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Greenspan Agrees: Time to Rein in Fannie and Freddie

- Between 1992 and 2002, the outstanding debt of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) increased by 433 percent and 1,112 percent, respectively.
- At the end of 2002, the total amount of debt outstanding at the three housing government-sponsored enterprises – Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System – was $2.317 trillion, an amount equal to about 65 percent of total publicly held U.S. government debt at the time.
- In recent testimony before the Senate Banking Committee, Federal Reserve Chairman Alan Greenspan suggested that, if the GSEs' balance sheet assets and debt continue to grow rapidly, a financial crisis would be likely.
- This likelihood arises because of investors' expectations that the government would intervene in the event of a crisis. This perception precludes normal market constraints on the GSEs' growth and effectively results in a credit subsidy, allowing the GSEs to acquire more assets at a lower cost than would otherwise be the case.
- Do the benefits of the status quo outweigh this risk? The two most recent government studies on the subject suggest that Fannie Mae and Freddie Mac lower mortgage rates by between 0.07 percent [Federal Reserve, 2003] and 0.25 percent [CBO, 2001]. For the median-priced $160,000, 30-year mortgage, this savings translates into just $7 to $25 a month for the homebuyer. Studies compiled by the Federal Reserve suggest that such marginal savings have *no effect on homeownership*. These studies also found that, while first-time homebuyers make up 41 percent of all home purchases, only 25 percent of the GSE-financed loans go to first-time homebuyers.
- This revealing data – that the GSEs' effect on homeowners is minimal – undercut their claim to special treatment.
- Greenspan's testimony should challenge the Senate to act quickly to reduce the risks to the taxpayer, either by fundamentally altering their relationship with the government, or by establishing a new regulatory regime. Today's markup by the Senate Banking Committee of S. 1508, the "Federal Housing Enterprise Regulatory Reform Act of 2004," represents an important first step toward this end.

Alan Greenspan, chairman of the Federal Reserve Board of Governors, has added his voice to the growing chorus for fundamental reform of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Chairman Greenspan's testimony before the Senate Committee on Banking, Housing, and Urban Affairs on February 24 largely echoes the recommendation by the Office of Management and Budget (OMB), contained in the President's FY 2005 budget request, to substantively reform the current regulatory regime applied to these housing government-sponsored enterprises (GSEs).[1]

Among the specific concerns that both Greenspan and the President's budget referenced with respect to these privately owned and publicly traded housing GSEs were: their increased participation in the "asset management business;"[2] their low capital base relative to the amount of assets held on balance sheet; and their astonishing growth in outstanding debt.

Both Greenspan and OMB recognize that these concerns are but symptoms of the underlying problem: Fannie Mae and Freddie Mac's special relationship with the federal government largely relieves them of the market discipline imposed on purely private companies' activities. Despite explicit statements contained in the companies' prospectuses and in law that disavow government responsibility for Fannie Mae and Freddie Mac's obligations, investors are convinced that the cumulative effect of these companies' government charters is such that the government would have no choice but to come to their aid in a crisis. [3]

As a result, these GSEs take on more risk – and achieve higher returns on equity – than would otherwise be the case.[4] Greenspan and OMB are concerned that, in the event that unforeseen risks wipe out the GSEs' capital or threaten their ability to meet their obligations, the resulting financial and economic consequences could be calamitous given the GSEs' enormous size, importance to the housing sector, and close integration with the overall financial system.

What is perhaps the most telling – and compelling – observation by Greenspan and OMB is their suggestion that *Fannie and Freddie likely do little to increase homeownership or reduce mortgage rates*.[5] This assessment is of critical importance to the debate because Fannie and Freddie cite their role in promoting homeownership and reducing mortgage rates as the primary rationale for their charters and credit subsidy. Thus, given the very real risks and uncertain benefits of the status quo, it is time for

[1] OMB, "The Budget of the United States Government, Fiscal Year 2005," *Analytical Perspectives*, Credit and Insurance, pp. 81-85. Note: In addition to Fannie Mae and Freddie Mac, OMB also recommends that the regulatory reforms be extended to the other housing GSE, the Federal Home Loan Bank System (FLHB).

[2] *Analytical Perspectives*, p. 81.

[3] Alan Greenspan, Fed Chairman, in testimony before the Senate Banking Committee, February 24, 2004.

[4] Greenspan.

[5] Greenspan and *Analytical Perspectives*, pp. 83-84.

Congress to either officially sever the ties to these companies that give rise to the implicit guarantee, or dramatically heighten the regulatory scrutiny of these firms' activities.

The Senate Banking Committee today marked up S. 1508, the "Federal Housing Enterprise Regulatory Reform Act of 2004." As reported out of committee, the bill represents an important first step towards improving the regulatory supervision of the housing GSEs and reducing the risks the current regulatory regime poses to taxpayers.

The Crux of the Problem: The Implicit Guarantee

> *The GSEs' special advantage arises because . . . most investors have apparently concluded that during a crisis, the federal government will prevent the GSEs from defaulting on their debt. An implicit guarantee is thus created not by the Congress but by the willingness of investors to accept a lower rate of interest on GSE debt than they would otherwise require in the absence of federal sponsorship.*
>
> -Federal Reserve Chairman Alan Greenspan

The concept of an implicit guarantee can be a difficult one to grasp: Do taxpayers underwrite the risk of default on Fannie and Freddie's obligations or don't they? As Chairman Greenspan noted, "We're confronted with a situation in which, on one hand, there is a general belief in the marketplace that these securities are backed by the full faith and credit of the United States government…. but the law says they are not. And the larger that debt becomes, the more this is an issue."[6]

The term "implicit guarantee" is used by the Congressional Budget Office (CBO) to explain how – absent a full-faith-and-credit clause – Fannie and Freddie are able to borrow "at lower rates of interest" and in "far larger sums" than fully private firms.[7] As CBO notes, when taken together, the numerous privileges conferred on Fannie and Freddie's securities by their charters "have been sufficient to overcome an explicit denial of federal backing that the GSEs include in their prospectuses."[8]

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[6] Greenspan, in response to a question posed by Senator Allard.

[7] Douglas Holtz-Eakin, director, Congressional Budget Office, in testimony before the Senate Banking Committee, October 23, 2003.

[8] Holtz-Eakin. Fannie and Freddie's explicit advantages written into their charters and subsequent acts are as follows: Their debt and mortgage-backed securities are exempt from registration with the Securities and Exchange Commission, although in July 2002, both companies agreed to register their common stock under the Securities and Exchange Act of 1934 and to make other disclosures; they are exempt from state and local corporate income taxes; they have a line of credit from the Treasury that authorizes Treasury to purchase up to $2.25 billion of Fannie Mae and Freddie Mac's obligations; banks are permitted to make unlimited investments in Fannie and Freddie's debt securities, whereas there are limits placed on their investments in any other company's debt securities; Fannie and Freddie's securities are eligible as collateral for public deposits and for loans from Federal Reserve Banks and Federal Home Loan Banks; Fannie and Freddie's securities are lawful investments for federal fiduciary and public funds; the President can appoint five members of their board of directors; Fannie and Freddie's regulator lacks receivership authority, perhaps obviating any possibility of bankruptcy and the consequent damage to debt and equity holders; and Fannie and Freddie are authorized to use Federal Reserve Banks as their fiscal agents, including issuing and transferring their securities through the book-entry system maintained by the Federal Reserve. "Federal National Mortgage Association Charter Act," (12 U.S.C. 1716-1723); "Federal Home Loan Mortgage

Despite its ambiguity, there is much evidence to suggest that the implicit guarantee was an intentional policy choice of Congress. Former Freddie Mac Chief Economist Robert Van Order noted that it was "budget pressures from the Vietnam war" that led Congress to transform Fannie Mae from a wholly-owned government corporation to a private, government-sponsored enterprise in 1968.[9] Given some Senators' concerns about the potentially deleterious effects an explicit guarantee of housing GSE debt would have on the economy – and on investor perceptions of total outstanding U.S. debt – it is easy to understand why a previous Congress would move Fannie's debt off the balance sheet and explicitly deny responsibility for it.[10]

Avoiding an explicit guarantee makes sense for budgetary purposes. On the other hand, maintaining the impression among investors that a GSE would be bailed out in the event of a crisis helps to maintain the artificially low interest rates the GSEs enjoy. While some GSEs have needed a taxpayer-financed bailout (in 1987, Congress authorized $4 billion to prevent the failure of the Farm Credit System), federal policy relating to GSE obligations has mostly focused on maintaining investor expectations of a bailout without allowing their finances to deteriorate to the point where one is actually required.[11]

A good example of this dynamic was the near-demise of the Financing Corporation (FICO).[12] FICO is a government-sponsored private firm that was created in 1987 to finance a recapitalization of the Federal Savings and Loan Insurance Corporation (FSLIC) following the savings-and-loan (S&L) disaster of the 1980s. Beginning in 1995, many analysts grew concerned that FICO would default on the roughly $8 billion in bonds it sold in its FSLIC recapitalization effort. Because the FICO bonds were "explicitly and deliberately not guaranteed by law at the time of issuance" and relied on unrealistic assumptions of growth in S&L deposits to finance their interest payments, several analysts argued that FICO should be allowed to default.[13]

However, many policymakers suggested that allowing FICO to "fend for itself" could leave investors with the impression that the government would not stand behind the obligations of other GSEs. This would negatively affect their borrowing capacity and could even trigger a panic. The Undersecretary of the Treasury at the time, John Hawke,

Corporation Act," (12 U.S.C. 1451-1459), and "Federal Housing Enterprises Safety and Soundness Act of 1992," Title XIII of P.L. 92-550 (12 U.S.C. 4501).

[9] Robert Van Order, "The Structure and Evolution of American Secondary Mortgage Markets, with Some Implications for Developing Markets," *Housing Finance International*, Vol. 16, No. 1; Pg. 16-31, September 2001.

[10] Exchange during the Greenspan testimony involving Chairman Shelby, Senator Allard, and Senator Sarbanes concerning the economic and financial effects of adding $2.2 trillion to the nation's outstanding publicly held debt.

[11] The Agricultural Credit Act of 1987 (P.L. 100-233) authorized up to $4 billion in federal financial assistance to avoid a default on bonds with an implicit guarantee. Estimated outlays for the bailout were closer to $1 billion.

[12] For background see: Keith J. Leggett and Robert W. Strand, "The Financing Corporation, Government-Sponsored Enterprises, and Moral Hazard," *Cato Journal*, Vol. 17, No. 2., Fall 1997.

[13] Martin Mayer, "No Federal Welfare for S&L Bondholders," *The Wall Street Journal*, April 24, 1996.

suggested that, in deciding what to do, Congress would "have to consider what the implications of [default] would be for probably – maybe trillions of dollars of GSE debt that doesn't bear explicit government guarantee."[14] In a similar vein, Federal Deposit Insurance Corporation Chairman Ricki Helfer suggested that a potential consequence of the default on FICO bonds "could be downward pressure on the prices and upward pressure on the interest rates of securities issued by government-sponsored enterprises, such as Fannie Mae, Freddie Mac, Farmer Mac, and Sallie Mae, which, like the FICO, are not backed by the full-faith-and-credit clause of the United States."[15]

Not wishing to shake investors' confidence in the government's willingness to rescue GSE debt, but also reluctant to add to the roughly $125 billion in taxpayer funds already used to "clean up" S&Ls,[16] the Treasury Department and FDIC proposed a plan whereby banks and thrifts would be assessed premiums to pay the FICO bond interest. This plan was included in the FY 1997 Omnibus bill (P.L. 104-208) passed by Congress later that year. This legislation succeeded in its objective of shoring up the implicit guarantee on GSE debt without direct taxpayer assistance.

Marketplace Effects

Given that the overall quantity of resources at any given time is limited, the housing GSEs' credit subsidy represents a resource misallocation: Funneling excess credit to Fannie Mae and Freddie Mac necessarily implies less credit directed towards other enterprises and sectors of the economy.[17] Because of this, as CBO stated in a previous study, the GSE annual credit subsidy is "equivalent to those provided by writing Treasury checks."[18] CBO currently estimates the value of the subsidy to be $23 billion per year for Fannie, Freddie, and the Federal Home Loan Banks (FHLBs) combined.[19]

By issuing debt at an artificially low cost, the GSEs are able to "pay higher prices to originators for their mortgages than can potential competitors, and to gradually but inexorably take over the market for conforming mortgages."[20] It is by paying higher prices for mortgages that the GSEs reduce mortgage costs. However, the gross value of the credit subsidy is tied to the amount of debt the GSEs issue, not the number of

[14] John Hawke, Deputy Secretary of the Treasury, *Remarks to the Conference on Bank Structure and Competition*, May 2, 1996.
[15] Ricki Helfer, FDIC chairman, in testimony before the House Committee on Banking and Financial Services, Subcommittee on Financial Institutions and Consumer Credit, August 2, 1995.
[16] Hawke. The "Financial Institutions Reform, Recovery and Enforcement Act of 1989" (P.L. 101-73) authorized $150 billion in direct assistance.
[17] Dwight Jaffee, "The Effect on the Mortgage Markets of Privatizing Fannie Mae and Freddie Mac," *Thinking About the Future of Fannie Mae and Freddie Mac*, American Enterprise Institute, May 23, 2003.
[18] CBO, *Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac*, May 1996.
[19] Holtz-Eakin quoted in Rob Blackwell, "Budget Office: GSE Subsidies Are Growing, Under More Scrutiny," *The American Banker*, March 19, 2004.
[20] Greenspan. Conforming mortgages are mortgages below the conforming loan limit (currently $333,700). Fannie and Freddie may purchase only conforming mortgages.

mortgages they purchase from originators or the amount of liquidity they provide to the mortgage markets.[21]

When Fannie and Freddie purchase mortgages from originators, they either hold those mortgages on their respective balance sheets or, as is far more likely, package similar mortgages together into bond-like instruments for sale to investors as mortgage-backed securities (MBS). The sale of MBS to investors provides Fannie and Freddie with funds to purchase new mortgages, obviating the need in most circumstances to issue additional debt. For example, in 1992, Freddie Mac purchased $191.1 billion in mortgages, but reduced its total outstanding debt by over $600 million that same year.[22]

However, over the past several years, Fannie and Freddie increasingly have become, in the words of OMB, "asset management companies" by holding more of the mortgages they buy and repurchasing much of the MBS they sell to investors. And the more assets Fannie and Freddie hold in portfolio, the more debt they must issue.

As OMB notes, between 1992 and 2002, Fannie Mae's balance sheet assets grew by 416 percent, which required an increase of 433 percent in its debt, while Freddie Mac's balance sheet assets grew an astonishing 1,099 percent during that period, requiring an increase of 1,112 percent in its outstanding liabilities.[23] When including the debt of the Federal Home Loan Banks, the total outstanding debt of the housing GSEs stood at $2.317 trillion at the end of 2002, which was roughly equal to 79 percent of the amount of privately held debt of the U.S. government at that time, or about 65 percent of more commonly cited publicly held federal debt.[24]

Greenspan Suggests a 'Systemic Event' is Likely

> *To fend off possible future systemic difficulties, which we assess as likely if GSE expansion continues unabated, preventive actions are required sooner rather than later. . . . The systemic risk issue is wholly related to the question of issuing debentures and investing the proceeds of those debentures in other assets, whether they be mortgages, mortgage-backed securities, or as a significant part of the portfolio of the GSEs indicate, non-mortgage assets.*
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> -Federal Reserve Chairman Alan Greenspan

[21] Since every dollar of debt issued by Fannie and Freddie is subsidized, the gross dollar value of the subsidy is a function of the total amount of debt issued. However, this function is nonlinear, meaning that the marginal value of the subsidy increases as a percentage of each additional dollar of outstanding debt. This is because the markets do not demand a higher yield as relative debt loads increase, as is the case for private borrowers.

[22] Office of Federal Housing Enterprise Oversight, *Report to Congress*, June 2003.

[23] *Analytical Perspectives*, p. 81.

[24] *Analytical Perspectives*, p. 82. Privately held debt differs from debt held by the public (the measure generally used in the budget) by not including the debt held by Federal Reserve Banks. Bureau of the Public Debt, September 30, 2002. This figure does not include Fannie and Freddie's obligations for timely payment on the MBS they have guaranteed and sold, which brings the government's total implicit obligation to almost $4 trillion for F&F alone.

Chairman Greenspan made clear in his testimony that he and his colleagues in the Federal Reserve System believe that, if the increase in the GSEs' balance-sheet assets and debt continue apace, a "systemic event" – that is, a financial crisis – will be likely. Recalling the extraordinary cost to taxpayers of the S&L meltdown in the 1980s, this dramatic statement underscores the need for real, substantive reform – and "sooner rather than later," as the Fed chairman urged.

By rapidly adding billions of dollars of assets to their balance sheets, the GSEs also have acquired ever-increasing amounts of interest-rate and prepayment risks.[25] Instead of managing these risks by holding greater capital, Fannie and Freddie have elected to increase leverage (the ratio of assets to capital) in a manner that is not disciplined by the financial markets for reasons discussed above. As Greenspan explains, Fannie and Freddie have taken this approach "to multiply the profitability of subsidized debt in direct proportion to their degree of leverage."[26]

This strategy requires a sophisticated risk-management system that involves the heavy use of derivatives, principally callable debt and interest-rate swaps.[27] Although Chairman Greenspan emphasized several times during his recent testimony that Fannie and Freddie appear to be managing this risk very well at present, the economy remains vulnerable because "the current system depends on the risk managers at Fannie and Freddie [doing] everything just right."[28]

To add to the concern, *more than six out of ten banks hold as assets GSE debt in excess of 50 percent of their equity capital.* This concentration of GSE debt holdings exists because banks can hold an unlimited amount of GSE securities and those securities receive a 20-percent risk-weight for regulatory purposes (versus 100 percent for private firms).[29] If Fannie's or Freddie's debt becomes illiquid and its price drops dramatically, these banks' liquidity also would be compromised – or worse. As the FY 2005 budget explains, "Even a small mistake by a GSE could have consequences throughout the economy."[30]

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[25] Interest-rate risk relates to a situation in which rising interest rates depress the value of mortgage investments at the same time that they raise the cost of new debt issued to replace maturing debt. This could reverse the yield spread between assets and liabilities and lead to insolvency. Prepayment risk relates to a fall in interest rates that causes mortgage borrowers to prepay their balances while Fannie and Freddie retain their longer-term debt obligations, resulting in a maturity mismatch that reduces their asset base and creates liquidity problems as assets pay off faster than liabilities. In this situation, the value of their MBS may also decline as prepayment eliminates the expected future interest payments.

[26] Greenspan.

[27] Callable debt is a security whose issuer has the right to redeem the security prior to its stated maturity date at a price established at the time of issuance, on or after a specified date. A swap is the exchange of one stream of cash flows for another. In most Fannie and Freddie interest-rate swaps, a short-term floating interest rate is swapped for a long-term fixed interest rate, or vice versa.

[28] Greenspan.

[29] *Analytical Perspectives*, p. 82.

[30] *Analytical Perspectives*, p. 82.

Reform Proposals

Serious reform, as outlined by Greenspan and OMB, must confront the status quo's three principal problems: Fannie and Freddie's balance sheets have grown too large; their operations are too complex relative to current supervision; and, the market accepts the risks they assume because of the presumption of a federal backstop. While Greenspan signaled his preference for full privatization, he acknowledged that the current political environment makes his "a highly minority point of view." With that acknowledgment, he offered a series of regulatory changes that largely matched those of the Administration. [31]

Congress Should Establish a Strong, Powerful Regulator

A new independent regulator should be established that is not financed through the annual appropriations process, has the freedom to set minimum and risk-based capital standards, and has the authority for placing a GSE in receivership in the event of insolvency.

Given the fact that Fannie and Freddie are not subject to the same degree of market discipline as other financial firms, it would be aberrant for their regulator not to have the same authority as bank regulators to impose stringent capital standards that could be adjusted to adapt to new perceptions of risk.[32] Failing to grant the new regulator such authority would invite the sort of regulatory breakdown that permitted the S&Ls to hold too little capital relative to their high-risk portfolios.[33]

Furthermore, Congress must outline a clear process through which the regulator has the authority to take receivership and resolve a GSE in the unlikely event of insolvency.[34] If the new regulator lacks such authority, investor perceptions will largely remain unchanged, as would the risk of a large-scale taxpayer bailout. As Greenspan explained, "under existing statute, there is a conservatorship, not a receivership, which essentially says, for all practical reasons, that the Congress will bail out the GSEs in the event of a crisis."[35]

With no receivership authority in place, the regulator will have every incentive to allow an insolvent GSE to continue to operate to delay the day of reckoning, even if it has the authority to adjust capital standards. As was the case in the S&L debacle, in this situation, the regulator will give the GSE every opportunity to reverse unrealized paper

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[31] Greenspan. Although privatization is, in fact, a 'highly minority point of view', the American Enterprise Institute has put together a privatization plan that would gradually move Fannie Mae and Freddie Mac into fully private companies, without disrupting the housing finance market. See: http://www.aei.org/docLib/20040315_GSEPrivatization.pdf

[32] *Analytical Perspectives*, p. 83.

[33] George J. Benston, "Deposit Insurance Reform in the FDIC Improvement Act: the Experience to Date," *Economic Perspectives*, No. 2, Vol. 22, Federal Reserve Bank of Chicago, March 13, 1998.

[34] Section 143 of Subtitle C of the Senate Banking Committee Print introduced by Chairman Shelby provided for such authority in the event a GSE became insolvent, unlawfully concealed records or violated a cease-and-desist order, or could not meet its obligations.

[35] Greenspan. Bankruptcy laws also do not apply to the GSEs.

losses by increasing its risk profile. In the early 1980s, regulators reduced S&Ls book-value capital requirements and implemented new accounting standards to make them appear healthy and able to extend more credit. As a result, "instead of shrinking, S&L assets more than doubled between 1980 and 1988," and the ultimate bailout exceeded 3 percent of Gross Domestic Product.[36]

It is also important to note that even if the inclusion of receivership is viewed by credit rating agencies as a reduction in implied government support, and leads investors to demand a higher yield on GSE debt, a recent Federal Deposit Insurance Corporation (FDIC) study indicates such an outcome would "not significantly weaken the banking industry" despite its large exposure to GSE debt.[37] This is primarily because the decline in risk-weighted assets is less severe than may be expected, and because the industry's current regulatory capital levels leave it well positioned to deal with any shock.[38]

Moreover, Fitch Ratings, an international investor service, makes a compelling argument for why an implication of reduced government support is incorrect.[39] This position is also endorsed by Moody's Investor Service, which contends the inclusion of receivership power is no evidence of diminished US Government support for the GSEs.[40]

<u>Congress Should Limit Fannie and Freddie's Portfolios</u>

Finally, Congress must consider limiting the size of Fannie Mae and Freddie Mac's portfolios. As Greenspan explained, "world-class regulation, by itself, may not be sufficient" if it encourages investors to regard GSE debt as government debt and allows "the GSEs to play an even larger unconstrained role in the financial markets."[41]

Capping the amount of debt the GSEs may issue in proportion to the amount of their MBS that is held by other investors would force the GSEs to attend to improving secondary market liquidity – their original mission – and to devote less time on the Herculean effort of managing the interest-rate risks of a trillion-dollar portfolio.[42] Increased focus on the securitization business could yield newer products and asset

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[36] Benston.
[37] Federal Deposit Insurance Corporation, "Assessing the Banking Industry's Exposure to an Implicit Government Guarantee of GSEs," *FYI: An Update on Emerging Issues in Banking*, March 1, 2004.
[38] FDIC.
[39] "Fitch Ratings Comments on GSE Receivership Provision," March 25, 2004. Fitch does not believe receivership would do anything to reduce implied government support: "Under provisions of the Federal Deposit Insurance Act, the regulator determines the fiscal impact of conservatorship or receivership and potential cost to the government. The process is designed to choose the least cost approach and the mode that best protects asset valuations. This provides greater flexibility and specific powers to stay transactions to assure the value of the assets, thus improving the ability to reduce loss of capital…. The GSE status is an extension of the role the government has played in all areas of social interest, a role that Fitch believes will not be changed by the legislative and regulatory proposals under consideration."
[40] Moody's quoted in Nancy Leinfuss, "US Agencies improve on Moody's GSEs Ratings Assurance," *Reuters*, March 30, 2004.
[41] Greenspan.
[42] Many economists, including Greenspan, believe that Fannie and Freddie's borrowings completely offset any effect associated with their purchase of mortgages and MBS, so their accumulation of mortgages and MBS does not affect interest rates on mortgages. Fannie Mae challenges this claim.

classes for investors and spread interest-rate risks to other firms with different risk tolerances and hedging strategies.[43]

Effect of Reform on Homeownership and Mortgage Markets

> *"There are many ways to enhance the attractiveness of homeownership at significantly less potential cost to taxpayers . . . . I'm not saying that interest rates don't have an effect; what I'm largely saying is that . . . the notion that that [the GSE-provided interest rate subsidy] significantly enhances homeownership is something we find statistically difficult to sustain."*
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> -Federal Reserve Chairman Alan Greenspan

Officials at Fannie Mae, Freddie Mac, and their allies argue that some of the tougher regulatory solutions favored by Greenspan and OMB would harm U.S. homeownership and raise mortgage rates. They present the choices as being between the known benefits of the current system and the uncertain costs of precipitous reform. Yet, based on Greenspan's testimony and the OMB's analysis, the actual choices may be precisely the opposite.

The justifications for the creation of the housing GSEs – a lack of reliable information for making loans and local constraints on liquidity – no longer exist. This is due to several factors: the emergence of truly nationwide banking institutions; the standardization of both mortgage-backed security design and credit and interest-rate risk evaluation; and the increased maturity of modern capital markets.[44] There is little question that Fannie Mae and Freddie Mac deserve much of the credit for these successes; but it is equally true that these improvements will remain whether or not Fannie and Freddie are fully privatized.[45] The issues, then, are to what degree Fannie and Freddie affect mortgage rates and, concomitantly, to what degree mortgage rates affect homeownership.

The two most recent government studies on the subject suggest that Fannie Mae and Freddie Mac lower mortgage rates by between 0.07 percent and 0.25 percent.[46] For the median-priced $160,000, 30-year mortgage, this savings translates to between $7 and $25 a month for the homebuyer. As OMB notes, one reason the subsidy is not larger is that *Fannie Mae and Freddie Mac's shareholders, executives, or other stakeholders*

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[43] For a description of the segmentation of the MBS or REMIC markets, see CBO, *Effects of Repealing Fannie Mae's and Freddie Mac's SEC Exemptions,* May 2001.

[44] Jaffee. See also: Holtz-Eakin: "GSE status and the benefits it conveys are no longer necessary to the functions that Fannie Mae, Freddie Mac, and the Federal Home Loan Banks perform. Those purposes include ensuring a reliable source of funds to housing and increasing access to mortgage credit by low- and moderate-income borrowers so that more families can own their homes. Private financial institutions that lack GSE status, such as Washington Mutual and Bank of America, currently maintain a reliable link between the wholesale capital markets and retail lenders who originate home mortgages not eligible for financing from the GSEs."

[45] Jaffee.

[46] CBO, *Federal Subsidies and the Housing GSEs*, May 2001. Wayne Passmore, "The GSE Implicit Subsidy and the Value of Government Ambiguity," *2003 Finance and Economics Discussion Series,* No. 64, Federal Reserve Board of Governors, December 2003.

retain an estimated 37 percent of the gross credit subsidy.[47] A more recent Federal Reserve study suggests that shareholders retain *52 percent* of the gross subsidy, or $72 billion [differences in model specifications and explanatory variables are responsible for the different estimates].[48]

It is the position of Franklin Raines, Fannie Mae chairman and chief executive, that not only does his company retain *none* of the subsidy, but that it actually passes 123.8 percent of it through to mortgage borrowers.[49] However, Greenspan cast doubt on this assertion, arguing that "the probability that all of the subsidy goes through to the homeowner . . . approaches zero".[50]

Based on studies compiled by the Federal Reserve Bank of Minneapolis, which were alluded to by Greenspan in his testimony, such small declines in mortgage rates as those attributed to Fannie and Freddie have little or no effect on homeownership, particularly for minority communities. A 3-percent reduction in mortgage rates only increases the total number of renters who could afford to buy by between 0.8 percent and 0.9 percent, has no effect on the number of African American renters who could afford to buy, and increases the number of Latinos who could afford to buy by between 0.1 percent and 0.3 percent.[51] Given that even the highest estimates of Fannie Mae and Freddie Mac's effect on mortgage rates suggest they only reduce rates by 1/12th of 3 percent, it is difficult to conclude that Fannie and Freddie's efforts do anything to increase homeownership.

Beyond reducing mortgage rates, Fannie Mae and Freddie Mac are required by statute to address affordable housing needs. Yet, data compiled by the Department of Housing and Urban Development (HUD), Federal Reserve Banks, and the Samuel Zell and Robert Lurie Real Estate Center at the Wharton School of Business suggest that Fannie and Freddie lag the market in providing such services.

For example, the Federal Reserve Bank of Minneapolis found that, while first-time homebuyers make up 41 percent of all home purchases, only 25 percent of the loans the GSEs finance go to first-time homebuyers.[52] Furthermore, according to HUD,

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[47] CBO estimate cited in *Analytical Perspectives*, pp. 83-84.
[48] Passmore.
[49] Franklin Raines, chairman and CEO of Fannie Mae, in testimony before the Senate Banking Committee, February 25, 2004. Mr. Raines suggested that the yield spread between Fannie Mae MBS and jumbo MBS (0.21 percent) versus the spread between the conforming primary rate and the jumbo primary rate (0.26 percent) suggests that the benefit Fannie Mae provides to mortgage borrowers is greater than the credit subsidy the government provides to Fannie Mae. However, most economists agree that the spread between F&F debt and AA- or A- rated financial firms is the more relevant measure of their funding advantage, which would imply that Mr. Raines' estimate is not reliable. Mr. Raines argues that his firm's efficiency allows it to "pass on more than all of the benefit."
[50] Greenspan. Given that the management at Fannie and Freddie owe a fiduciary responsibility to their shareholders, it is unlikely that they would oppose reform so vociferously if their shareholders captured none of the subsidy.
[51] Ron J. Feldman, "Mortgage Rates, Homeownership Rates, and Government-Sponsored Enterprises," *Banking and Policy Studies*, Federal Reserve Bank of Minneapolis, February 2001.
[52] Feldman.

between 1999-2002, home loans for low-and-moderate-income families accounted for 44.3 percent of all home purchases originated in the conforming market, yet such loans accounted for only 42.5 percent of Fannie's purchases and 42.3 percent of those of Freddie.[53]

The Wharton School's analyses provide another interesting facet to the debate: It appears that the low-and moderate-income family loans that Fannie and Freddie do purchase are largely relegated to high-income tracts, i.e., Fannie and Freddie "fulfill their low-income-related mortgage purchase requirements disproportionately by buying qualifying loan issues in tracts with higher ownership rates."[54] This policy is likely to maximize profits, as "the downside to default almost certainly is lower in higher-income neighborhoods."[55]

Conclusion

It is the view of the Federal Reserve System of the United States and successive Presidential administrations that the risks posed by the publicly traded housing GSEs far outweigh the benefits that they provide to borrowers. Despite the GSEs' public-policy mission, analysis of these companies suggests they seek to maximize profits in the same manner as purely private firms. The data on the GSEs' effect on homeownership undercuts their claim to special treatment, and the risks identified by Alan Greenspan challenge the Senate to act quickly to either fundamentally alter the GSEs' relationship with the federal government or establish a much tougher regulatory regime to minimize taxpayer liability.

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[53] HUD cited in *Analytical Perspectives*, p. 84.

[54] Joseph Gyourko Dapeng Hu, **"**The Intra-Metropolitan Area Distribution of GSE Mortgage Purchases Made in Support of Low-income Related Goals," Zell/Lurie Center Working Papers, number 317, March 1999. There is a high correlation between the ownership rates in specific housing tracts and the income of their residents.

[55] Joseph Gyourko and Dapeng Hu**, "**The Spatial Distribution of Affordable Home Loan Purchases in Major Metropolitan Areas: Documentation and Analysis," Zell/Lurie Center Working Papers, number 333, June 24, 2002.