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On the Issues

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Addressing the Real Public Risk from Fannie Mae and Freddie Mac

By Peter J. Wallison

Curtailing the ability of Fannie Mae and Freddie Mac to hold mortgages and mortgage-backed securities will lower the risks these two government-sponsored enterprises pose to taxpayers and the economy yet will not undermine whatever support they give to the residential housing market.

Congress has been working for more than a year now to tighten the regulation of Fannie Mae and Freddie Mac, the two troubled government-sponsored mortgage companies that have helped banks to finance home ownership for millions of Americans. Accounting problems at both have spurred this effort, because it has become clear that if the companies should fail or otherwise encounter a severe financial setback, it would pose a considerable risk to taxpayers (who may have to bail them out) and the economy in general (because of their dominance of the residential mortgage market and the potential vulnerability of their derivative counterparties).

Yet, as much as tougher regulation of Fannie Mae and Freddie Mac is warranted, Congress has so far circled the central issue instead of engaging it. The purpose of tighter regulation is to reduce or control the companies' risks. But we already know why these risks arise: Fannie Mae and Freddie Mac have accumulated portfolios of mortgages amounting to $1.7 trillion that are financed largely by short-term borrowing. Much of their income depends on the spread between the interest rates on the long-term mortgages they purchase from commercial lenders and the short-term rates on the money they borrow—a strategy that makes them extremely vulnerable to changes in interest rates. To limit their risks, they employ a variety of derivatives, which spread their risks to their counterparties.

Peter J. Wallison (pwallison@aei.org) is a resident fellow at AEI. A version of this article appeared in the *New York Times* on April 2, 2005.

Reducing Risks to Markets and Taxpayers

In recent Congressional testimony, Federal Reserve chairman Alan Greenspan made a notably sensible suggestion: give their regulator the power to limit the size of Fannie Mae's and Freddie Mac's portfolios of mortgages and mortgage-backed securities (MBS). If implemented by their regulator, a limitation of this kind would substantially reduce the interest rate risks faced by Fannie and Freddie without interfering with their support for the residential housing market. Instead of holding mortgages for investment, they would expand their existing business of pooling these mortgages and selling interests in them as mortgage-backed securities. This process would transfer the interest rate risk on the underlying mortgages to investors. This idea, of course, is not new: Fannie Mae and Freddie Mac have been doing this to some extent for many years and now bear the credit risk—but not the interest rate risk—of $1.5 trillion in outstanding mortgage-backed securities. The credit risk, as it turns out, is trivial—less than 0.01 percent of the principal amount of the mortgage.

Advocates for Fannie Mae and Freddie Mac will point out that limiting their ability to buy and hold mortgages and mortgage-backed securities will substantially reduce their profits, and they will be right. Both companies profit handsomely from using their government-granted financing advantages to buy and hold these assets, which pay considerably higher interest rates than they have to pay to their lenders. But Congress ought to understand that this strategy is a classic case of making society take the risks while private investors take the profits—which is just what happened with the savings and loan associations that went belly up in the late 1980s. If Fannie Mae and Freddie Mac profit from the interest rate risks they are taking, the management and the shareholders pocket the gains; but if they fail or suffer financial reverses because of this risk, the taxpayers will bear the burden.

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If there were some evidence that this risk-taking was necessary to make the country's mortgage system function, then it might be argued that the taxpayers should take these risks because they receive benefits as homebuyers. But Greenspan and other eminent economists have advised Congress that this is not the case. As the Fed chairman pointed out in his testimony, Fannie and Freddie borrow money to buy mortgages and MBS. This is likely to raise interest rates as much as their purchase of these instruments will lower rates. Fannie and Freddie's supporters conveniently point to only the purchase side and ignore the borrowing that they have to do in order to hold investment portfolios. Thus, the transaction is a wash; its only effect is to make Fannie and Freddie more profitable, while creating risks for the economy and the taxpayers.

Greenspan's testimony has finally spurred key members of the House and Senate to consider limiting Fannie and Freddie's investment portfolios. Senator Richard C. Shelby (R-Ala.), chairman of the Senate Banking Committee, has said that he will consider limiting the size of Fannie Mae's and Freddie Mac's portfolios as part of the legislation he is developing. And Richard H. Baker (R-La.), chairman of the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, has included a provision in his new bill that would give Fannie and Freddie's new regulator explicit authority to limit the size of their portfolios. It would be better to prohibit portfolio accumulation entirely, but this is a real step forward.

Because it will reduce their profitability, both Fannie Mae and Freddie Mac will strongly oppose portfolio limitations. But tightening regulation of these two companies without reducing the real source of the risks they create would be like bailing furiously while ignoring the hole in the boat.