

The ***GSE*** REPORT™

Special Supplement

**Fannie Mae & Freddie Mac:
Doing Well By Doing Good?**

July 2000

In 1819, Chief Justice Marshall declared, “The power to tax is the power to destroy.” The use of federal power to subsidize can be equally lethal, in its own covert way. During the twentieth century, the federal government subsidized a growing number of financial transactions. When the subsidies have been broadly distributed, such as deposit insurance, financial services firms and their customers both benefit. When the government bestows substantial concentrated subsidies to a favored few, these advantaged companies have the ability to dominate the markets they target. Their growth is limited only by constraints the government imposes.

For over sixty years, the federal government has sought to expand homeownership through a variety of tools. The two most important initiatives have been the mortgage interest personal income tax deduction and the FHA loan program. A third approach, first initiated in the 1960s, was to create two federally chartered private corporations – GSEs – Fannie Mae and Freddie Mac, to enhance private capital flows into the residential real estate market. Fannie Mae and Freddie Mac provide a living case study of a successful public/private partnership. In the age before telecommunications and computers, they were created to make mortgage credit readily available across all regions of the United States by offering mortgage lenders outlets to sell their mortgages. Backed by “implied” federal government financial backing and other specified subsidies, these two GSEs perfected the design of financial instruments called “pass-through certificates” (PCs) and “mortgage backed securities” (MBSs). They provided liquidity to support a secondary mortgage market, where individual mortgages are purchased from lenders, then collected into multi-million dollar investment pools, and finally “cut up” into PCs and MBSs that are sold in the public debt markets.

Consumers have gained two key benefits from the market activities of the GSEs, but these benefits do not have the same value now that they did in the past:

- They can be confident that mortgage money will always be available to them when they wanted to buy a home. In the days before global financial markets and Internet lenders who will bid for consumers’ mortgages in an online auctions market, consumers had to worry about the availability of credit.
- The GSEs have passed along some of their subsidies to consumers in the form of lower interest rates. In 1989, a GSE-supported mortgage carried an interest rate that was about .6 percent lower than a standard private mortgage. Today, however, the GSEs’ profits are soaring while consumer savings are shrinking. According to market statistics tracked by HSH Associates, the interest rate differential has dropped from .6 percent to about .25 percent.

Duopoly control of the secondary mortgage market means less competition. The GSEs can throttle private sector innovation by refusing to buy new products. Millions of homeowners who apply for conforming mortgages are losing the opportunity to choose cutting edge products introduced by private companies that would put more money into consumers’ pockets. Less competition will give the GSEs even more market control than they have already, stifling the free market forces that assure cost savings and efficiencies are passed to the consumers. Over time, consumers will not be able to find a “better deal” than a GSE loan because they will have no choice. If Fannie Mae and Freddie Mac extend their reach into new lines of business, such as home equity lending, insurance, and other products, the same thing will happen.

Fannie Mae – The Largest GSE

Originally, the Federal National Mortgage Association was an agency inside the Department of Housing and Urban Development. In 1968, President Johnson and Congress partially privatized it, and the new Fannie Mae received a special federal charter with unique powers that was supposed to curb its scope of activities and restrict it to supplementing the secondary market for home mortgages of the highest credit quality.

Fannie Mae faced its largest financial crisis in 1981 and 1982, when interest rates soared. The Congressional Budget Office (CBO) reports that if Fannie Mae's mortgage portfolio had been marked to market in the early '80's, the market value of its mortgages would have been \$10 billion less than its debts.

The firm struggled through '85, and in '86, it entered into a period of phenomenal growth that turned its stock into a Wall Street darling. From '88 through '97, Fannie Mae stock's ten-year rate of return exceeded that of Intel, Coca-Cola, and General Electric.

Freddie Mac – The Younger Sibling

In 1979, the Nixon Administration felt that Fannie Mae needed a competitor and that S&Ls needed a ready market to fund their mortgages. Freddie Mac was created as an affiliate of the

Federal Home Loan Bank System. In 1988, Freddie Mac became a publicly traded corporation with a special federal

charter that was supposed to restrict its business activities to those related to backing the residential mortgage market.

Freddie Mac's mission compliance came into question in '97, when it used GSE-backed funding to purchase \$340 million in Phillip Morris bonds for its investment portfolio. In addition, the GSEs face pressure to improve their record of buying mortgages for low- and moderate-income homeowners. Freddie Mac has expressed concerns that it may have difficulty meeting the latest goals set by HUD.

Wall Street investors love Freddie Mac stock, which provided average 30+ percent returns from '88 through '97, like Fannie Mae. In '98, Freddie Mac stock yielded 55.1 percent.

Combined Fannie Mae /Freddie Mac Financial Data (\$ billions)

	1989	1994	1999
Net Income	1	3	6
Total Assets	160	379	963
Equity	5	15	29
Total Liabilities	153	363	922
MBS Outstanding	454	973	1,428

What are the GSE subsidies?

1. They have lower capital requirements than other financial institutions, and can maximize their use of leverage.
2. They enjoy a lower cost of capital, either through direct access to the Treasury, or in the debt markets. The Secretary of the Treasury is authorized to buy up to \$2.25 billion of GSE securities, effectively providing each GSE a \$2.25 billion line of credit. The GSEs are perceived to have "implied" government backing that allows them to issue bonds when they find a need, regardless of market conditions, at interest rates lower than those granted to the best fully private companies.
3. Federal support allows them to increase financial flexibility by issuing callable long-term debt.
4. With an "implied federal guarantee," private investors do not judge GSEs with the same risk standard, providing a benefit to both their debt and their stock. The high leverage that they employ gives them exceptional returns on equity.
5. GSE debt securities are eligible for open market transactions by the Federal Reserve Board, qualify for investment by insured banks and thrifts, and can be used as collateral for the federal government's deposits of tax revenues in banks.
6. GSE securities held by banks and thrifts require only a 20 percent risk weighting, compared to a 50 percent risk weighting assigned to prudently underwritten private MBS under the Basle Accord.
7. They do not pay state and local taxes.
8. They are exempt from filing with the SEC, saving both the expense and time of complying with SEC rules or publicly filing timely and complete financial data, and exempting them from laws such as the Foreign Corrupt Practices Act.
9. Their exclusive charters assure shared-monopoly status.

GSE Subsidies are Flowing Through a “Leaky Conduit” that Diverts Them to Profits

GSE stock returns outperforming Intel and GE have not been generated by the development of innovative products. Rather, the GSEs are broadly applying their subsidies and pocketing 45 percent of related profits. In 1995, the CBO calculated how much of the GSEs' profits resulted from just a few of these seven subsidies. It concluded that 42 percent, or \$2.1 billion, was due solely to preferential federal legislation. If the CBO were to undertake the study now, the corresponding figures now would be \$3.1 billion and 45 percent:

Fannie Mae and Freddie Mac Subsidies

	1995	1998
Average Combined Debt Outstanding	\$384.0	\$644.8
Debt Subsidy (70 bps-Fannie/68bps-Freddie)	\$2.7	\$4.5
Average Combined MBSs Outstanding	\$945.2	\$1,078.1
MBS Subsidy (40 bps)	\$3.8	\$4.3
Total Subsidy	\$6.5	\$8.8
Conforming Mortgages Financed	\$1,249.0	\$1,612.4
Subsidy pass-through (35 bps)	\$4.4	\$5.6
Subsidy retained (\$)	\$2.1	\$3.1
GSE Pre-tax Income	\$4.9	\$7.0
Subsidy retained (% of Pre-tax Income)	42%	45%

1995 data and subsidy rates are from the CBO Study; 1998 average balances are averages of 1997 and 1998 year-end balances

Their \$9 billion worth of subsidies fuel a duopoly engine that can vanquish any private competitor, allow the GSEs to protect their markets, and eventually gain controlling market share in any line of business they choose to enter. Without competition, we can only rely on the GSEs promises that they will pass through the profits earned through subsidized growth to consumers, and not keep these earnings to fuel continued 30+ percent stock appreciation.

Today, the GSEs' overwhelming market presence is giving lenders and consumers fewer choices, not more. Fannie Mae and Freddie Mac are using technology to automate their services and broaden the product offerings sold over their technology pipeline. Their duopoly status and federal subsidies allow the GSEs to demand that their systems and software become the market standard if lenders want access to the conforming secondary market. Lenders learn that if they do not use the GSEs' proprietary underwriting systems, they must take back more risk when they sell their loans – or they can forget selling the loans to the GSEs. Consumers who do not fit the GSE “black box” automated underwriting (AU) model either pay a higher interest rate or get no loan at all. Other consumers never find out about innovative new programs being developed in the mortgage industry, because the GSEs kill the product by refusing to buy the loans.

Lenders are discovering that Fannie Mae's and Freddie Mac's growing “brand name” identity with consumers and brokers, especially through their online pipeline, is developing GSE “distribution networks,” which means loans are referred to them only if they agree to “do business the GSE way.” The GSEs' actions will displace lenders in the mortgage process, reducing their roles to order takers and servicers. Over time, GSE expansion plans will exert control over real estate appraisers, brokers, realtors, and other professionals now being invited into “partnerships” with the GSEs.