

The **GSE** REPORT

Special Supplement

**Executive Summary/Highlights of 2nd AEI Conference
On Fannie Mae and Freddie Mac**

American Enterprise Institute (AEI) Seminar
Fannie Mae and Freddie Mac: Public Purposes and Private Interests
September 8, 1999

September 1999

The American Enterprise Institute (AEI) held its second conference in a series of seminars about Fannie Mae and Freddie Mac. The first AEI conference was held in March 1999 (see the April *GSE Report Special Supplement* for in-depth coverage). At the end of the first AEI Conference, there was agreement that –

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

With that in mind, the conference planners at AEI wanted to address some questions that had arisen out of presentations and discussions from the first conference. Some of the questions included:

- How can the use of the GSEs' subsidy be controlled by Congress or their regulators?
- If regulation or legislation is necessary to control their use of public resources, what form should it take and what obstacles would it face?
- What risks do Fannie and Freddie create for taxpayers and competitors if they are not controlled?
- Where does the GSEs' subsidy go?
- Do they make a compelling case for their continued existence as government-sponsored entities?

At the end of the second AEI Conference, there was agreement that –

- **Fannie and Freddie growth plans will concentrate mortgage market share with the GSEs and away from private lenders**
- **They are leveraging their dominance in automated underwriting to increase market share and move into new product lines**
- **They are not effectively regulated by Congress or their regulators**
- **They pose risks for American taxpayers**
- **They receive substantial subsidies from the US government, but only pass some of their value to consumers, and people who already own homes get more of the subsidy than new homebuyers do**
- **They are not doing enough for the affordable housing market**
- **They are different from banks**
- **They have outgrown the regulation and oversight controls now in force, so these must be reformed and privatization plans should be considered**

Congressman Richard Baker's (R-LA) speech was one of the high points of the conference. Using a common sense approach, he described many of the challenges reformers must overcome to win support for complicated issues that pit them against two popular companies that employ many Washington insiders. However, he warned that Fannie and Freddie have become so large that their economic impact reaches beyond the housing markets, and reform is needed. In his role as Chairman of the House Banking Committee Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises, he is committed to completing the following during the 106th Congress:

- Introducing legislation that tightens oversight of GSEs
- Oversight of GSEs' record on affordable housing
- Urging OFHEO to expedite a final risk-based capital rule for Fannie and Freddie

Views Expressed at the Conference

Speakers

Cong. Richard Baker	Edward Kane, Boston College
Charles Calomiris, AEI	Patrick Lawler, Chief Economist, OFHEO
Richard Carnell, Fordham Law School	Ralph Nader, consumer advocate
Bert Ely, Ely & Co	Nicolas Retsinas, Jt. Centre Housing, Harvard Univ.
Ron Feldman*, Federal Reserve of Minneapolis	Thomas H. Stanton, Attorney at Law
Mark Flannery, University of Florida	Peter Wallison, AEI
Edward Golding, Freddie Mac	

* Personal comments only

ONE: Fannie & Freddie growth plans will concentrate mortgage market share with the GSEs and away from private lenders. To meet Wall Street's expectations, the GSEs will retain more mortgages in their portfolios -- increasing risk and doing nothing for homeownership -- and enter into new markets. Potential markets for Fannie and Freddie include subprime, mortgage insurance, title insurance, appraisal, and even origination

- Wallison and Ely stressed that Wall Street and the “need to constantly grow their earnings” drive Fannie and Freddie. The problem is that Fannie and Freddie face the prospect of not having enough conforming loan business available by 2003 to maintain the earnings growth expected and promised to Wall Street.
- Deriving growth projections from statements made by Fannie Chairman Franklin Raines, Wallison and Ely predicted that Fannie Mae will control 28 percent of the mortgage market by 2003. To meet that estimate, they increased Fannie's growth rate from 11.2 percent between 1995-1998 to 11.4 percent annually from 1999 to 2003. Wallison further noted that Fannie “will need earnings to maintain its return on equity of approximately 24 percent for the next five years. He elaborated, “We projected that its retained portfolio, mortgages plus MBSs, will grow at a rate of 19.8 percent between 1999 and 2003, up from 18 percent in the 1995-1998 period.” They assumed Freddie's numbers would echo Fannie's, explaining, “In order to achieve this parity, we increased the growth rate of Freddie's retained-plus guaranteed mortgages from 9 percent to 11.5 percent, and reduced the growth of Freddie's retained portfolio from 33.4 percent to 22.8 percent.” Ely stated that the “key to the assumptions is the continuing growth pressure the GSEs are under from Wall Street.” He believes this pressure is “even more critical because their stocks are down this year.” Their presentation made some alarming predictions:
 - From 1999 through 2003, in order to meet their projected growth rate, the GSEs will be required to retain or guarantee approximately three-quarters of all the new mortgages that are coming on stream in the U.S. “In the case of conventional/conforming mortgages alone, they can't meet their future needs with new mortgages since, beginning in 1998, there were not enough of those mortgages – even if they bought all of them,” Wallison stated. They can retain or guarantee 50 percent or 25 percent of all new mortgages coming on stream, but they must make up the difference by purchasing outstanding MBS in the secondary market or exploit new markets, such as subprime mortgages.

- Ely stated, “If Fannie meets its market share growth projection for 2003, increases its portfolio investment growth rate, Freddie tags along, and the Federal Reserve does not engineer a recession, the two agencies combined will increase their net income by \$6.1 billion, more than double their combined \$5.1 billion in net income in 1998. Much of that increase will have to be taken from private-sector participants in the housing finance industry.”
- Ely further noted that portfolio income will become more important to Fannie and Freddie’s earning growth, “rising from 55.6 percent of net income in 1998 to 65.7 percent in 2003.”
- Loan portfolio growth will result in a massive concentration of risk in these two companies. Ely stated, “While credit guarantee income for Fannie and Freddie is projected to grow 74 percent in the 1999-2003 period, portfolio investment income is projected to grow 155 percent. Increasingly, Fannie and Freddie will look like giant S&Ls.” By 2003, Fannie and Freddie are expected to hold 21.2 percent of *all* conventional/conforming and subprime mortgages in the United States, and the GSEs together will hold 36 percent in their portfolios. Fannie and Freddie will either have purchased and retained or guaranteed 47.6 percent of all residential mortgage debt, and 63.5 percent of all conventional/conforming and other mortgage debt, including subprime mortgages.
- By the year 2003, Fannie and Freddie will have approximately \$1.8 trillion in outstanding debt. According to Ely, “If either GSE experienced any difficulty in rolling over its debt, it would face a liquidity crisis of an enormous magnitude.” This makes a Treasury or Federal Reserve bail out almost inevitable – placing the burden of rescue on the taxpayer.
- If the GSEs continue their rate of growth, by 2003, the GSEs will have \$1.7 trillion in assets leveraged off of a \$26 billion base, for a ratio of 1.5%. Most national banks and thrifts need at least a 4% ratio in order to be adequately capitalized.
- Fannie and Freddie’s interest rate risk would double between 1999-2003. Fannie’s interest rate risk would jump from \$485 billion at the end of this year, to over \$1.14 trillion in 2003, while Freddie Mac’s will go from \$321 billion to \$795 billion, for a jump of 148 percent.
- In terms of increasing their retained portfolios, Wallison noted that to the extent that the GSEs are buying mortgage-backed securities that are already out in the market, they are not helping current homebuyers, and “even though Fannie and Freddie now argue that their purpose is to reduce middle class mortgage rates, that will become a less and less important part of their activities as they fill their portfolios with MBSs that are already outstanding. Although they will undoubtedly continue to claim that they are putting people into homes, in reality they will simply become the biggest S & Ls the world has ever seen.” As the GSEs add to their portfolios, they will increase their risk to the federal government who is their implicit guarantor. Unless Fannie and Freddie change their goals, they will have to eat into more portions of the market and take on more risk.”
- Ely warned that the GSEs are going to keep on expanding in order to keep up with their “lion’s share” of the growth. He said the GSEs will act aggressively in order to continue expanding. They may:
 - Attempt to persuade Congress to eliminate the ceiling on conforming mortgages
 - “Dig deeper” into the subprime market

- Enter the origination process. In Ely's view, this is "another opportunity for eating further into the housing finance food chain is to provide a broad range of housing finance services, particularly at the origination stage." Fannie and Freddie "are steadily building the infrastructure and marketplace presence to step into the loan origination business. They probably will not do so in one fell swoop. However, once they get their nose into the proverbial tent, they will be able to move quickly to grab mortgage origination market share, particularly for the easy-to-do mortgages, such as refinances."
 - Develop more mortgage insurance-like products
 - Assume title insurance risk "as Fannie and Freddie build computerized records on an increasing portion of the US housing stock."
 - Absorb much of the appraisal process "since they have a growing data base of housing sale prices to use as comparables when assessing a home's market value." They "could also provide local governments with appraisal values to use for levying real estate taxes."
 - Head into mortgage servicing -- paying real estate taxes, insurance, all while holding the escrow balances for those payments.
- Freddie Mac's Golding justified the company's interest in mortgage insurance as consistent with its mission to cut mortgage loan costs. He stated that the secondary market developed by the GSEs was more efficient than mortgage insurance for measuring credit risk. He saw few differences between the government support provided to GSEs and that granted to insured financial institutions.

TWO: Fannie and Freddie are leveraging their dominance in automated underwriting to increase market share and move into new product lines

- Ely argued that Fannie and Freddie already control more of the origination process than ever before through their automated underwriting systems. They are collecting market, consumer, and loan information through their automation that will launch them into new businesses, such as insurance and appraisal.
- Feldman noted, "There is room for significant interpretation even when the charge to Fannie Mae and Freddie Mac seems clear." He wrote, "Congress clearly prohibited both firms from originating mortgages. The growth of the GSEs' automated underwriting program is viewed by Fannie Mae and Freddie Mac as central to achieving articulated congressional goals and the enterprises do not literally originate mortgages through the systems. Yet, the systems shift some activities of mortgage originators, and assumedly the profits from such activities, to Fannie Mae and Freddie Mac."
- Stanton stated that HUD has not played a significant role in promoting GSE service to high priority public purposes and is not in a strong position to provide mission oversight for the GSEs. The agency "has essentially stood by and watched in the 1990s as the GSEs deployed new technologies to expand their market power into areas that previously had been off limits...the result of the new information-based technologies has been to shift much value added, and the associated profits, from lenders and other firms in the primary market to the GSEs in the secondary market."
- Calomiris did not agree with the argument that the GSEs are better able to capture the benefits of technological progress as justification for preserving the GSE duopoly. With respect to the

mortgage market of recent years, he sees little evidence of GSE technological superiority. In the past, he notes, Fannie and Freddie have entered important new mortgage products with a lag. He cited the use of credit scoring and the development of the new high-loan-to-value and subprime mortgage markets as examples of private sector initiatives that were initially relied upon entirely by private financing sources.

THREE: GSEs are not effectively regulated by Congress or their regulators (HUD and OFHEO)

- Feldman noted that the conflicts between the GSEs' public mission and private purpose create obstacles for Congressional oversight. The GSEs weaken the strength of their regulators when they use political power to sway members of Congress by opening partnership offices in Members' home districts and by contributing campaign money.
- Feldman has not found a convincing quantification of the actual public benefit the GSEs provide by the GSEs in homeowner savings. However, the fact that the GSEs are granted public subsidies to fulfill a public mission "creates a clear interest in oversight to ensure that their use is consistent with congressional goals... Fannie Mae and Freddie Mac have always been creatures of the Federal government. This gives Congress a strong justification for oversight."
- Feldman pointed out that vague interpretations of the GSE mission makes proper regulation even more difficult, saying, "There is room for significant interpretation even when the charge to Fannie Mae and Freddie Mac seems clear." He stated, "Congress clearly prohibited both firms from originating mortgages. The growth of the GSEs' automated underwriting program is viewed by Fannie Mae and Freddie Mac as central to achieving articulated congressional goals and the enterprises do not literally originate mortgages through the systems. Yet, the systems shift some activities of mortgage originators, and assumedly the profits from such activities, to Fannie Mae and Freddie Mac."
- Stanton argued that the GSEs' regulators cannot handle the size and power of the GSEs. The structure of the GSEs' charters allows for GSEs to deprive Congress of important information. Stanton also had little confidence in HUD and OFHEO, and noted that the two GSE regulators are weak politically compared to the GSEs. In particular, OFHEO's budget is too small to regulate the two biggest financial institutions in the US, and OFHEO's annual budget review allows the GSEs to exert even more political influence.
- Nader had little hope for proper Congressional or regulatory oversight. Fannie and Freddie are able to exert significant political power in Washington by appointing a "virtual who's who of Washington power elite" as their top executives, contributing over millions of dollars of soft money contributions, and spending millions of dollars hiring powerful Washington lobbyists. He further noted that both were "extremely skillful at playing the heartstrings to the fullest about America's love affair with homeownership" and are quick to suggest that success by their political foes would translate immediately into higher mortgage rates.
- Congressman Baker stated that he believes that Fannie and Freddie should be examined now when they are profitable and "present no risk to the American taxpayer at this time." Baker cautioned that there will be an economic downturn someday and that Fannie and Freddie have become so large that their impact on the economy goes beyond the housing market. Baker encouraged OFHEO to expedite a final risk-based capital rule for Fannie and Freddie. "It would be a travesty

if we do not move forward with the implementation of the stress test as soon as is possible,” stated Baker. He is uncertain about how effective OFHEO and HUD are as regulators of the GSEs. He will continue to push for more funding for OFHEO so that they can better regulate the GSEs. He wants to propose legislation to create one regulator for all the housing GSEs.

- Kane said that the GSEs have only two constraints to their growth and risk capital: limits on the types of mortgages Fannie and Freddie can purchase, and OFHEO oversight. Neither of these two restraints is effective. In Kane’s opinion, “A GSE is an awkward blend of a private stockholder corporations and a government agency. Blending creates a brutal conflict of interest between the duties managers – as quasi public servants – owe taxpayers to direct the entire subsidy into mortgage interest rates and the duties they owe GSE shareholders to retain a good portion of subsidies.” The stock-based incentive plan provided to GSE executives makes these conflicts even more acute. Kane noted that the oversight system remains “poorly targeted and riddled with loopholes. Unless or until enforceable duties of adequate and truthful disclosure of subsidy benefits can be imposed on the managers of Fannie and Freddie, government control of GSE subsidies will remain distressingly cosmetic.”
- Retsinas, who served on the team that set up the GSE mission regulation at HUD, believes it is too early to judge the effect of the 1992 legislation that revamped the GSE regulatory framework. He sees some inherent conflicts between safety and soundness and mission oversight, but believes the system is biased to favor safety and soundness.
- With regard to the proposed risk-based capital rule, Freddie Mac’s Golding said that his company believes that it is a step in the right direction. However, Golding said that Freddie does want to fully review the proposed rule to make sure it is the best determinant of risk. Golding made no response to the many criticisms made about HUD’s weak oversight of the GSEs. In fact, Freddie believes that it is subject to too much regulation, and that the expense of this regulation increases consumers’ borrowing cost.
- OFHEO’s Lawler affirmed the need for the OFHEO regulations and defended OFHEO’s risk-based capital procedures and testing techniques. He began by noting that there is “fertile ground” for oversight within the GSEs. Lawler defended his organization’s methods for determining credit risk, saying that OFHEO’s model uses the “worst of the worst” scenario in order to make sure the GSEs have adequate capital. They have over \$1 trillion outstanding debt, no insurance, and have are immune from market discipline compared to other financial institutions. That is why OFHEO’s rule will act like “catastrophic risk insurance.”
- Professor Mark Flannery from the University of Florida noted that OFHEO’s stress test amounts to marking the GSEs’ capital today, as compared to 10 years of losses. He argued that risk guideline must first look at the probability of a GSE failure before developing capital standards. He believes OFHEO’s risk-based capital proposal is good. However, like Freddie, he is concerned that overzealous regulation will harm the secondary mortgage market.

FOUR: Fannie and Freddie pose risks for American taxpayers

- Feldman stated, “The GSEs pose a significant financial liability to the federal government by virtue of the implicit guarantee of the government on their debt and mortgage-backed securities. Not only is the government liable but the act of providing the GSEs with an implicit guarantee encourages Fannie Mae and Freddie Mac to take on more risk than they would otherwise. The

significance of this off-budget liability and moral hazard problem was underscored for Congress by the S&L crisis. Thus Congress has significant interest in the companies' financial health and risk-taking and has expressed such interest through, for example, charter limits on their activities," such as on the loan-to-value of mortgages they can finance.

- Stanton and others made reference to the 1980s Savings and Loan Crisis as a reminder of financial risk and little government regulation. According to Stanton's Law, "risk will migrate to the place where the government is least equipped to deal with it." Stanton asserted that the government is least equipped to deal with GSE risk. The GSEs have managed to play to America's heartstrings quite well by touting their contribution to help "families achieve the American Dream" in every newspaper and television ad. However, there is risk of significant loss, which is likely to follow a two-step process that Stanton observed during the S&L crisis and again in the Orange County investment debacle. First, a GSE will suffer financial loss due to economic conditions, a market downturn, or a poor management or investment decision. Second, to recoup this loss and get back on earnings track, the company will make a gamble with credit risk or in the financial markets. It will take the long odds bet and fail, compounding the first loss. OFHEO must position itself to prevent the GSEs from taking any gambles to recoup losses.
- According to Nader, Fannie and Freddie are not the first to use the "American Dream" for public relations gains. The Federal Home Loan Bank System used the same phrase to help build consumer confidence in their banks during the Depression. This may be why it took so long for Congress to act on the Savings & Loan Crisis of the 1980s -- because they kept clinging to the FHLB System's "American Dream." Then, said Nader, when they did look behind the "American Dream," it was too late for oversight.
- Ely warned that the GSEs pose considerable risk to the taxpayer in three areas -- credit risk, interest rate risk and liquidity risk. These risks are continuing to grow as Fannie and Freddie grow relative to the size of the US economy.

FIVE: Fannie and Freddie receive substantial subsidies from the US government, but only pass some of their value along to consumers, and people who already own homes get more of the subsidy than new homebuyers do

- Kane noted that the GSEs receive both indirect and direct subsidies. Examples of direct subsidies include the GSEs' exemption from state and local income taxes and exemption from paying SEC registration fees. The GSEs' indirect subsidies include the lower cost of credit due to their implied federal guarantee, and benefit the GSEs greatly. These subsidies confuse taxpayers because they do not fully understand their stake in the GSEs' future. In addition, the GSEs' off-budget status and the size and distribution of the GSEs' subsidy make it hard for taxpayers, regulators, academics, government officials and the media to understand, said Kane. He noted that there is a wide variance in estimates of the GSE subsidy – from 30 basis points to 100 basis points. However, most studies indicate that Fannie and Freddie do not pass along the value of all of their subsidies to the consumer. The midpoint value of subsidy estimates indicates that the GSEs keep about half of the subsidy value they have been granted. Of course, it does not help that the GSEs employ what Kane has termed a "Bart Simpson" defense about their subsidies: The GSEs: (1) deny that they get a subsidy; (2) say no one can prove that they get a subsidy; and (3) even if they do acknowledge they get a subsidy, say that they don't hold onto the subsidy.

- Ely suggested that the subsidies granted to Fannie and Freddie are now worth about \$6 billion yearly, commenting, “Clearly, a subsidy of this magnitude is unjustifiable, but it also quantifies the inefficiency with which Fannie and Freddie deliver the housing finance subsidy.”
- Nader, suggested that the GSEs use their subsidies to pad the pocketbooks of their executives. He listed the salaries of various Fannie employees and noted that if each executive took lower pay, then more money could reach homeowners. “It is obvious that a significant part of the subsidy derived from the GSE status is being used, not by homebuyers, but to increase corporate power and control over all facets of the mortgage business
- Stanton listed the GSEs’ public costs as the impact of GSE borrowing on Treasury borrowing, the costs the government-sponsored duopoly imposes on the US economy, and the financial exposure created by the perception of an implicit government guarantee of GSE securities. In addition, the subsidy that the GSEs receive from that implicit guarantee and other “extras” must be taken into account said Stanton. The subsidy has been estimated by the Congressional Budget Office to be over \$6 billion in 1995 -- with \$4 billion going to taxpayers and over \$2 billion going to shareholders and executives of the GSEs. Stanton believes that the GSEs are inefficient vehicles for passing along federal subsidies. They might even be stifling innovation if they are using their duopoly power to support only new products that expand their markets and enhance their duopoly status.
- Carnell listed the major benefits -- indirect and direct subsidies -- that Fannie and Freddie receive that make them GSEs. The most important is the GSEs implied federal guarantee, which allows Fannie and Freddie to borrow at rates only slightly higher than the US Treasury. Other key benefits include:
 - Their line of credit with the US Treasury
 - Their exemption from state and local taxes
 - Their exemption from registering securities with the SEC
 - The lack of limits on the amount of GSE mortgage-backed securities that can be held by federally chartered depository institutions
 - Eligibility for open-market purchase by the Federal Reserve Banks
 - Eligibility as collateral for deposits of public funds
 - Classification as lawful investments for fiduciaries and each is permitted to issue and transfer securities through the Federal Reserve’s electronic book-entry system.
- Calomiris noted that the GSEs’ subsidies are distributed too unevenly to make much difference in home affordability. They do not “optimally promote” homeownership. The subsidies are not targeted to the low-income individuals who need it the most, while middle-class homeowners are the recipients of the largest gross transfers from government support for the GSEs. He argued that evidence suggests that the GSEs are not channeling significant subsidies to low-income borrowers and that the GSEs are limiting the credit risk exposure they bear on these low-income mortgages either by requiring higher down payments or external credit enhancements. According to Calomiris, “The GSEs lay off risk partly because of statutory limits on their powers...and partly because of their profit-maximizing risk management choices.” He noted that the GSEs sometimes say their special GSE charters allow them to pass along subsidies to homebuyers, while other times the GSEs deny they even receive a subsidy.

SIX: They are not doing enough for the affordable housing market

- Congressman Baker criticized Fannie and Freddie for not helping more minorities become homeowners. The majority of loans that Fannie and Freddie purchase are made to affluent and middle-income homebuyers, he stated, even though the government supports Fannie and Freddie so they “facilitate homeownership to lower-income minorities and others deprived of access to credit in traditional mechanisms.” Baker stated, “What is the cost to the United States taxpayer ultimately, in light of their rather poor mission compliance?” he asked. Mission compliance needs to be improved and Fannie and Freddie should do a better job of providing access to credit for low-income, minority, and women homebuyers. Baker noted that lending to African Americans by conventional lenders makes up 4.3% originations while only 3% of loans purchased by the GSEs are to African Americans.
- Stanton cautioned that if HUD does not set meaningful affordable housing goals for Fannie and Freddie, “then supernormal profits will continue to accrue to GSE shareholders, in part because of the GSEs’ exceptional financial leverage and low capitalization. It is precisely because HUD has not set serious housing goals that the GSEs have been able to attack the OFHEO capital requirements on grounds that higher capital standards might create an incentive for the GSEs to reduce their service to underserved borrowers and communities.” He recommends that Congress require Fannie and Freddie to set aside a fixed percentage of its income to serve special high priority public purposes. This would be similar to the FHLBank System’s Affordable Housing Fund. This would limit the ability of the GSEs to put pressure on regulators to influence the contribution, would be set by law, and would be easy for the government to administer.
- Nader pointed out that inadequate regulation even condones unacceptable performance in the area of affordable housing, concluding, “The overwhelming political power of these GSEs raised serious questions about the willingness of the ability of the federal government to regulate them. The same is true of affordable housing goals; a critically important mission assigned the GSEs. Can these goals be set high enough and enforced with the vigor needed to really catch up with the needs of low and moderate income families for housing?” He further asked if Fannie and Freddie could carry out the same functions without their current level of subsidies. Nader then suggested that Fannie and Freddie could provide more subsidies to homeowners if they would cut the amount of compensation given to their top executives. He ended by remarking, “Can the Congress summon the courage to address these issues, to revisit the GSE charters and reform the present GSE system? Or has Fannie and Freddie built a political-public relations wall so strong that Congress won’t dare try to breach it?”
- According to Nader, the GSEs exert political power through the use of their foundations, masking their poor performance in affordable housing. As shown in a 1999 Urban Institute Study, the GSEs are not be fulfilling their mission of serving low- and moderate-income and minority borrowers, and even lag behind private lenders in the markets that serve their target areas. The Fannie Mae Foundation and the Freddie Mac Foundation are effective public relations tools. For example, their Foundations provide “grant payolas” to local DC groups that is only a small portion of the \$300 million windfall Fannie and Freddie enjoy from exemptions from DC taxes. The Freddie Mac Foundation plans to pass out over \$17 million in grants this year. Most programs are geared to programs for children. In 1998, the Fannie Mae foundation gave out \$33 million of grants to 1,100 national and local organizations. Many of the grants have gone to advocacy and research groups involved in housing and other areas, such as the Center for Community Change,

ACORN, and the National Low Income Housing Coalition. All this is aided and abetted by a press that “infrequently uses its vast investigative resources to look beyond the handouts and smiling faces of young couples and children that invariably adorn the slick brochures which sell the GSEs’ housing role to the American public.”

- Calomiris argued that evidence suggests that the GSEs are not channeling significant subsidies to low-income borrowers and that the GSEs are limiting the credit risk exposure they bear on these low-income mortgages either by requiring higher down payments or external credit enhancements. He notes that the “GSEs lay off risk partly because of statutory limits on their powers....and partly because of their profit-maximizing risk management choices.” He recommended a down-payment assistance program as a more powerful and cost-effective alternative for delivering mortgage subsidies and increasing home ownership.
- Feldman pointed out that the public mission/private profit conflict inherent in the GSE structure jeopardizes low income housing goals. The GSEs have publicly stated that they will cut back on certain affordable housing programs if government requirements reduce the profits that the GSEs can earn. All of the GSE goals and concerns – program objectives such as affordable housing, financial safety and soundness, profitability, and the boundaries of GSE business – should be addressed simultaneously by Congress.
- Ely warned that the GSEs might cause bubble effects to residential land values by stimulating housing demand with their subsidies. Their moves into new markets may make homes less affordable for lower-income borrowers, the very people that Fannie and Freddie are supposed to help.

SEVEN: Fannie and Freddie are different from banks

- Carnell stated that GSEs and FDIC-insured depository institutions are “two different species of financial institution -- and not a single generic ‘GSE’ species. As financial institutions, GSEs naturally tend to have more in common with depository institutions than with animals, vegetables, minerals, or nonfinancial companies. But they receive significantly different government benefits and incur significantly different government-mandated costs. To blur the two types of entities into one is to obscure -- and even rhetorically assume away -- distinctions important to informed policymaking.” According to Carnell, FDIC institutions incur substantial costs for their government support, including:
 - Deposit-based assessments
 - Foregone interest earnings on required reserves
 - The cost of complying with banking regulations

Consequently, many independent economists have noted that FDIC institutions’ offsetting costs may be too large, once the institutions cover the costs of regulation and interest payments, to leave little room for a subsidy. The FDIC and many independent economists agree that any such subsidy is relatively insignificant. The chairperson of the FDIC, Donna Tanoue, has said that “for well-capitalized banks, the evidence shows that if a net marginal funding advantage exists at all, it is very small.”

- Comparing the FDIC’s regulations with those of OFHEO for the GSEs, Carnell noted that it is much easier for the government to limit and monitor an explicit guarantee than an implicit guarantee. “How can you explicitly limit a potential liability whose existence you officially deny? Pulling that off convincingly would be a gymnastic feat beyond the skills of any government I’d care to live under.” Then he stated his fundamental point: “If the government can limit and manage an explicit guarantee better than an implicit guarantee, then the implicit backing of GSEs will tend to impart a richer subsidy than explicit deposit insurance.” Carnell also stated that explicit guarantees would heighten political responsibility for those who enact and regulate them. Implicit guarantees only provide for little accountability, complacency, and policymakers can avoid their existence altogether if they desire.
- Feldman stated, “Clearly, these two companies are different than other private corporations and must submit to some form of supervision from the elected representatives of the American people who, even indirectly, provide their support.” And, “unlike many banks with which the GSEs are often compared, Fannie Mae and Freddie Mac have always been creatures of the federal government. This gives Congress a strong justification for oversight.”
- Stanton stated that the GSEs have several specific qualities that make them much different from the FDIC institutions and others:
 - There are only two GSEs compared to thousands of other financial institutions.
 - The structure of the GSEs’ charters allows for the GSEs to deprive Congress of important information.
 - The GSEs have been described as having “dueling charters” by Robert Van Order, where the GSEs have a “distinctive set of regulatory and other benefits that are not available to other firms. This dependence on charter benefits for their success means that GSE managers have a special incentive to dominate the political process, rather than merely concerning themselves with becoming more efficient in the marketplace.” The GSEs also have a “peculiar vulnerability” that exists due to the lack of feedback in response to their actions. Fannie and Freddie are able to use their subsidies to quiet market competition, Stanton said.

EIGHT: Fannie and Freddie have outgrown the regulation and oversight controls now in force, so these must be reformed and privatization plans should be considered

- Feldman advocated that the House Ways and Means Committee be responsible for Congressional oversight of the GSEs. Stanton said that since that committee is more technically up to date, the Members might be able to handle some of the technically challenging aspects of the GSEs. However, the biggest reason the Ways and Means Committee should be responsible for GSE oversight is because it is the committee that would have to decide how to bail out the GSEs, should anything ever happen.
- Feldman suggested the following reforms, including the idea of privatization:
 - require additional information to Congress (to determine exact size of subsidies);
 - try to get GSEs on-budget (perhaps have Ways and Means Committee regulate);
 - protect Congressional oversight from Fannie and Freddie’s resources (subject GSEs to lobbying rules of government agencies and institute reporting requirements or ban campaign contributions);

- create incentives/restrict activities (reduce the compensation of GSE managers by an amount related to retained subsidy or forbid GSEs from engaging in new activities); and
- restructure the GSEs (make them more public like government agencies or make them purely private).

He also suggested that the GSEs could enter into contracts with the government to provide more affordable housing.

- Stanton advocated a much stronger regulator than HUD and OFHEO. Like Feldman, he suggested that the Ways and Means Committee regulate them, since that would be the committee that would consider a bail out should anything happen. He also recommended that the Federal Reserve, not HUD, monitor GSE activities.
- Since Congress chartered GSEs to fulfill a public purpose, Stanton believes that a sunset provision tied to the fulfillment of their public purpose should be considered. Comparing the GSE charter to mercantilist charters of American colonial times, he said, “In earlier times, the sovereign might bestow a corporation charter that was limited to a fixed period of time. A fixed term thus can serve as the occasion for reauthorization of a GSE and could provide an opportunity for the Congress periodically to assess, and perhaps to adjust, the public benefits that a GSE provides and the associated public costs.” He finds this type of review preferable to today’s process of adding technical amendments to a GSE charter that have the effect of weakening government’s ability to regulate the public purposes of Fannie and Freddie. In his conclusion, Stanton offered one final alternative: the privatization of the GSEs. He sees a “reasonable chance” that at some point in the future the GSEs may decide they want to be fully privatized. He noted that the Treasury Department and the Office of Management and Budget have taken public positions on sunseting GSEs when the GSEs have successfully fulfilled their purpose. Sallie Mae echoed similar statements when they decided to privatize in 1994: “the missing element in the GSE concept is the notion of a life cycle for government sponsorship. The political power of the GSEs may not provide for much chance at privatization. However, there is some chance for change, concluded Stanton. United States history shows that its citizens do not care for government sponsored monopolies. The tea that colonists threw into Boston Harbor during the Boston Tea Party belonged to the government-sponsored East India Tea Company.
- Nader appeared to advocate GSE privatization, but did not seem to think it possible. In addition, if the GSEs were privatized, he warned that it must be done in a way that assures that they do not use their government-subsidized duopoly status to crush private competition. He stated that the remedies he heard at the AEI conference were not extreme and would curb some of the expansionist tendencies of the GSEs.
- Cong. Baker discussed potential legislation that might cover the following areas:
 - eliminate the GSEs’ line of credit at the US Treasury;
 - strengthen and establish uniform risk-based capital standards for all housing GSEs;
 - examine growth in non-mission related investments;
 - review the process for setting the conforming loan limit;
 - establish a “meaningful” process for approving new GSE products; and
 - combine the regulators of the all the housing GSEs.

- Ely called for a two-part GSE privatization similar to the one Sallie Mae is currently undergoing in order to free the taxpayers from a potential GSE bailout.
- Kane said he would try to reform the GSEs by focusing on managerial compensation reform – which he refers to as “the easiest and biggest loophole to plug.” Kane said he would
 - Require GSE managers to account for subsidy under penalties for fraud;
 - Insist on deduction of subsidy increases from compensatable stock appreciation;
 - Defer taxpayer compensation for CEOs contingent on low values of retained subsidies; and
 - Subject GSEs’ political donations and other benefits to elected officials to special reporting restrictions and other ethical controls.
- Calomiris suggested five ways to reform the GSEs.
 - Make housing subsidies on-budget priorities, and offer down-payment programs to make sure the subsidies are passed on to their rightful owners;
 - Increase the power of OFHEO and make sure OFHEO can force the GSEs to comply;
 - Phase out and privatize Fannie and Freddie or divide them into smaller entities, none of which could be considered “too big too fail” (Small enough so that one failure would not require a bail-out. He suggested in his statement that 20 entities might be the right number)
 - Eliminate the GSEs' credit line at the Treasury;
 - Close the FHLBanks. Once the GSE special privileges have been eliminated, they should be closed since they would no longer be needed to act as competition for Fannie and Freddie in the secondary mortgage market.
- During the question and answer period, Alex Pollock, President of the FHLBank of Chicago, said that if Fannie and Freddie were to be privatized, then so should the FHLBanks. He noted that in the meantime, GSE competition in the secondary market would reduce the federal subsidies flowing to the GSEs.

Some of the quotations contained in this supplement are taken from *Real Estate Finance Today*, Marshall Taylor, 9/17/99; *National Mortgage News*, 9/13/99; *Dow Jones Newswire*, John Connor, 9/9/99, 9/10/99; *American Banker*, Katharine Fraser, 9/9/99; and *BNA Daily Report for Executives*, Marc Selinger, 9/9/99

Politics of Reform

GSE reform is not an easy sell to Congress. The GSEs have protected themselves from Congress, media, and consumer advocacy groups. Ralph Nader described the current situation:

“Born out of the federal bureaucracy, these enterprises have managed to swiftly and skillfully pick up the rough shod practices of the private corporate world and, at the same time, cling tightly to one of the federal government’s deepest and most lucrative welfare troughs. The combination has produced two government sponsored enterprises that are not only too big to be allowed to fail, but, perhaps, too influential and too politically connected to effectively regulate or shape in the public interest.” And, “any suggestion that their power be limited or that subsidies be reduced triggers an immediate ‘no holds barred’ counterattack from Fannie and Freddie... This ‘see no evil, hear no evil and speak no evil’ mentality that pervades official Washington’s approach to the GSEs is the product of an influence machine that is oiled by revolving doors, care and feeding of key politicians across the nation, a quick-strike ‘take no prisoners’ public relations operation, and targeted contributions to advocacy organizations – activities financed by slush funds created by generous forms of corporate welfare.”

- Nader further stated, “These GSEs, particularly Fannie Mae, have built an almost impenetrable moat that essentially seals off their operations from serious ongoing examination by the Congress, the media, or even by many advocacy groups engaged in promoting affordable housing.” Most consumers, therefore, have no idea what a government sponsored enterprise is or the existence of their federal subsidies. He stated that in Congress, Fannie and Freddie have the “highest quake ratio” (when their name is mentioned staffers reflect a fear of retaliation). A *Legal Times* reporter earlier this year quoted three unnamed former and current public officials as saying that Fannie has gone so far as to try to get uncooperative Hill staffers and regulators fired.
- Congressman Baker noted that his plans for legislation to alter a booming business -- housing -- might not be an easy sell to Members of Congress. The GSE issues are also quite complex and require a great deal of attention from Members of Congress and their constituents. “This is boring stuff. It’s just not something that grabs voters,” added Baker. In addition, most Members of Congress do not realize that the GSEs issue more debt than the US Treasury. They do not have the time to study the GSEs at the depth level that may be needed to understand all the intricacies of the GSEs. In order to successfully push more stringent GSE legislation through Congress, Baker said that it would be a “multi-session” process. “No one in Congress wants to be seen as ... having raised interest rates on prospective home buyers. At the same time, we want to make sure that we are not asleep at the switch and allow our housing market to unexpectedly fall into economic disrepair.”
- Baker was asked why Congress seems to show no concern for the GSEs’ subsidies or their monopoly over private enterprises. Baker said that the 1996 CBO study had little effect in Congress because members of Congress were unwilling to question the GSEs when the market was so good. He added, “You know Congress, we don’t act unless there’s a crisis.” He also noted that to necessitate their mission, the GSEs do need some compensation. It is hard to determine whether that margin of profit should be 3% or 30%, said Baker. In terms of the GSEs’ monopoly power over private enterprises, Baker said many Members of Congress do not respond because they feel the system works. He further explained that most feel that homeownership is good.

Members believe that if they do anything to stop the current system-- by curtailing the GSEs--then homeowners will suffer. In addition, Baker said that Members of Congress fear Fannie Mae's lobbying force that would ask Members, "Do you want to be in the Coalition for Higher Mortgage Costs?"

- To fight the GSEs and make an impact on Capitol Hill, Baker suggested a cohesive group of people concerned about the power and influence of the GSEs should lobby members of Congress. Such lobbying must play "catch up" with Fannie and Freddie. The Center for Responsive Politics reported that Fannie Mae spent over \$5.5 million on lobbying expenses in 1998, while Freddie Mac spent around \$2.2 million. Both Fannie and Freddie employ a group of full-time lobbyists and also keep various former elected officials on retainer.
- This year's formation of FM Watch, the coalition aiming to curb the GSEs' influence, may raise the GSEs' lobbying expenditures to record heights, said Nader. Fannie Mae has been aggressively pressuring any lobbying firms and trade groups to stay away from FM Watch. Fannie Mae Director of Communications, John Buckley conceded that Fannie Mae approached firms with this message: "We said to a number of our friends: 'You don't want to be on the side of the bad guys,'" noted Nader
- Feldman noted that FM Watch "could change the dynamic of the oversight process. However . . . for the most part, Fannie Mae and Freddie Mac have defined their current businesses quite broadly, putting the onus on HUD, or Congress to intervene when it sees something amiss."
- The greatest challenge, according to Stanton, is lack of political will. He does not support a legislative solution to the existing regulatory shortcomings because the GSEs have managed to exercise a dominant hand in shaping their charters and boundaries, instead of accepting direction from Congress. Until the sentiment for change becomes more widespread, Congress will not act.

Fannie Mae's Response - Stonewalling, Personal Attacks

December 2 will be "Fannie Mae Day" at AEI

- Fannie was a "no-show." As moderator Peter Wallison noted, the AEI had hoped for another frank and open discussion about the GSEs. Freddie agreed to participate, but Fannie declined, instead asking for a one-on-one type of forum where they could present in the manner that they wanted. The AEI has agreed to this set-up, and has set aside December 2, 1999 as "Fannie Mae Day." Fannie has yet to respond to the AEI's invitation.

Fannie responds to AEI's public policy conference with personal attacks against participants

- According to *Dow Jones Newswire* articles by John Connor, Fannie spokesman David Jeffers stated the following about the AEI conference, "Honestly, I view this conference as a continuation of the campaign by the mortgage-insurance industry and its allies to punish Fannie Mae for taking steps to lower costs for consumers." Jeffers argued that Peter Wallison, the AEI Resident who coordinated the conference, is a member of the Board of Directors for the Mortgage Guarantee Insurance Corp., which Jeffers claims, helped to fund the campaign. He claimed that Wallison was "simply carrying out his fiduciary duty" as a member of the MGIC board.
- Wallison called Jeffers' charges "astonishing," noting that Fannie's comments highlight "how they will not deal with issues but instead attack people who raise questions," and provides another example of why the company is among the most disliked and feared presences in Washington. "It's just disgusting how they insist on attacking individuals," said Wallison. Wallison further noted that his personal view was that Fannie and Freddie should be privatized, a view that is not shared by MGIC.

Wall Street's Opinion - Don't Worry, Be Happy

Political Smoke, but Little Fire, at Policy Conference

- Morgan Stanley Dean Witter analysts Ken Posner and Michael Courtian wrote an Investor's Report about the AEI Conference on GSEs, entitled *"Political Smoke, but Little Fire, at Public Conference."* Posner and Courtian's overall reaction was that the GSEs have little to fear. "We don't see any consensus emerging among the various opponents of current GSE challenges to the status quo or a threat to our investment thesis. To the contrary, it's ... differences among consumer advocates, mortgage industry trade groups, and public policy pundits create a real logjam with respect to organizing GSE reform." They also commented that Congressman Richard Baker (R, LA), a longtime advocate of GSE reform, acknowledged that GSE reform is a "political non-issue" for Members of Congress and their constituents.
- However, the analysts noted that one area worth monitoring was the FHLBanks as competitors to Fannie and Freddie. Posner and Courtian said that this might be one of Congressman Baker's strategies to add competition to the GSE market. But, the analysts noted that the FHLBanks have a long way to go -- they lack stockholder focus, have limited technology and operational expertise, have a decentralized structure, and plenty of opposition towards a third GSE. Therefore, Posner and Courtian concluded that it is "premature to worry about the FHLBanks impact on Fannie's and Freddie's growth."
- Posner and Courtian listed several highlights from the conference:
 - There were numerous complaints by the opponents of GSEs -- that the GSEs receive a subsidy from the government and only pass some of it to homeowners, the GSEs do not serve low-income homeowners well enough, the GSEs play political hardball, and the GSEs unfairly monopolize the market.
 - Posner and Courtian seemed to feel that no one in the conference desired GSE privatization except for a few academics, consultants and "fringe characters." (Editor's Note: Privatization was suggested by many presenters at the conference including Ron Feldman, Tom Stanton, Bert Ely and Charles Calomiris.) According to the analysts, consumer advocates like Ralph Nader do not want consumers to lose the government's subsidy, while the mortgage industry does not want to lose their mortgage insurance, large lenders do not want to directly compete with the GSEs, and Congressman Baker did not seem to want "a world without GSEs." However, the analysts did note, **"it's our sense that the GSEs will advocate privatization of their own volition when they sense that the benefits from product and market diversification outweigh the benefits of the charter (this might be five to ten years out)."**
 - Tougher capital standards and higher affordable housing goals may be moot issues. Posner and Courtian said that the OFHEO standards are so complex and difficult to replicate that once the capital standards are implemented, no one will argue for stronger capital requirements. Housing goals may not be an issue now that HUD has issued the 50% goals. In addition, they note "consumer advocates will always ask for more here, which is fine with us as it makes it difficult for mortgage industry competitors to argue against GSE penetration of the subprime sector."

- **There was only vague talk of curbing “expansionist goals,” but little talk of the GSEs’ strong hold on technology, noted Posner and Courtian. These issues are important to the GSEs’ mortgage industry competitors, but were mostly absent at the conference, save for some discussion of the GSEs entry into subprime lending.**
- Congressman Baker’s discussion was a “frank acknowledgment” that GSE reform is not a big political issue. Posner and Courtian noted that Baker called for “balance and fairness” in GSE reform, and said that it would take many years to deal with an “unpredictable” issue like the GSEs. Baker also said that the GSEs were “boring stuff.” In addition, Baker’s legislative initiatives seemed mild to the analysts -- his goals of eliminating the GSEs’ line of credit to the Treasury, of strengthening OFHEO’s role in regulation, and requiring a risk-based capital rule for all GSEs (including the FHLBanks) all seemed “innocuous.” However, Posner and Courtian did state that the issue of consolidating all regulators into one is an issue to follow.
- Despite all this, Posner and Courtian acknowledged that there are still some political risks associated with the GSEs. “We’ve talked to Fannie’s and Freddie’s opponents, to political consultants, and to contacts on the Hill. And we’ve had to acknowledge that the political noise isn’t abating as quickly as we would have liked and in fact may have contributed to some weakness in the share prices.” Posner and Courtian still recommend a “Strong Buy” for Fannie and Freddie stock, however. (Kenneth A. Posner and Michael D. Courtian; *Morgan Stanley Dean Witter Report on Government Sponsored Enterprises*; September 9, 1999)

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