicit government guarantee to account for the success of Fannie. “We have lower spreads than the banks. We’re profitable because of our efficiencies and constant lowering of costs. Since the 1980s we’ve fundamentally re-engineered our business.”
- Marzol referenced a mortgage rate chart that ran in a recent edition of the *Washington Post* as evidence that Fannie saves Americans around 20 basis points on their loans because they can get a Fannie Mae loan.
- Marzol addressed the four areas of expansion that McKinley focused on which Marzol refers to as “snipe sightings in the secondary mortgage market”: non-mortgage investments, the subprime market, technology, and mortgage insurance. In the non-mortgage investment category, Marzol noted that the GSEs feel that these investments are crucial to their mission. He cited the “credit crunch” of last October as one example, where Fannie stepped into the market to keep spreads from widening. And, Marzol quoted Paul Reid, Executive Director of the Mortgage Bankers Association, as calling the GSEs “an anchor in the storm.”
- The subprime market is another area where Fannie Mae is simply meeting its charter, according to Marzol. In fact, he noted that Fannie shares some of the concerns about this market -- that costs are too high and not entirely beneficial to the consumers. He hinted that technology could help break down some of the problem areas.
- Technology, especially the use of automated underwriting is not the “Trojan Horse” that Fannie’s competitors make it out to be, according to Marzol. Marzol noted that “Some critics see technology as a Trojan Horse – it seems like a gift, but it’s really part of Fannie Mae’s strategy to slide into the primary market, originate mortgages, and eliminate the lenders. This is nonsense. I wonder how much of this concern is really general nervousness by players who face the challenge of adopting to a broad technological wave?” Marzol stated that “All I can do is declare, once again, that Fannie Mae will not originate mortgages. Not just because the law says we can’t, but fundamentally we don’t want to. We don’t know how. We like the business we’re in, and that’s where we’re staying.” He said it is a simple tool that saves Fannie Mae, lenders and consumers, time and money. “Lenders don’t have to use our technology to sell us their loans. But when they do, it helps us manage risk better, which in turn has allowed us to offer lenders low-down payment mortgages ... However, there are some that will always believe technology is our stalking horse to serve consumers directly.”
- Fannie Mae is not trying to enter the mortgage insurance business, Marzol assured, they were just adjusting the mortgage insurance coverages they need for low down-

payment loans because they found that this type of lending wasn't as risky as they originally projected. Therefore, Fannie decided to lower the mortgage insurance coverage and "take the credit risk." Marzol stated that "It is just bad business to require more coverage than we need and force consumers to pay for it." Marzol further noted that there was little competition within the mortgage insurance industry, because rates and products are approved by the states.

- Marzol concluded his remarks with a call to "break down the barriers" of homeownership, and implored all to remember that the average American homebuyer is the most important aspect of the mortgage industry.

(Source for Portions of this Section: *Real Estate Finance Today*, Electronic Edition, Marshall Taylor, 3/26/99 *National Mortgage News website*, 3/24/99;)

Vern McKinley Responds to Marzol's Comments

- In a written statement, McKinley responded to the remarks of Adolfo Marzol of Fannie Mae. Referring to Marzol's tale about snipes (search for something that is non-existent), McKinley noted that Marzol's snipe analogy is perfect to use when analyzing the continued government sponsorship of Fannie and Freddie. "Marzol is sending us on another venture to discover something that does not exist – a good reason for allowing Fannie Mae and Freddie Mac to be the continued recipient of government largesse." History has shown that the Senior Executives of Fannie will go to great lengths to fight to defend this government sponsorship which only serves one purpose – "to enrich the shareholders and executives of Fannie Mae and Freddie Mac."
- McKinley noted that Marzol's comparison of Fannie and Freddie to national banks is a good comparison but he reminded Marzol that there are differences between national banks and Fannie and Freddie. National banks do have government charters and are backed by the credit standing of the federal government in the form of government deposit insurance. While, Fannie has a government charter and is implicitly backed by the federal government – there is a major difference – Fannie doesn't pay for its government sponsorship, which gives them a competitive advantage over those institutions that pay for their government backing. "If Mr. Marzol's analogy to national banks is meant as an admission that Fannie Mae should be charged a 'capitalization fee' to recover some of the benefits retained by the government sponsored enterprises (GSEs), then progress has been made today."
- Second, McKinley disputed Marzol's comments that it was ridiculous to discuss the privatization of Fannie and Freddie because Marzol argued that they are already privately owned. Marzol's definition of privatization is narrow and McKinley pointed out that if the discussion of privatizing Fannie and Freddie was such a "fruitless exercise" than why would Congress have passed a law in 1992 to direct the Treasury, GAO, HUD and CBO to prepare studies on the impact of privatizing the GSEs? The 1992 legislation defined privatization as "repealing the Federal charters of [Fannie Mae and Freddie Mac], eliminating any Federal sponsorship of the enterprises, and allowing the enterprises to continue to operate as fully private entities."

- Third, McKinley disputed Marzol’s comments that there is a “myth that Fannie Mae thrives because of an implied government guarantee that lowers the cost of funds” and that the “AEI participants were getting carried away with a lot of ‘academic arguments.’” McKinley states that, “The implication here is that everyone else speaking at the conference today is in a fantasy world of academia, while the Fannie Mae and Freddie Mac executives are the only ones grounded in reality. I would argue that the representatives of Fannie Mae and Freddie Mac are the ones who are not in the real world on the issue of the implied guarantee. Those who argued at today’s conference that no such implied guarantee exists, coincidentally enough, all work within the ‘hallowed halls’ of either Fannie Mae or Freddie Mac. On the other hand, all the other panelists at today’s proceedings, as well as the recent privatization reports prepared by Treasury, HUD, GAO and CBO, all recognize the existence of this implied guarantee and the resulting reduced costs of funding for Fannie Mae and Freddie Mac.”
- McKinley also commented on the “oldie but goodie” when Marzol flashed the mortgage rate chart in a recent *Washington Post* pointing out the differential between the rates offered by GSEs and non-GSEs. This differential McKinley argues is “almost entirely attributable to government sponsorship.” Further, McKinley notes that “if Fannie Mae would like to argue that this benefit is entirely attributable to the efficiency of their operations, then this is a strong argument on the side of privatizing their operations.” And, “[I]f the differential is truly attributable to Fannie Mae’s efficiencies then these efficiencies would pass through to a fully privatized entity.”
- Marzol’s comments about the “credit crunch” last October when Fannie and Freddie were “anchors in the storm,” McKinley further cited as evidence that Fannie and Freddie do have an implied government guarantee. McKinley believed that Marzol’s comments were incorrect. “What happened in late 1998 was what is referred to in financial markets as a ‘flight to quality.’ This means that funds flow to investments that have the backing of the United States Government. So the real reason Fannie Mae and Freddie Mac were able to ‘pump liquidity into the conforming mortgage market’ is the implied government guarantee that the GSEs argue does not exist.”

Panel III

The Costs of Federal Support

How does the federal government subsidize Fannie Mae and Freddie Mac, what is the cost of those subsidies, and how are they allocated? The effect of Fannie and Freddie securities on the government securities market

Speakers:

Robert Seiler, Jr., Congressional Budget Office
Frank Cavanaugh, Economist & Former Senior Career Executive in Charge of Debt
Management, US Treasury Department
Robert Van Order, Economist, Freddie Mac

“Estimating the Value and Allocation of Federal Subsidies to Fannie Mae and Freddie Mac”

Robert S. Seiler, Jr., Congressional Budget Office (Remarks are Seiler’s views only)

- Seiler noted that in 1996, a series of studies by the Congressional Budget Office (CBO), the General Accounting Office (GAO), the Department of Treasury and the Department of Housing and Urban Development (HUD), were conducted to analyze and determine the value of the economic benefits that Fannie and Freddie receive from their government sponsorship. Seiler noted that the CBO and Treasury studies used a “reasonable method” to determine the approximate estimate of the size and allocation of the federal subsidies devoted to Fannie and Freddie and uses the two studies to suggest how future research could improve the estimates of government sponsorship.
- Seiler first outlined the manner in which GSEs receive federal subsidies- both explicit and implicit. Explicitly, Fannie and Freddie are exempted from paying state and local corporate income taxes; exempted from registering their securities with the SEC; receive a conditional line of credit with the Treasury Department of \$2.25 billion; can use the Federal Reserve as a transfer agent; can borrow in the federal agency debt market; and are exempt from restrictive state business laws. Investors infer an implicit federal guarantee of Fannie and Freddie obligations which “reduces the interest rates that investors require on the GSEs’ obligations and means that they are not subject to as much market discipline of their risk-taking as would be imposed in the absence of federal credit support. The perception of an implicit federal guarantee also allows Fannie Mae and Freddie Mac to issue much larger volumes of securities, sell a much larger proportion of debt that is callable, and enter into much large volumes of hedging transaction.
- The 1996 CBO study estimated that in 1995 Fannie and Freddie received \$6.9 billion in total federal subsidies, while the Treasury study estimated the total subsidies at between \$4.6 billion and \$6.9 billion. Both the CBO and Treasury privatization reports estimated that Fannie and Freddie retain about one-third of their federal subsidies.
- However, Seiler noted that the “reasonable methods” used by CBO and Treasury in their 1996 studies actually *understate* the value of the GSEs’ federal subsidies because the method assumed that government sponsorship only benefits the enterprises by lowering their borrowing costs. He believed that the methods could be modified to “provide insight into how government sponsorship also benefits Fannie

Mae and Freddie Mac by allowing them to operate with less capital than fully private firms.” Another modification he suggested was to more accurately measure the value and the allocation of the GSEs’ federal subsidies by “reflecting how their funding cost advantage and the amount by which they reduce interest rates on conforming FRMSs [fixed-rate mortgages] fluctuates from year to year.” This modification he noted “also indicates that, when the GSEs buy mortgage securities and non-mortgage investments, they pocket all of the federal subsidies associated with the debt issued to finance those investments.”

- Seiler also noted that even if most of the reduction in interest rates on Fannie and Freddie obligations is due to lower transaction costs that represent efficiency gains - as many GSE supporters argue – the gains are not a “public good” since the government only allows Fannie and Freddie to use them. “The narrow definition of the cost of government sponsorship would only be appropriate if any firm could obtain, free of charge, the same statutory authority and exemptions as the two GSEs possess, or if the government auctioned off the charters and the enterprises’ related benefits to the highest bidders,” he said. “The enterprises’ protected position gives their owners and managers greater control over the allocation of the economic benefits of government sponsorship than they would have if identical charters were freely available to all their potential competitors,” Seiler remarked. “The issue of how Fannie Mae and Freddie Mac allocate their resources they receive is worthy of policy analysis and public debate. Adopting the narrow definition of the GSEs’ federal subsidies obscures that issue.”
- Seiler recommended that the following research avenues could help improve and refine the estimates of federal subsidies to Fannie and Freddie:
 - (1) Size of the GSEs’ cost advantage in issuing debt and equity;
 - (2) The relationship between the size of single family fixed-rate mortgages and the interest rates on those loans;
 - (3) Whether the GSEs are earning above-normal returns in setting their guarantee fees;
 - (4) Effect of the GSEs’ purchases of mortgage securities on the interest rates on conforming fixed-rate mortgages.

(Source for Portions of this Section: *Real Estate Finance Today, Electronic Edition*, Francis Chu, 3/26/99)

“Impact of Fannie Mae and Freddie Mac on the Government Securities Market”

Francis Cavanaugh, Economist and Senior Career Executive in Charge of Debt Management at the Treasury Department

- During his remarks, Cavanaugh noted that federal subsidies, including the Fannie and Freddie’s direct credit line to Treasury, might have been justified 30 years ago when Fannie and Freddie began to establish themselves in the market as wholly privately owned companies. However, since the companies are now well established, they should be able to stand on their own feet without federal subsidies. “A gradual phasing out of the

subsidies might reveal any institutional weaknesses and allow time to correct them to avoid serious disruptions in GSE operations,” Cavanaugh stated.

- Cavanaugh noted that there has been a shift in market dominance in the government securities market – a “new era” where there is a shrinking role for Treasury debt and an expanding one for the securities of the GSEs. He pointed out that in 1999, it was estimated that \$2.7 trillion of GSE securities outstanding will equal the amount of privately held Treasury marketable securities (excluding US savings bonds as well as Federal Reserve and federal trust fund holdings of Treasuries). Reportedly, five years earlier in September 1995, GSE debt was only \$1.8 trillion, and the privately held Treasury marketable debt was \$2.9 trillion.
- GSE debt has also “exploded” relative to the total US economy. He noted that as a percentage of total net borrowing in US credit markets, including federal, state and local government, business, household, and foreign borrowers, GSE net borrowing increased from 7.0% in 1985, to 17.8% in 1995, and to 31.4% in 1998. Further, based on the Administration’s projections, Cavanaugh stated that “US Treasury securities, which have emerged as the dominant market instrument over the past 50 years, will become relatively insignificant over the next 15 years.” He cited the Administration’s projections that the publicly held Treasury debt, as a share of GDP, will fall from around 45% currently to less than 10% in 2014 – its lowest level since 1917.
- Cavanaugh pointed out that although Fannie and Freddie are clearly not government agencies, Congress has given them certain “agency-like” benefits which make their securities close substitutes for Treasuries in the government security market and allows them to borrow at interest rates only slightly above Treasury rates and below the rates paid by the highest rated (AAA) private firms. Thus, while securities issued by Fannie and Freddie must legally contain a disclaimer that they are not guaranteed by the government, investors generally believe that they are implicitly guaranteed and that Congress would never allow them to fail. He noted that “Fannie Mae currently promotes its ‘US agency status’ on its Web site and states that its debt securities ‘will often provide investors with a spread pickup to the treasury structure.’” And, he noted that in a 1998 letter to the OCC by Fannie’s own Deputy General Counsel, Anthony Marra, it was noted by Fannie that their standard domestic obligations were viewed by the rating agencies and investors as having implied government backing. Without the implied government guarantee, Cavanaugh remarked that the GSEs’ debt ratings would have varied substantially over the past 20 years.
- Cavanaugh observed that GSE borrowing clearly has a significant impact on increasing Treasury borrowing costs and the implicit government guarantee puts the government at risk to cover principal and interest payments on GSE debt. He noted a 1996 report to Congress by the Treasury Department that stated: “...since GSE securities serve as substitutes for Treasury securities for many purposes, and since they benefit from investors’ perception that the federal government implicitly stands behind them, those securities compete directly with Treasury securities in the government securities markets. To some extent, therefore, the considerable and growing supply of GSE securities (relative to the supply of Treasury securities) tends to lower prices in the government securities market and thereby increase the Treasury’s borrowing costs.” He suggested

that the Treasury and the OMB work with the Congressional Budget Office to estimate a cost or range of costs to the Treasury of the GSE competition.

- Short of limiting GSE activities, Cavanaugh suggested that there are three ways that Congress could reduce the net costs to Treasury of GSE borrowing:
 - (1) Reduce subsidies to GSEs, including their Treasury lines of credit, thus reducing GSE competition with Treasury;
 - (2) Assess a fee on the GSEs for federal benefits including the Treasury line of credit; or
 - (3) Provide an explicit full government guarantee of GSE issues, which would reduce further their borrowing costs, and charging a guarantee fee to offset the estimated costs to Treasury.

- In conclusion, Cavanaugh explained that “if Congress wishes to continue the favored GSE status for Fannie Mae and Freddie Mac, guarantee fees equal to the estimated amount of subsidies retained by GSEs would probably cover both the estimated increase in Treasury borrowing costs and the cost of the GSE default risk. If Congress wishes to cover as well the total opportunity cost to the government of the free guarantees, then the guarantee fee should equal the estimated total funding advantage, or subsidy, to the GSEs. This latter approach would also level the playing field for private competitors with the GSEs.” Congress, he believes, should request that the CBO and the Administration determine the estimates of federal subsidies.

(Source for Portions of this Section: *Dow Jones News Service*, John Connor, 3/24/99; *Real Estate Finance Today, Electronic Edition*, Francis Chu, 3/26/99)

“Notes on the Economics of Fannie Mae and Freddie Mac”

Robert Van Order (his views were not necessarily the views of Freddie Mac)

- Van Order presented a paper that questioned the methods of previous economic research on the GSEs. He noted, “research on Fannie Mae and Freddie Mac has not always been lucid, well-grounded in economic theory or serious about data.” He set out to first analyze what the existing data can and cannot support, and then to analyze what “neoclassic welfare economics” say about the GSEs. In his opinion, the real issue regarding GSE regulation should be control of “embedded options” and that their value matches public benefits, adding that analysis should center on incentives for the GSEs and implications for economic welfare.

- Van Order presented a “dueling charter” theory, arguing that banks were like GSEs and Freddie is at least as “private” as banks for the following reasons: (1) Both banks and GSEs have a government guarantee (Freddie – implied; banks - deposit insurance); (2) Both banks and GSEs have a federal charter; (3) Both banks and GSEs are regulated for safety and soundness; (4) Both banks and GSEs have

- Van Order stated that depending on one’s point of view, the federal guarantees that are given to Fannie and Freddie could be viewed as either subsidies or tools and that the word “benefits” should be used instead. He then distinguished between the gross benefit, which reflected interest rates spreads and net benefits which affected resource

allocation. Van Order did note that Fannie and Freddie are able to borrow at lower rates than they would if they had the same portfolio but a different (nondepository) charter. However, he noted that the size of the “gross benefits” (or interest rate spreads for comparable debt) to the GSEs have been overestimated in previous studies, such as the ones by the CBO and Treasury. “The best guess is more like 30 basis points, which is similar to the estimate of the difference between non-conforming and conforming rates,” he stated. Other analysts at the AEI conference said that the housing GSE subsidy could be as much as 50 basis points.

- Van Order believed that the benefits of federal subsidies given to the GSEs have already been auctioned off to shareholders when Freddie was “privatized.” Van Order stated that one cannot say that the “benefit” (i.e., subsidy) goes to the current GSE stockholders “because in an efficient market, like the stock market, it will be capitalized into stock price, so that current stockholders paid for it when they bought the stock and cannot be expected to earn more than normal returns. The benefits of the GSE charter have, indeed, been auctioned off.” More important than the distributional effects of Fannie and Freddie, are the reasons and public policy goals for the GSEs.
- Van Order believed that Congress wants GSEs “because whatever the goal is that they have in mind they think that it can [be] accomplished better by a profit-oriented institution than by a government bureaucracy.”
- In terms of regulations, Van Order did not see the need for other regulations and only advocated regulation for safety and soundness. He commented that “mission issues” with regard to the GSEs are “interesting and controversial” but “beyond the scope” of his comments. Van Order stated, “given the mission stuff and the charter, I think the main focus of regulation should be on safety and soundness with an eye on keeping embedded options under control and equal access charters. That is not likely to be easy. Once this is done regulation can focus on mission issues in a cost benefit sort of way.”

(Source for Portions of this Section: *Real Estate Finance Today, Electronic Edition*, Francis Chu, 3/26/99)

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