Some of the nation’s leading economists are concerned about the safety and soundness of twin mortgage giants Fannie Mae and Freddie Mac.

There are two frequently asked questions on this topic: Who are Fannie and Freddie? And then: Who cares?

Casual listeners of National Public Radio might recognize Fannie Mae as the top-of-the-hour sponsor that’s “in the American dream business.” The spots don’t mention that Fannie Mae and Freddie Mac happen to be among the largest (among the top five in assets) and most profitable companies in the country.

As you can imagine, these firms carry a lot of political clout. They credibly argue that their activities result in lower mortgage rates. They have also spent much of the last decade asserting that the chances they might need a government bailout are way, way down the list of doomsday financial calamity scenarios. A lot of people think they’re right.

Invisible to most Americans, the high-stakes battle over the future of Fannie Mae and Freddie Mac has arrived at an important moment. Lawmakers are proposing bills that may fundamentally change the way these “government-sponsored enterprises,” or GSEs, operate. Over the past decade, both camps have unleashed a flurry of research studies that alternately play up and play down the risks and benefits of Fannie and Freddie.

On one side are economists, free-market champions as well as some financial companies that might gain if the housing GSEs were forcibly downsized. The U.S. Treasury and the Federal Reserve Board of Governors have also taken strong positions in favor of GSE reform. These critics find objectionable the breathtaking growth of Fannie Mae and Freddie Mac. The companies are owned by private shareholders but their debt is viewed by the market as implicitly backed by the U.S. government. The way detractors see it, that’s a recipe for moral hazard. Investors can reap profits as long as things are going well. But their ability to borrow at low rates allows them to dominate their markets and accumulate large concentrations of risk, and if there is a downturn, ultimately taxpayers are on the hook. The firms are so big that their crashes could cause ripple effects throughout the entire economy. Their debt totaling more than $1.7 trillion, about the same amount of assets held in the 1980s by the savings and loan industry, whose taxpayer bailout totaled $150 billion.

On the other side are Fannie and Freddie and virtually the entire U.S. housing industry, including mortgage lenders, investment banks (which underwrite the GSEs’ substantial debt offerings), home builders, and real estate brokers. All assert that the advantages shared by the housing GSEs serve a wider cause: Fannie and Freddie help reduce the cost of housing for everybody. Without them, homeownership would be an unreachable dream for scores of Americans, the story goes.

At its center, the debate boils down to matters of principle and potential peril. Economists like Dwight Jaffee at the University of California at Berkeley, find the principle of housing GSEs disagreeable at best, perilous at worst. “I do believe that there is an extremely serious systemic risk,” Jaffee says. “In our lifetime, if we don’t change the system, there will be a day when Fannie and Freddie are in trouble.”

Truth be told, there is broad agreement among economists that the housing GSEs are flawed — they are inefficient ways to subsidize the U.S. housing market and they pose significant risks to the economy. Fixing them simply makes economic sense. But real reform will require overcoming arguments like those of Princeton University economist Alan Blinder, whose hard-to-argue-with position is, basically, we could do a lot worse.

“At least with the GSEs, we get something. We created a very liquid, very efficient market which didn’t exist before,” says Blinder, a former Fed Governor, who has since conducted research sponsored by Fannie Mae. “If I fall asleep worrying about financial risks, it’s not Fannie and Freddie. There are many things that come ahead.”

Wall Street Darlings

Fannie Mae and Freddie Mac are the respective nicknames of the Federal National Mortgage Association and the Federal Home Mortgage Corp. Fannie was created in 1938 by the Federal Housing Authority and Freddie in 1970 by Congress. Both were later converted to private corporations and now investors can buy shares in the companies on the New York Stock Exchange.
But many of their government ties remain intact.

Today Fannie and Freddie are very similar in business profile: Together they dominate the secondary mortgage market. This is where “primary” mortgage lenders — like banks and other originators — sell the loans they’ve made to home buyers. By selling their loans, they get back cash or other currency and thus can turn around and make more loans.

The GSEs do one of two things with their purchased mortgages. First, they bundle them up into securities and sell them to investors. These securities are backed by the mortgages that the GSEs have bought, hence the name “mortgage-backed securities.” Investors receive payment of interest and principal on the underlying mortgages, and Fannie and Freddie reap an annual “guarantee fee” of about 20 basis points.

As economists W. Scott Frame of the Atlanta Fed and Lawrence White of New York University explain it in a working paper, “In essence, Fannie Mae and Freddie Mac are providing insurance to holders of mortgage-backed securities.”

The second thing Fannie and Freddie do with purchased mortgages — either ones they’ve bought directly from mortgage originators or else picked up in the form of securities on the open market — is keep them on their books. In this case, they directly collect principal and interest payments. They are able to fund their portfolio purchases primarily by issuing enormous sums of debt. (As of this summer, about 95 percent of Fannie’s and Freddie’s assets were reported as funded with debt.) These retained portfolios, much more so than the securitization business, are red flags for economists because all that risk sits squarely on the GSE balance sheets.

The housing GSEs make money in large part because they’re not like other companies. Their special features include: 1) exemption from state and local income taxes; 2) a direct line of credit with the U.S. Treasury for up to $2.25 billion; and 3) a release from many state investor protection laws.

Most important, their charters lend a “halo of government support.” That is, investors assume that when Fannie and Freddie borrow, their debt will ultimately be backed by the federal government. Thanks to this assumption, Fannie and Freddie enjoy an approximately 40 basis point funding advantage over firms of similar size and with similar risk characteristics, according to the most widely cited studies.

Nowhere can you find a written statement that if Fannie or Freddie were to fail, the government would jump in. Fannie and Freddie themselves declare that the government does not back their debt. Just the same, investors assume that the government wouldn’t let Fannie and Freddie collapse. They’re probably right.

The savings and loan bailout is the most widely named precedent, but a more proper citation is that of the Farm Credit System, a bona fide government-sponsored enterprise to which lawmakers offered $4 billion to save in 1987. Indeed, Fannie Mae itself was granted special tax relief when it experienced financial difficulties in the 1980s.

Far from being failures, Fannie Mae and Freddie Mac arguably have been the Wall Street success story of the past 15 years. In 1990, the two brought in combined profits of $1.6 billion. By 2004, earnings had soared to almost $13 billion. Their assets enjoyed similar growth — from a combined $174 billion in 1990 to more than $1.8 trillion in 2004. Stock in each firm has quadrupled in value over the past 15 years.

Most of the growth is attributable to bulk up their retained mortgage portfolios, the business that stays on their balance sheets instead of being sold to investors. Today, Fannie and Freddie together hold about one-fifth of all U.S. home mortgages and mortgage-backed securities in these retained portfolios.

Analysts say that 1990 was the approximate point when Fannie and Freddie recognized the profit-maximizing strategy of growing their retained portfolios. Whereas the average guarantee fee for issuing mortgage-backed securities is 20 percent, the average spread between interest rates earned on mortgage assets and the interest costs of funding those liabilities is between 172 and 186 basis points. Fannie Mae and Freddie Mac now earn about 85 percent of their profits and revenues from their retained portfolios. “Opportunity knocked and they answered,” Jaffee says.

The “Principle” Objection

There is a whole school of would-be reformers who want to yank government ties from Fannie and Freddie for the simple reason that they think there is no need to subsidize the housing market. In the United States, homeownership stands at 69 percent — well above any other developed country. There is no market failure here and so there should be no subsidy, their logic goes.

At the same time, some economists — and many politicians — believe that the more homeownership, the better. Homeownership is thought to produce positive “externalities” of making good citizens and good neighborhoods. Thus, even a 69 percent homeownership rate should be improved upon.

But are Fannie Mae and Freddie Mac really the most efficient way to promote homeownership? That 40 basis point funding advantage is supposed to trickle down into reduced borrowing rates for residential loans. How much of it actually trickles down is one of the biggest sticking points in the “principle” debate over Fannie and Freddie.

Wayne Passmore, an economist at the Federal Reserve Board, takes one of the more skeptical views. In a series of papers he comes up with seven basis points for the amount of the GSE subsidy that gets passed on to consumers. In other words, mortgage rates are 0.07 percentage point lower thanks to Fannie and Freddie. The other 33 basis points, Passmore concludes, end up in the pockets of GSE shareholders.

Looking at Passmore’s findings, it’s as if the GSEs have been issued a government-backed credit card and gone on a spending binge. Fannie and Freddie shareholders have been enriched, taxpayers endangered, and the net result to homeowners, has been trivial. Seven
basis points is not believed to be sufficient to influence homeownership in the aggregate; in a 2002 study, economists at the Minneapolis Fed concluded that 200 basis points are needed to influence home buying trends.

A Fannie Mae spokesman declined to comment on a series of questions. Freddie Mac did not return several phone messages seeking comment.

Fannie and Freddie managers defended their turf before Congress in April. “Fannie Mae has drawn in billions of dollars from investors abroad to expand the availability and lower the cost of housing for low- and moderate-income Americans,” Daniel Mudd, interim CEO with Fannie Mae, told the U.S. Senate Committee on Banking, Housing, and Urban Affairs. In written testimony, Freddie Mac CEO Richard Syron (who served as president of the Boston Fed from 1989 to 1994) said: “The housing GSEs have attracted global capital, created new mortgage tools, and served as a shock absorber when the broader financial markets locked up. As a result, housing today is less vulnerable to the business cycle than ever before.”

Perhaps. It’s important to keep in mind, though, that foreign capital has been pouring into many sectors of the U.S. economy, not just the housing market. Fannie’s and Freddie’s portfolios arguably have grown because foreign investors believe they are subject to implicit federal protection and are therefore especially safe places to invest. Other than that, there is no reason why these companies should have a special ability to attract foreign capital.

In a study commissioned to address Passmore’s findings, economist Blinder and two co-authors said their research shows that 25 to 30 basis points of the implicit subsidy get passed on to consumers — not seven basis points.

“The peril of difference,” Blinder says. And to him, it justifies the continued government backing of Fannie and Freddie.

The “Peril” Objection

Fannie Mae and Freddie Mac are supervised by the Office of Federal Housing Enterprise Oversight, or OFHEO, which is part of the Department of Housing and Urban Development. OFHEO’s chief job is enforcing GSE capital requirements. The legislation that created OFHEO also dictates that HUD each year establish the percentage of loans that the GSEs must buy from low- and moderate-income plus urban home buyers. (Another key way the GSEs target affordable housing is by virtue of the limits of the size of mortgages they can buy. In 2005, the limit was $359,650. Anything bigger than that is termed a “jumbo” mortgage and only private firms can buy them in the secondary market. Of course, the vast majority of loans that fall below the jumbo limit do not go to low-income home buyers.)

OFHEO is among those supporting reform of the housing GSEs. The office wants increased powers consistent with what bank regulators have, such as strengthened capital powers, enforcement authorities, and the power of receivership. Patrick Lawler, chief economist with OFHEO, grants that the odds of Fannie and Freddie actually causing a systemic problem to the economy are remote, but adds, “A remote possibility with very large consequences is important to consider.”

What worries examiners at OFHEO is the GSE Achilles’ heel: interest-rate risk. If rates suddenly decline, homeowners are more likely to refinance their mortgages, in which case Fannie and Freddie would be making debt payments at rates higher than the returns they would be collecting from newly acquired mortgages. Conversely, a rapid rise in rates would mean the GSEs would be taking on new debt at rates higher than the returns they’d be raking in from their retained mortgages.

Lawrence White of New York University, describes it this way: “They generally do what they do well — but there is the possibility that something could go wrong.”

Fannie and Freddie and their defenders point out that modern-day financial vehicles like derivatives offer protection from rate swings. The GSEs are among the biggest users of derivatives like interest-rate swaps and related transactions — and they maintain that they are among the best at it. But hedges like these aren’t perfect. And more to the point, some studies have found that Fannie and Freddie aren’t even trying to come close to perfectly hedging their interest rate risks because to do so would hurt profits. By Jaffee’s count, the GSEs would give up at least $1 billion in profits if they were to fully hedge their interest rate risks.

Economists like Jaffee have been sounding alarms about the housing GSEs for years to no effect. It wasn’t until this past year that reform efforts finally gained traction. Accounting scandals hit Freddie Mac and Fannie Mae in 2003 and 2004, respectively, making the firms suddenly vulnerable. Both firms were found to be improperly accounting for their interest rate hedges and had to restate earnings down by $9 billion in Fannie Mae’s case and up by $5 billion in Freddie Mac’s.

Now, reformers can basically be grouped into three camps: those wanting to keep the GSEs intact with a stronger regulator; those pushing for strict limits on their retained portfolios; and those aiming for full privatization.

The “mini” reform crowd includes members of the housing industry. “We do believe they play an important role, particularly in the provision of liquidity through the securitization process,” says Doug Duncan, chief economist with the Mortgage Bankers Association. As a purely descriptive matter, this is surely true. But many economists doubt whether Fannie and Freddie are now essential to a well-functioning secondary mortgage market. In their absence, private firms would likely step in and provide similar services.

Duncan’s group supports the creation of an “independent, well-funded regulator, very much bank-like.” Fannie and Freddie officers have testified before Congress that they would support the establishment of a new regulator with expanded powers to rewrite risk-based capital standards and place troubled GSEs into receivership. They don’t want detailed statutes that spell out what the GSEs can and
can’t do. And most important, they don’t want restrictions on their mortgage portfolios. Freddie Mac CEO Syron, in prepared remarks before the Senate in April, said: “For Freddie Mac to continue fulfilling its mission, there is a very real limit to how far the restrictions on us can be increased — and our abilities diminished.”

Clamping Down
The next tier of those pushing for overhaul call for dramatic curtailments in the GSEs’ mortgage portfolios — the combined $1.5 trillion sitting on Fannie and Freddie balance sheets that constitute the interest rate risks. Those in favor of this approach, including the Federal Reserve Board and the U.S. Treasury, focus on that part of GSE activity with the greatest potential for systemic risk and taxpayer loss — the companies’ ability to borrow at subsidized rates and build large exposures to interest rate swings through their portfolio holdings.

Fannie and Freddie are especially opposed to this idea. They argue that forcing them to cull their mortgage portfolios would hurt U.S. home buyers. They say that foreign investors in particular are attracted to GSE debt — but wouldn’t be so enamored with fully private-sector alternatives, thus reducing overall liquidity in the U.S. mortgage market. (But any such special characteristics of GSE debt come only from their special status and their implicit subsidy, and foreign investment in a wide array of U.S. assets has shown healthy growth since the late 1990s.) Finally, Fannie and Freddie say that profits from their portfolios support affordable housing activities, and that their interest rate risks are no worse (and perhaps better) than those faced by the largest U.S. banks. Recent accounting problems associated with their use of derivatives (for risk-management) at the very least call this assertion into question.

The case for limiting portfolio size is strong, though, and was summed up by Fed Chairman Alan Greenspan in his testimony before the Senate in April. “We have been unable to find any purpose for the huge balance sheets of the GSEs, other than profit creation through the exploitation of the market-granted subsidy,” he said. “As far as we can tell, GSE mortgage securitization, in contrast to the GSEs’ portfolio holdings, is the key ingredient to maintaining and enhancing the benefits of the GSEs to home buyers. And mortgage securitization, unlike the GSEs’ portfolio holdings, does not create substantial systemic risks.”

Time to Cut Ties?
Privatization is the goal of the third tier of reformers. In a June 2005 paper, the Heritage Foundation, a Washington think tank, summed up its case this way: “Congress has an opportunity to reduce federal market risk and taxpayer exposure and to restore competition in the residential mortgage market. At the same time, the housing industry and homeownership opportunity will remain unaffected.”

Short term, privatization would be both logistically difficult to achieve and bad for shareholders in Fannie Mae and Freddie Mac. But it could also allow the GSEs to get into new businesses, such as making loans to home buyers, now the exclusive domain of primary market mortgage lenders, for example.

On this possibility, housing industry participants are united in opposition: Fannie Mae and Freddie Mac must be confined to their own business; there should be a “bright line” between allowed and forbidden endeavors. “There’s no question we have strong feelings what their charter empower them to do,” says Duncan of the Mortgage Bankers Association.

In fact, the housing GSEs have already made several forays into nonsecondary market activities. As detailed by the American Enterprise Institute, another Washington-based think tank, these forays include: expanding purchases of home equity loans; lending to luxury apartment developers; and marketing appraisal, title insurance and full-service insurance agency services. Additionally, both Fannie and Freddie are believed to be eying the consumer lending market. It is thus contrary to the interests of many in the housing industry to support broad GSE reform.

On the flip side? In the end, even a massive bailout wouldn’t be likely to directly cost taxpayers very much on a per-capita basis. So a Congress interested in promoting homeownership while protecting the economy faces mixed incentives. In a July research note about the possibility of new mandates forcing the GSEs to curtail their portfolios, Morgan Stanley analyst Kenneth Posner said, “We do not foresee Congress agreeing on such an extreme piece of legislation.”

That might be true. But it doesn’t make the case for reform any less compelling. “This is a bad way to supplement low-income housing,” says Jaffe.

**Readings**


Utt, Ronald D. “Time to Reform Fannie Mae and Freddie Mac.” Heritage Foundation Backgrounder #1861, June 20, 2005.


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