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H.R. 2900 — DOES IT REDUCE THE RISK OF FANNIE MAE AND FREDDIE MAC FAILURE?

INTRODUCTION

The Senate is now considering legislation passed overwhelmingly this September by the House of Representatives that will have profound consequences for America's residential mortgage lending industry. The Government-Sponsored Housing Enterprise Financial Safety and Soundness Act of 1991 (H.R. 2900) is sponsored by Representatives Henry Gonzalez, the Texas Democrat, together with Chalmers Wylie of Ohio, and Marge Roukema of New Jersey, both Republicans.

The bill gives the U.S. Department of Housing and Urban Development (HUD) extensive responsibility to oversee America's two major providers of residential mortgage capital: the Federal National Mortgage Association, or "Fannie Mae," and the Federal Home Loan Mortgage Corporation, or "Freddie Mac." The bill also would give the Federal Home Loan Bank System (FHLBS), which is another source of mortgage capital, greater opportunities to promote housing investment. The Bush Administration supports some, though not all, provisions of the bill.

Lawmakers' Fear. This legislation was introduced in Congress principally because of concerns about how Fannie Mae and Freddie Mac, with a combined \$800 billion in assets, function in the economy and how much potential risk they pose to the taxpayer. Many policy makers, for instance, are troubled that while the organizations operate with the profit incentives of private firms, they enjoy special taxpayer subsidies and federal protection from failure. The haunting fear is that if the corporations falter, the taxpayer could end up being forced to bail them out.

Policy makers also are unsure how best to regulate such quasi-private organizations. Policy makers disagree about what public obligations should be required of such corporations as a condition of their special status. It was such worry among policy makers that current regulatory safeguards may not be sufficient to prevent

Fannie Mae and Freddie Mac from potentially experiencing heavy losses that has prompted H.R. 2900. Its sponsors do not want a repeat of the multi-billion dollar federal bailouts required for the thrift industry.

Privileged Status. Although technically privately owned, these corporations actually are in a twilight zone between the private and the public sectors. This is because they enjoy a privileged status that combines their right to profit from private sector mortgage lending with an obligation that they act in a way that serves the public good. They also receive special financial benefits from the United States Treasury.

Fannie Mae and Freddie Mac were established by the federal government, in 1938 and 1970 respectively, to serve the purpose of supplying banks and other institutional lenders with ready access to residential mortgage capital, on the assumption that only publicly sponsored institutions could do this effectively and safely. The corporations receive federal favors that are denied to other mortgage institutions. For this reason, they are among the group of commercial organizations known as "Government-Sponsored Enterprises," or GSEs.

A growing unease about the risks posed to taxpayers by GSEs, reinforced by the costly savings and loan crisis, led Congress in recent years to mandate several studies to assess the danger of losses to GSEs. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), for example, requires the Treasury Department and the General Accounting Office to conduct two annual studies to assess the financial safety and soundness of government-sponsored enterprises. The Omnibus Budget Reconciliation Act of 1990 (OBRA), meanwhile, requires the Treasury Department and the Congressional Budget Office (CBO) to assess GSE financial soundness and regulatory adequacy. OBRA also requires the Treasury Department to draft legislation to ensure the soundness of GSEs in general, and requires both the House Committee on Banking, Finance and Urban Affairs, and the Senate Committee on Banking, Housing and Urban Affairs to report such legislation by September 15, 1991. The legislation passed the House in September and is now before the Senate.

Triple-A Ratings. Despite the understandable sense of alarm, Fannie Mae and Freddie Mac are in no apparent danger of failing. Extensive review by five federal agencies—the Treasury Department, the Department of Housing and Urban Development, the Congressional Budget Office, the Office of Management and Budget, and the General Accounting Office—each concludes that Fannie Mae and Freddie Mac are well-run and pose no immediate threat to the taxpayer.¹ Fannie Mae and Freddie Mac also enjoy Triple-A ratings (the highest rating possible) from nationally recognized securities-rating agencies such as Standard and Poor's and Moody's.

¹ The most important of these studies are U.S. Department of the Treasury, *Report of the Secretary of the Treasury on Government-Sponsored Enterprises*, May 1990; U.S. General Accounting Office, *Government-Sponsored Enterprises: The Government's Exposure to Risks*, GAO/GGD-90-97, August 1990; Congressional Budget Office, *Controlling the Risks of Government-Sponsored Enterprises*, April 1991.

Nevertheless, widespread fear does exist among Bush Administration officials and lawmakers that the large obligations of the mortgage corporations, especially in the current recession, require more careful scrutiny of their activities. Treasury Under Secretary for Finance Robert R. Glauber told Congress this summer:

The lack of an immediate GSE problem has caused some to suggest 'If it ain't broken, don't fix it.' We, however, believe that complacency would be inappropriate. The financially devastating failure of many federally insured thrift institutions in the 1980s was preceded by many years of profitability of these institutions.. ..The luxury of waiting until a financial crisis is painfully evident has now clearly been seen as costly and difficult for the American taxpayer.²

H.R. 2900 thus is being touted as preventative medicine to preserve the financial integrity of Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System, but without undermining their historic mandate of widening opportunities for homeownership among all income groups.

As it now reads, H.R. 2900 would:

◆ ◆ **Place many of the operations of Fannie Mae and Freddie Mac under the supervision of a new regulatory office within the Department of Housing and Urban Development, to be known as the Office of Secondary Market Examination and Oversight (OSMEO).** HUD has had some regulatory powers over Fannie Mae since 1968, and over Freddie Mac since 1989, but H.R. 2900 would greatly expand HUD's authority to monitor the GSEs.

◆ ◆ **Set standards for capital reserves for Fannie Mae and Freddie Mac.** After an eighteen-month transition, these corporations would be required to maintain 2.5 percent of their total assets as equity capital. No such standards currently exist for GSEs, although each GSE is capitalized at about 1 percent. By comparison, federal regulators require fully private institutions to maintain 4 percent of their total assets as equity capital.

◆ ◆ **Require purchases of low-income mortgages.** Fannie Mae during 1992 and 1993 would have to buy \$2 billion in mortgages on homes purchased by low-income homebuyers from mortgage lenders. Half of these purchases would be for family residences (defined as fewer than five dwellings per structure) and the other half for multifamily residences. Freddie Mac would have to buy \$1.5 billion in such mortgages under the same guidelines. Some 45 percent of these mortgages must be for buyers with incomes of no more than 80 percent of the median income in the area. Fannie Mae and Freddie Mac additionally would be barred from doing business with lenders demonstrating "substantial non-compliance" with the Community Reinvestment Act. This 1977 law, strengthened in

² Statement of Robert R. Glauber, Under Secretary of the Treasury for Finance, U.S. Congress, House of Representatives, Committee on Banking, Finance and Urban Affairs, Subcommittee on Housing and Urban Development, July 1991, reprinted in *Treasury News*, July 18, 1991, pp. 1-2.

1989, mandates that lenders take affirmative steps to lend in low-income neighborhoods.

◆◆ **Lift the current 30 percent ceiling allowed on Federal Home Loan Bank System advances to banks making housing loans.** The Federal Home Loan Bank System makes available funds, known as “advances,” to thrifts and banks to use as capital for mortgages. But only 30 percent of these advances currently can be made to banks, limiting their ability to serve the mortgage market. The intent of this provision is for the Federal Home Loan Bank System to encourage more commercial banks to make mortgage loans, thereby increasing competition and giving homebuyers a wider choice of lender.

Although this legislation stems from laudable motives, it is by no means clear that it will make the mortgage market operate more efficiently, or actually protect the taxpayer from a bailout. Among the dangers implicit in the legislation:

◆◆ **The legislation retains the quasi-independent nature of Fannie Mae and Freddie Mac.** Thus managers of the corporations will still have the perverse incentive of shareholder pressure to pursue profit combined with taxpayer protection against failure. Further, the legislation continues the favored status of the corporations, courtesy of the Treasury; competing, fully private firms, of course, are not so privileged.

◆◆ **The new regulatory office proposed by Congress would be more answerable to Congress than to the Executive Branch.** Recent history, however, suggests that congressional “oversight” often leads to favoritism and corruption rather than to prudent regulation.

◆◆ **Raising capital standards actually may reduce the soundness of the corporations by encouraging managers to pursue riskier business to maintain acceptable returns to shareholders.**

◆◆ **Requiring Fannie Mae and Freddie Mac to increase their purchases of low-income mortgages will reduce further their profitability and financial soundness.**

Rather than trying to micromanage these quasi-independent government-sponsored enterprises, taxpayers would be better protected, and homebuyers better served, if Congress were to completely privatize Fannie Mae and Freddie Mac, ending the benefits that they receive from the Treasury. This would end the risk posed by corporations in which the profits are private yet the risks ultimately are public.

If Congress, however, insists on retaining Fannie Mae and Freddie Mac in their privileged position, lawmakers need to make sure that the corporations are regulated in a manner that will protect the taxpayer while distorting the mortgage market as little as possible.

To do this, Congress should assure that the regulators are answerable primarily to the Executive Branch, and then to Congress, rather than being micromanaged by Congress. In addition, Congress should establish reasonable minimum capital requirements for these institutions. While it is justified in establishing risk-based requirements, Congress should avoid the mistake of making them too high—

thereby actually weakening the soundness of the corporations. In addition, the bill should avoid mandating that Fannie Mae and Freddie Mac allocate a certain portion of their mortgage purchase to mortgages deemed "affordable" to low-income homebuyers. Instead, Congress would be wiser to take action through separate legislation to reduce the red tape that unnecessarily raises cost of housing.

The need for financial solvency at Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System is not at issue. Everyone in the Administration and Congress knows that taxpayers should not be exposed to widespread default on their assets. In seeking safeguards for solvency, however, the federal government should not hamper the ability of these firms to be run in the public interest.

HOW GOVERNMENT-SPONSORED ENTERPRISES FUNCTION

Fannie Mae and Freddie Mac are Government-Sponsored Enterprises designed to increase and manage investment in housing. Their function is to purchase mortgages from banks and other mortgage lenders, using funds from shareholders and other investors.

Other private firms, of course, also can buy mortgages. These private firms, however, mainly buy mortgages above \$191,250, since Fannie Mae and Freddie Mac legally are restricted to mortgages below this. Similar GSE corporations operate in other areas of the economy. In agriculture, the equivalent agency is the Farm Credit System. For higher education, it is the Student Loan Marketing Association ("Sallie Mae").

Fannie Mae was created by Congress as a government agency in 1938, and rechartered as a shareholder-owned private firm in 1968. Freddie Mac was created in 1970 as a part of the Federal Home Loan Bank System to specialize in conventional home mortgages; in 1989 it was made into a firm similar to Fannie Mae.

Fannie Mae and Freddie Mac are designed to serve sectors of the economy thought to be poorly served by private credit markets. Although they are private corporations, the GSEs do not function as ordinary firms, but rather as public-private partnerships. As partnerships, they have social obligations.

Close Scrutiny. The GSEs implicitly are protected by the federal government from insolvency. Considered "too big to fail," the GSEs are given commercial advantages, such as low-cost financing from the Treasury and exemption from state and local taxes. Because of these advantages over their private competitors, the GSEs are scrutinized closely by the federal government to ensure that their privileges are not misused and their legal obligations are discharged.

To entice investment in the GSEs by investors who want the same safety as they get from U.S. Treasury bills or bonds, the federal government gives Fannie Mae and Freddie Mac advantages obviously unavailable to competing purely private firms. These special benefits include:

- ◆ **A guarantee** against losses, enabling the GSEs to raise funds at interest rates below purely private corporations with similar credit ratings;³
- ◆ **An exemption** from federal deposit insurance fees, which ordinary banks and thrifts must pay;
- ◆ **Lower** minimum capital requirements, enabling the firms to attract capital at lower cost;
- ◆ **A line of credit** with the U.S. Treasury, currently at \$2.5 billion;
- ◆ **An exemption** from certain federal securities laws; and
- ◆ **An exemption** from state and local taxes.

Fannie Mae and Freddie Mac are not “primary” mortgage lenders; in other words, they do not underwrite mortgage loans to individuals or developers. Fannie Mae and Freddie Mac have special advantages because Congress chartered them to provide “secondary” mortgage funding. Secondary mortgage institutions buy loans from private lenders, such as thrifts and banks, who make them. Fannie Mae and Freddie Mac then either sell the mortgages to private investors as “mortgage-backed securities” (guaranteeing timely payment of interest and principal) or to a lesser extent, hold them in a separate fund. These secondary mortgage market operations link mortgage markets and capital markets. They provide greater liquidity for residential mortgages and increase the availability of mortgages in states and regions experiencing a tight mortgage market.

Short-Term Liquidity. The Federal Home Loan Bank System, unlike Fannie Mae and Freddie Mac, is not a single firm but an association of mortgage lenders served by twelve regional banks. Analogous to the Federal Reserve System, FHLBS was established in 1932 to provide loans to depository institutions—mainly savings and loan associations—that underwrite residential mortgages. FHLBS raises funds to make loans through issuing bonds in international capital markets. The Home Loan Bank System is subject to much stricter federal capital requirements than either Fannie Mae or Freddie Mac. Its loans, better known as “advances,” provide short-term liquidity for lenders to finance housing. The system is in sound financial condition. No member lending institution has ever defaulted. Because the agency’s main beneficiaries—savings and loans—are shrinking in size and influence, the demand for future loans is likely to fall.⁴

The cumulative loans outstanding to GSEs exceed \$1 trillion, more than \$800 billion of which is accounted for by Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac’s combined new purchases of mortgages amounted to about \$10.5 billion in 1981. By last year, new purchases jumped to \$190 billion, an almost 2,000 percent increase in less than a decade.⁵

³ Fannie Mae and Freddie Mac can raise funds at 35 to 75 “basis points” (0.35 to 0.75 of 1 percentage point of the value of the loan) below private lenders.

⁴ Congressional Budget Office, *Controlling the Risks of Government-Sponsored Enterprises*, p. xxxv.

⁵ *Ibid.*, p. 125.

Both corporations are enjoying healthy profits. Last year, Fannie Mae reported a record \$1.17 billion profit, a 45 percent jump from 1989's record \$807.3 million.⁶ Despite the recession, with many housing lenders forced to curtail new

mortgage underwriting, Fannie Mae and Freddie Mac this year are expected to enjoy combined profits of \$2 billion.⁷ In comparison with commercial banks, both GSEs are extremely profitable. According to the General Accounting Office, the annual return on average equity for Fannie Mae and Freddie Mac during 1985 to 1989 was 17.9 percent and 27.8 percent, respectively; the average return for banks was 8.9 percent.⁸

Because they are the largest Government-Sponsored Enterprises, the fortunes of Fannie Mae and Freddie Mac greatly affect the entire housing industry. During 1980-1990, the proportion of all new mortgage debt secured by these agencies rose from 17 percent to 52 percent.⁹ Yet, despite the growth and soundness of Fannie Mae and Freddie Mac, Congress and various federal agencies are concerned that many of their loans and securities may default, especially given the current deep real estate recession.

Distorting the Credit Market. Neither of the firms appears to be in any danger of failing. While they did experience heavy losses during the 1981-1982 recession, their profit margins have steadily increased since the mid-1980s.¹⁰ To be sure, the firms do receive benefits from state and local agencies. The Treasury Department estimates the value of these benefits at between \$2 billion and \$4 billion annually.¹¹ Yet even without such help, these GSEs would be sound. Indeed, financial experts agree that Fannie Mae and Freddie Mac would receive adequate credit ratings without actual or potential government assistance.¹²

Still, the existence of these GSEs distorts the credit market in a way that reduces overall efficiency. Fannie Mae and Freddie Mac both enjoy federal support enabling them to do profitably what other competitors cannot. HUD Deputy Secretary Alfred DelliBovi has termed Fannie Mae and Freddie Mac a "duopoly," noting, "The two agencies have no competition except each other."¹³ This is the price paid by taxpayers for the special privileges of the two giant GSEs.

6 See Albert B. Crenshaw, "Fannie Mae Profit Rises 45 Percent," *Washington Post*, January 16, 1991.

7 Martin Mayer, "Another Favor for Fannie Mae and Freddie Mac," *Wall Street Journal*, October 22, 1991.

8 U.S. General Accounting Office, *Government-Sponsored Enterprises*, p. 64.

9 Letter from Alfred A. DelliBovi, Deputy Secretary, U.S. Department of Housing and Urban Development, to Allan B. Hubbard, Executive Director, President's Council on Competitiveness, August 8, 1991, p. 1.

10 In 1981, for example, the estimated market value of Fannie Mae's net worth stood at close to minus \$11 billion. A wholly private firm, under such circumstances, would have not had access to credit, or would have had to borrow at unusually high rates. Yet with implicit federal guarantees, it was able to continue borrowing large amounts at only a slight increase in borrowing costs, and to maintain its high credit rating. See U.S. General Accounting Office, *Government-Sponsored Enterprises*, p. 9.

11 U.S. Department of the Treasury, *Report of the Secretary*.

12 See U.S. House of Representatives, Committee on Banking, Finance and Urban Affairs, "Explanation of Provisions, H.R.2900, Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991," p. 3.

THE MAJOR ISSUES BEFORE CONGRESS

The legislation now before Congress would overhaul the regulatory framework for Fannie Mae and Freddie Mac, and would calm fears that the corporations may encounter problems if the real estate market continues to be depressed. The legislation raises four questions about GSEs in general, and Fannie Mae and Freddie Mac in particular:

- 1) **Should these institutions continue to enjoy a quasi-public status?**
- 2) **Who should be responsible for regulating them if they do continue having a special status?**
- 3) **What is the best way to ensure that they remain financially sound?**
- 4) **What is the best way to balance their public purpose of serving first-time home seekers with the need to remain financially sound?**

Question #1: Quasi-Public or Private Status?

Congress should question the wisdom of allowing GSEs to have it both ways: 1) the right to pursue profit in the private markets, and 2) a taxpayer guarantee against failure. It was the mixture of private profit-making incentives and government protection against failure, in the form of federal deposit insurance, that led to the staggering financial problems of the savings and loan industry. Observes banking expert Martin Mayer: "There is a case to be made for freeing Fannie and Freddie from all constraint and making them ordinary stockholder-owned companies, without tax breaks, presidential appointees on their board or supervision by HUD. There is a case for keeping them as government entities and supervising them closely. But there is no case for extending their freedom while keeping their crypto-government status."¹⁴

Recommendation:

Instead of confining itself to the issue of how to regulate Fannie Mae and Freddie Mac, Congress additionally should consider whether they should retain their privileged status, or be turned into purely private companies. Ideally, Fannie Mae and Freddie Mac should be fully private firms, subject only to a modest degree of federal regulation but losing all their current special financial benefits from the government. This would force managers to balance risk and reward in their business decisions. Failing that, Congress should make sure that the special benefits of these GSEs are employed for their basic purpose in the secondary mortgage market, and are not extended to markets which are now being served effectively by other financial institutions.

¹³ Letter from Alfred A. DelliBovi to Allan B. Hubbard, p. 2.

¹⁴ Mayer, *op. cit.*

