CATO INSTITUTE BRIEFING PAPERS

Freddie Mac and Fannie Mae

An Exit Strategy for the Taxpayer

by Arnold Kling

No. 106 **September 8, 2008**

Executive Summary

The Fannie Mae-Freddie Mac crisis may have been the most avoidable financial crisis in history. Economists have long complained that the risks posed by the government-sponsored enterprises were large relative to any social benefits.

We now realize that the overall policy of promoting home ownership was carried to excess. Even taking as given the goal of expanding home ownership, the public policy case for subsidizing mortgage finance was weak. The case for using the GSEs as a vehicle to subsidize mortgage finance was weaker still. The GSE structure serves to privatize profits and socialize losses. And even if one thought that home ownership was worth encouraging, mortgage debt was worth subsidizing, and the GSE structure was viable, allowing the GSEs to assume a dominant role in mortgage finance was a mistake. The larger they grew, the more precarious our financial markets became.

Regulators should contemplate freezing the mortgage purchase activities of the GSEs while at the same time loosening the capital requirements for banks to hold low-risk mortgages. The result would almost surely be an industry much less concentrated than the current duopoly. A housing finance system that does not rely so heavily on Freddie Mac and Fannie Mae will be more robust.

We have to assume that sooner or later some of the institutions involved in mortgage finance will fail. The policy should be to promote a housing finance system where mortgage risk is spread among dozens of institutions. That way, the failure of some firms can be resolved through mergers and orderly restructuring, without exposing the financial system to the sort of catastrophic risk that is represented by Fannie Mae and Freddie Mac.

Arnold Kling is an adjunct scholar with the Cato Institute. After receiving his Ph.D. in economics from the Massachusetts Institute of Technology, he worked as an economist at the Federal Reserve Board for six years and then at Freddie Mac for about 10 years in the 1980s and 1990s. He blogs at econlog.econlib.org.

Cato Institute • 1000 Massachusetts Avenue, N.W. • Washington, D.C. 20001 • (202) 842-0200

The GSE crisis may have been the most avoidable financial crisis in history.

Introduction

The United States Congress has a genius for creating government programs that are difficult to terminate. For example, with Social Security and Medicare, there is no way to cut taxes on current workers without threatening the benefits of current recipients. There is no pool of accumulated assets that can be used to pay beneficiaries, the myth of trust-fund accounting notwithstanding.

Similarly, the mortgage market duopoly of Freddie Mac and Fannie Mae, which five years ago held over half of the outstanding mortgage debt in the United States, is difficult to terminate. They cannot be merged with other financial institutions, because those other institutions lack the special borrowing privileges that the government-sponsored enterprises (GSEs) enjoy.

In fact, the reaction of Congress to the crisis created by subprime mortgage defaults was to expand the role of the GSEs in mortgage finance. Each mortgage purchased by one of the GSEs would have been limited to no more than $417,000, except for emergency legislation last December raising the limit to $729,750. Indeed, in the first quarter of this year, the GSEs funded 70 percent of new mortgages.

Early in July, there was an abrupt collision between congressional intent and market reality. On July 9, Bloomberg reported that:

> Fannie Mae paid a record yield over benchmark rates on $3 billion of two-year notes amid concern that the U.S. mortgage-finance company doesn't have enough capital to weather the biggest housing slump since the Great Depression.
>
> The 3.25 percent benchmark notes priced to yield 3.27 percent, or 74 basis points more than comparable U.S. Treasuries, the Washington-based company said today in an e-mailed statement. That's the biggest spread since Fannie Mae first sold two-year benchmark notes in 2000 and triple what it paid in June 2006.[1]

The story goes on to note that the market was treating the debt of Fannie Mae and Freddie Mac as if it were rated A2 by Moody's. The actual rating on the debt is AAA, and historically investors priced it that way. But, alarmed by large losses and thin capital shields at the GSEs, investors began to contemplate the risk of a GSE default.

Once this risk was priced into their debt instruments, the two firms' borrowing costs soared, placing them in jeopardy.

The loss of confidence in the GSEs, which spread to the stock market, could quickly have driven them into bankruptcy. Had the Treasury and Congress failed to act, a GSE default would have become a self-fulfilling prophecy. The consequence of the hastily passed late-summer legislation is that if the housing market gets worse or if it turns out that the less-than-transparent portfolios of the GSEs contain hidden weaknesses, taxpayers could be liable for tens of billions of dollars in shortfalls.

In this briefing paper, I will suggest ways that Congress could gradually extricate housing policy from its dependence on the GSEs. While it may be too late to insulate taxpayers from the risks embedded in the GSEs' current portfolios, it is possible to shrink the GSEs without significantly damaging the housing market.

Three questions are worth examining:

1. What policies might have prevented the crisis?
2. How does the recently passed legislation deepen government involvement in housing finance?
3. Going forward, how could government extricate itself and the GSEs from a dominant role in the housing market?

An Avoidable Crisis

The GSE crisis may have been the most avoidable financial crisis in history. Economists

How Do the GSEs Work?

The GSEs operate in what is called the secondary mortgage market. That is, they purchase mortgage loans from other sources. As a home buyer, you cannot obtain a mortgage directly from Freddie Mac or Fannie Mae. Instead, you obtain your loan from someone in the primary mortgage market (a bank or a mortgage banker), and that lender sells the loan to one of the GSEs. The GSEs then combine your mortgage loan with similar loans into what are called mortgage pools. These pools are formed into pass-through securities, meaning that the principal and interest on the mortgages in the pool are passed through to investors in the securities. The GSEs can either sell the mortgage-backed securities to other investors or retain the securities for themselves. In the 1990's, Freddie gradually shifted from a strategy of selling most of its securities to a strategy of retaining most of its securities. Fannie has always predominantly held its securities in its portfolio. Whether it retains or sells the security, the GSE bears the default risk of the mortgages, which is the source of the recent crisis.

The GSEs take responsibility for ensuring that all the principal and interest on the underlying mortgages is returned to investors, even if the mortgage borrowers themselves default on their loans. If a borrower defaults, the loan is removed from the pool. The GSE pays the full principal amount to the holders of the security and then recovers what it can from a foreclosure sale. When this happens, the GSE typically absorbs a loss of about half the outstanding principal on the loan.

The GSEs charge a fee, known as a guarantee fee, that on average is sufficient to cover their losses and provide a profit. If the primary lender offers you a mortgage loan at an interest rate of 6.75 percent, the GSE may put the loan into a security that pays 6.50 percent. The remaining 0.25 percent is retained by the GSE as its guarantee fee.

GSEs earn profits in two ways. First, the guarantee fee is typically larger than what is needed to cover the cost of mortgage defaults. This is called their mortgage insurance business, because the GSEs are providing insurance to investors against mortgage defaults. Second, when the GSEs retain securities rather than selling them, they earn a financing profit. If a GSE retains a security that yields 6.50 percent and it can finance that security by issuing debt that costs only 6.25 percent, then the GSE earns a spread of 0.25 percent. This is called the portfolio lending business, because the GSEs are managing a portfolio of investments in mortgage securities.

In both the mortgage insurance business and the portfolio lending business, the GSEs have two important advantages. These advantages are a lower risk premium and lower capital requirements.

In the capital markets, U.S. Treasury debt is considered risk-free, and every other borrower pays a higher interest rate than the Treasury. That difference is called a risk premium. The greater the uncertainty about the borrower's financial condition, the higher the risk premium. Because investors believed that the GSEs would not be allowed to fail, until very recently the risk premium on GSE debt was very low.

The second advantage that the GSEs enjoy is low capital requirements. When banks engage in the mortgage insurance business or the portfolio lending business, they are required by their regulators to put more of their shareholders' funds at risk than the GSEs are. This makes it difficult for banks to compete with GSEs.

Economists have long complained that the risks posed by the GSEs were large relative to any social benefits.

have long complained that the risks posed by the GSEs were large relative to any social benefits. But the GSEs have used political clout to beat back attempts to limit their growth.

The growth of the GSEs took place in several stages. An approximate timeline of events is as follows:

- In 1938 the Federal National Mortgage Association (ultimately nicknamed Fannie Mae) was formed as a government agency to try to fill some of the gap in the mortgage lending industry left by the wave of bank defaults in the Great Depression.
- In 1968, in part to get Fannie Mae's liabilities off the government balance sheet, Fannie Mae was spun off to private investors.
- In 1970, to deal with regulatory impediments in getting mortgage money to California, the Federal Home Loan Mortgage Corporation (ultimately nicknamed Freddie Mac) was formed as a government agency.
- Throughout the 1970s the role of the GSEs expanded. The savings and loan industry, which at the time dominated mortgage finance, was plagued by disintermediation. Regulation Q, which limited the interest rate that thrifts could pay to their depositors, was causing an outflow of funds from the S&Ls. That was another classic example of a government intervention without a viable exit strategy. Regulation Q was not sustainable. However, lifting that regulation would have raised the thrifts' cost of funds, making many of them insolvent. Ultimately, the regulation was lifted, and many S&Ls went under, at a cost to taxpayers of more than $100 billion.
- Regulation Q helped to cause the downfall of the S&L industry. However, the large losses incurred by taxpayers were the result of flaws in the deposit insurance system. In response to the losses on the S&Ls, the government reformed the way that deposit insurance was implemented. Regulators corrected some accounting flaws that had allowed insolvent institutions to continue expanding. Regulators also made changes to the incentive structure of deposit insurance, forcing riskier banks to pay higher premiums.
- In the early 1980s, as the S&Ls were faltering, Fannie Mae was losing a million dollars a day. Fannie's problem was rising interest rates and a portfolio of long-term mortgages financed in part by short-term debt. However, Fannie Mae kept growing as its S&L competitors fell by the wayside, and when interest rates stabilized and came down, Fannie Mae became highly profitable.
- Also in the early 1980s both Freddie Mac and Fannie Mae fed off the carcasses of the thrift industry. Freddie and Fannie engaged in "swap" transactions that allowed S&Ls to liquidate mortgage portfolios without recognizing losses. In this way, they were able to expand their lending even as they were failing. With one hand—the GSEs—government was handing the S&Ls money to gamble, while with the other hand—the Resolution Trust Corporation—the government was absorbing the losses.
- In 1989, Freddie Mac was sold to private shareholders, just as Fannie Mae had been in 1968. Freddie Mac proceeded to grow dramatically, and the two GSEs held just over 50 percent of all mortgage debt outstanding in 2003.
- In 1992 Congress created a single regulator, called the Office of Federal Housing Enterprise Oversight, to oversee Freddie Mac and Fannie Mae.

Strong lobbying by Fannie Mae and Freddie Mac was sufficient to offset the warnings of many public officials that the dominance of the GSEs was unwise.

Congress never explicitly said that it was designing a mortgage finance system based on this duopoly. However, strong lobbying by Fannie Mae and Freddie Mac was sufficient to offset the warnings of many public officials that the dominance of the GSEs was unwise.

Concerns about the GSEs spanned the political spectrum. Lawrence Summers, Treasury

Secretary under President Bill Clinton, complained in 1999 of the anomalous status of the GSEs. When the crisis broke this July, Summers was understandably bitter. On a web site called Creative Capitalism, he wrote:

> What went wrong? The illusion that the companies were doing virtuous work made it impossible to build a political case for serious regulation. When there were social failures the companies always blamed their need to perform for the shareholders. When there were business failures it was always the result of their social obligations. Government budget discipline was not appropriate because it was always emphasized that they were "private companies." But market discipline was nearly nonexistent given the general perception—now validated—that their debt was government backed. Little wonder with gains privatized and losses socialized that the enterprises have gambled their way into financial catastrophe.[2]

However, Summers was far from a lonely critic of the GSEs. Lawrence J. White, who served on the board of the agency regulating Freddie Mac from 1986 through 1989, wrote a study for the Cato Institute in 2004 in which he advocated full privatization of the GSEs.[3] He suggested having the government disavow any guarantees to GSE investors.

That same year, in *Privatizing Fannie Mae, Freddie Mac, and the Federal Home Loan Banks: When and How*, Peter J. Wallison, Bert Ely, and Thomas J. Stanton proposed that steps be taken to level the playing field so that banks could compete with GSEs, thereby reducing the dependency of the housing finance system on GSEs.

In hindsight, knowing what we know today, we can say that:

1. The overall policy of promoting home ownership was carried to excess. By 2006, the demand for housing had boosted prices to unsustainable levels. However, Congress was reluctant to restrain the market. Instead, even though the GSEs were not supposed to purchase high-risk mortgages, under pressure from Congress they bought hundreds of billions of dollars of securities backed by subprime loans.
2. Even taking as given the goal of expanding home ownership, the public policy case for subsidizing mortgage finance was weak. Rather than constituting a "positive externality," the heavy load of mortgage indebtedness posed a major systemic risk.
3. The case for using the GSEs as a vehicle to subsidize mortgage finance was weaker still. As Summers and others have pointed out, the GSE structure serves to privatize profits and socialize losses.
4. Even if one thought that home ownership was worth encouraging, mortgage debt was worth subsidizing, and the GSE structure was viable, allowing the GSEs to assume a dominant role in mortgage finance was a mistake. The larger they grew, the more precarious our financial markets became. It reached the point where the health of the entire financial system appeared to depend on the health of the GSEs.

The Latest Legislation

In July 2008, Congress passed comprehensive legislation aimed at the housing market, including some provisions pertaining to the GSEs. The legislation provides for a multi-year increase in the ceiling on loans eligible for purchase by the GSEs, to $625,000. What is more important, in order to restore investor confidence in GSE securities, the new law gives the U.S. Treasury the authority to extend almost unlimited credit to the GSEs and even to purchase equity in the companies. Lastly, the legislation creates a new independent regulatory agency to oversee the GSEs.

It appears that the intent of Congress is to keep the GSEs substantially as they are.

The overall policy of promoting home ownership was carried to excess.

Freddie Mac and Fannie Mae are supposed to continue to add to their portfolios. As long as their financial condition does not deteriorate radically, the management and ownership structure of the GSEs will remain unchanged.

In short, the new legislation contemplates business as usual. The GSEs will continue to serve as the conduit for an indirect subsidy to home buyers, with GSE shareholders getting much of the profits and taxpayers bearing the costs and, most importantly, the risks.

Unwise Approach

Current policy treats the GSEs as essential to U.S. housing finance. That is an unwise approach. It makes the housing market unnecessarily fragile. It sets up a permanent conflict between shareholders and taxpayers, to be mediated by an untried regulatory agency.

The U.S. mortgage market is the largest financial market in the world. When two firms together hold more than one-third of the outstanding mortgage debt, the entire financial system is fragile. The risks involved in mortgage lending would be better spread among dozens of institutions, rather than concentrated in the two GSEs. With dozens of mortgage lenders, the failure of any one firm could be dealt with through a merger, rather than forcing the taxpayers to bear the full brunt of the risk.

The risks involved in mortgage lending would be better spread among dozens of institutions, rather than concentrated in the two GSEs.

With GSE debt guaranteed by the government, there is a conflict between shareholders and taxpayers. For shareholders, the way to maximize profits is to borrow at the nearly risk-free rate (courtesy of the government's guarantee) in order to finance risky lending. The incentive is to take on a large portfolio with minimal capital. The goal of protecting taxpayers requires the opposite: stiff capital requirements, with limits on portfolio size and risk-taking. Until recently, the Office of Federal Housing Enterprise Oversight was charged with implementing capital regulations. It remains to be seen whether under a new regulator, called the Federal Housing Finance Agency, this function will be handled any more effectively. The FHFA merely takes the existing personnel out of the Department of Housing and Urban Development. Its permanent director will be appointed by the next president, and the transition is not expected to be complete until at least July of 2009.

Alternatives

The attempt to preserve the status quo is not necessarily the best approach. In a July 27, 2008, newspaper column, Lawrence Summers compared the Bear Stearns merger with the housing legislation:

> Consider how much more problematic the Bear Stearns response would have been had policymakers signalled their commitment to back the company's liabilities without limit; left management in place with no change in the business model; and allowed dividends to be paid and shareholders to keep going with hope for a better tomorrow. Yet all of these elements are present in the cases of Fannie and Freddie.[4]

Summers compared the status quo with the GSEs to the S&L crisis of the early 1980s, where the attempt by Congress and regulators to keep the thrifts going ultimately added to the taxpayers' losses. Summers recommends operating the GSEs as government corporations for several years. At that time, he would sell whatever components of the GSEs are profitable to fully private entities.

I would recommend a strategy that aims at spreading the mortgage business across a wider range of financial institutions. In particular, regulators should contemplate freezing the mortgage purchase activities of the GSEs while at the same time loosening the capital requirements for banks to hold low-risk mortgages.

A freeze would have two beneficial effects. First, in the event that Freddie or Fannie becomes insolvent, the failure will be easier to manage if the firm is smaller, with less uncertainty about the outlook for its mortgage portfolio. Second, a freeze would lead to an expansion of the role of banks and other financial institutions in the mortgage market, ultimately resulting in a stronger mortgage finance system.

As the GSEs continue to purchase new mortgages, their portfolios become more difficult for other firms to assess or to absorb. New mortgages are the most difficult to assess in terms of risk. Within a few years, any flaws in the borrower's capacity to manage credit have been exposed, and the initial trend of home prices in the area has been observed. Once mortgages have been seasoned for several years, the default rate is usually predictable.

Assuming that the GSEs' capital is sufficient to absorb any losses, it would be possible for the government, within 5 to 10 years, to credibly eliminate its guarantee of GSE liabilities. Today, government cannot limit its guarantee, because too many security-holders would be adversely affected. However, in several years, when the financial condition of the firms will be much clearer and the size of their obligations will be much smaller, the blank-check guarantee should no longer be needed. Once the guarantee is eliminated, the GSEs can resume their purchases of new mortgages. At that point, they would face the discipline of the capital markets, which would make it extremely unlikely that their market shares would reach dangerously high levels.

What would a GSE freeze do to the mortgage market? Other lenders, primarily banks, would have to step in and bear the default risk and investment risk of mortgages. They tend to charge higher rates than the lenders who sell their loans to the GSEs. This can be seen in the market for so-called "jumbo" loans, which are mortgages that are larger than the GSEs' purchase limits. Historically, jumbo loans have cost about one-fourth of one percentage point more than GSE-eligible loans. That would suggest only a modest impact of losing the GSE presence in the mortgage market.

More recently, however, as mortgage-backed investments have acquired a stigma, the spread between jumbo rates and GSE-eligible rates has widened to a full percentage point. This suggests that the impact of losing the GSE presence could be that large.

It might be argued that even an increase of one-fourth of one percentage point in mortgage rates is something that public policy should seek to avoid. If so, public policy can avoid that consequence through a number of means. One approach to consider would be to modify the capital requirements of banks.

Banks, like the GSEs, have liabilities that are guaranteed by the U.S. government. Bank deposits are insured by the Federal Deposit Insurance Corporation. Accordingly, banks have no inherent cost disadvantage relative to the GSEs in making mortgage loans. However, banks do have a regulatory disadvantage, based on differences in capital requirements. Reducing or eliminating those differences would allow banks to offer mortgage loans at rates that compete with GSE rates.

The main reason that the GSEs grew to dominate the market for loans that fit their eligibility criteria is that their capital requirements were derived from the default risks of the mortgage loans. In contrast, banks have to hold an amount of capital against their mortgage assets that is higher, particularly for those mortgage loans with the lowest default risk.

Bank regulators could, on either a temporary or permanent basis, reduce the capital requirements for low-risk mortgages held by banks. Low-risk mortgages would be mortgages where the borrower makes a down payment of 20 percent, or 10 percent with mortgage insurance. These are the loans that are "conforming loans," meaning that they fall within the GSEs' charters. Reduced capital requirements would encourage banks to compete more aggressively for those loans, thereby mitigating some of the impact of a freeze on new purchases by the GSEs.

One approach might be to reduce the capital requirements for low-risk mortgages purchased over the next three years, so that the housing market can start to recover from the collapse of prices in the past year. After three years, the capital requirements for new mortgage purchases could be brought back to current levels, perhaps under a gradual phase-in.

With or without modifying bank capital requirements, freezing GSE purchases would

One approach might be to reduce the capital requirements for low-risk mortgages purchased over the next three years, so that the housing market can start to recover.

serve to restructure the mortgage finance system. The result would almost surely be an industry that is much less concentrated than the current duopoly. A housing finance system that does not rely so heavily on Freddie Mac and Fannie Mae will be more robust.

There is no fool-proof system for handling mortgage credit risk. We have to assume that sooner or later some of the institutions involved in mortgage finance will fail. The policy should be to promote a housing finance system where mortgage risk is spread among dozens of institutions. That way, the failure of some firms can be resolved through mergers and orderly restructuring, without exposing the financial system to the sort of catastrophic risk that is represented by Fannie Mae and Freddie Mac.

Notes

1. Dawn Kopecki and Bryan Keogh, "Fannie Mae Pays Record Spreads on Two-Year Note Sale (Update3)," Bloomberg.com, July 9, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a5DLtYxm1Y08

2. Lawrence Summers, "Our Creative Mortgage Crisis?" Creative Capitalism: A Conversation, July 16, 2008, http://creativecapitalism.typepad.com/creative_capitalism/2008/07/our-creative-mo.html.

3. Lawrence J. White, "Fannie Mae, Freddie Mac, and Housing Finance: Why True Privatization Is Good Public Policy," Cato Institute Policy Analysis no. 528, October 7, 2004.

4. Lawrence Summers, "The Way Forward for Fannie and Freddie," *Financial Times*, July 27, 2008, http://www.ft.com/cms/s/0/b150d388-5bf8-11dd-9e99-000077b07658.html.

Published by the Cato Institute, Cato Institute Briefing Papers is a regular series evaluating government policies and offering proposals for reform. Nothing in Cato Institute Briefing Papers should be construed as necessarily reflecting the views of the Cato Institute or as an attempt to aid or hinder the passage of any bill before Congress.

CATO INSTITUTE

Contact the Cato Institute for reprint permission. Additional copies of Cato Institute Briefing Papers are $2.00 each ($1.00 in bulk). To order, or for a complete listing of available studies, write the Cato Institute, 1000 Massachusetts Avenue, N.W., Washington, D.C. 20001. (202) 842-0200 FAX (202) 842-3490.