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Coming Out of Conservatorship: Developing an Exit Strategy for Fannie and Freddie

Abstract

This brief article reviews the various policies that the Obama Administration can choose from as it considers how Fannie Mae and Freddie Mac should exit conservatorship. It first reviews the benefits and costs associated with the two companies. It then reviews four broad positions regarding the appropriate role of Fannie and Freddie in the housing finance market. It argues that the two companies should be privatized because Fannie and Freddie pose a systemic risk to the financial system, unfairly benefit from their regulatory privilege and do not create net benefits for the American people. Finally, it reviews four concrete plans to fundamentally change Fannie and Freddie's structure, each involving different degrees of government involvement. It concludes that the two companies should be converted into generic financial holding companies and their public functions be reassigned to various federal instrumentalities.

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Coming Out of Conservatorship: Developing an Exit Strategy for Fannie and Freddie*

As part of its response to the ongoing credit crisis, the federal government recently placed Fannie Mae and Freddie Mac, the government-chartered, privately owned and politically powerful mortgage finance companies, in conservatorship. These two massive companies are profit-driven, but as government-sponsored enterprises (GSEs) they also have a government-mandated mission to provide liquidity and stability to the United States mortgage market and to achieve certain affordable housing goals. The fate of Fannie and Freddie has been linked with the Obama administration's long term proposals for comprehensive financial reform. How the two companies should exit their conservatorship is of key importance to the future of federal housing finance policy.

Notwithstanding recent events, Fannie and Freddie remain extraordinarily large companies: together, they own or guarantee well in excess of forty percent of all the residential mortgages in the United States. This amounts to nearly 5.3 trillion dollars in mortgages. By statute, Fannie and Freddie's operations are limited to the "conforming" portion of the mortgage market, which is made up of mortgages that do not exceed an annually adjusted threshold. The two companies effectively have no competition in the conforming sector of the mortgage market because of advantages granted to them by the federal government in their charters.

The most significant of these regulatory advantages has been the federal government's implied guarantee of Fannie and Freddie's debt obligations. The government guarantee is a privilege that arose from Congress' efforts to create a national secondary residential mortgage market. It is the characteristic that allows them to borrow more cheaply than other financial institutions. It is the characteristic that allows them to

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completely dominate the prime conforming mortgage market. And it is the characteristic that poses the greatest threat to the federal government and the American taxpayer.

One important consequence of conservatorship is its impact on this implied guarantee. Some commentators argue that the implied guarantee is now an explicit one. The government and the market have not yet embraced this view, although recent testimony by both the director of the Federal Housing Finance Agency (FHFA) overseeing the GSEs and statements by members of Congress may indicate a movement toward its long over-due recognition. How the two companies exit their conservatorships will determine the nature of their government guarantee as well.

While the American taxpayer will likely be required to fund a bailout of the two companies that will be measured in the hundreds of billions of dollars, the current state of affairs presents an opportunity to reform the two companies and the manner in which the mortgage market is structured. I believe that Fannie and Freddie should be privatized so that they can compete on an even playing field with other financial institutions and their public functions should be assumed by government actors. While this is a radical solution and one that would have been considered politically naïve until the recent credit crisis, it is now a serious option.

Fannie and Freddie are Poor Servants of Public Policy

There is very little controversy regarding the overwhelming benefits that Fannie and Freddie brought to the national mortgage market during the 1970s; indeed, they effectively created it. Fannie and Freddie claim they still provide important benefits. These claims have been contradicted, to a great degree, by researchers.

- *Systemic Stability and Liquidity.* Fannie and Freddie claim they provide liquidity and stability to the mortgage market. At early stages in the current crisis, they promoted themselves as white knights and lobbied for access to a broader swath of the mortgage market in order to stabilize them. But as the credit crisis developed, it became clear that Fannie and Freddie were subject to the same forces that led to the insolvency and massive write-down of private mortgage lenders, until the government stepped in quite forcefully to bolster the entire government-supported mortgage market. Thus, while providing some short term

liquidity and stability, Fannie and Freddie fail to provide a long term solution to systemic risk in the secondary mortgage market.

- *Affordable Housing.* Fannie and Freddie claim they advance the American Dream of homeownership by making mortgages more affordable for underserved groups. Fannie and Freddie typically do meet the minimal affordable housing goals set forth by statute and by their regulatory agencies, although they sometimes may use financing shenanigans (such as buying a portfolio of loans solely to meet affordable housing goals) to do so. However, a number of studies have indicated that Fannie and Freddie actually cannibalize the Federal Housing Administration loan market and the U.S. General Accounting Office has questioned whether the two companies do any more than other lenders to promote affordable housing. Thus Fannie and Freddie's affordable housing efforts duplicate and even hinder other government initiatives, and may embrace unsound business practices just to hit their housing targets.
- *Consumer Protection.* Fannie and Freddie argue that they have helped to standardize the conforming mortgage to the benefit of consumers. And indeed, through their dominance of the conforming market, Fannie and Freddie have helped to standardize the market and reduced bad options for consumers. However, as Fannie and Freddie's significant purchases of subprime and Alt-A loans originated by other companies shows, the two giants are complicit with the predatory lending practices of others even though they did not engage in them directly. Consequently, recent events have undermined to some extent their claim that they safeguard consumer rights.
- *Lower Overall Interest Rates for Homeowners.* Fannie and Freddie accurately claim that they lower overall interest rates for homeowners. Research shows that they are responsible for a reduction of between 24 to 43 basis points on conforming mortgages. This is not an extraordinary benefit to the average homeowner, measured as it is in the tens of dollars a month. If the federal government acted directly to provide or guarantee certain mortgages, much like it provides student loans at a cheaper cost than private education lenders, interest rates for targeted homeowners would be lower still. Comparing Fannie and

Freddie's staggering profits to the modest benefits passed on to homeowners, their impact on interest rates cannot justify their privileged regulatory status. Given the limited benefits that Fannie and Freddie now provide, one concludes that Fannie and Freddie are not particularly useful agents of public policy. If the federal government acts on this finding, it would, however, need to reassign some of Fannie and Freddie's key functions to other federal instrumentalities.

Budgetary implications of the government's guarantee provide an additional public policy argument against Fannie and Freddie's special relationship with the federal government. Fannie and Freddie present four distinct budgetary problems. First, the cost of the government's guarantee is hidden because it is off-budget. Second, the cost of the guarantee is particularly difficult to quantify because it depends on the companies' ever-changing exposure to mortgage obligations. Third, the cost of the guarantee is not capped by the federal government, given that the federal government has not imposed any meaningful limits on Fannie and Freddie's growth. Finally, Fannie and Freddie's charters and the costs they might pose to the federal government are infrequently revisited by Congress. Indeed, Congress only takes a serious look at them every ten years or so, usually in the midst of some sort of crisis.

The first of these budget problems is particularly thorny. The federal government's contingent liability for its guarantee of Fannie and Freddie's obligations has been off-budget, allowing Congress to avoid having that liability trigger debt ceiling limits. If off-budget accounting is a bad sign when found in corporations such as Enron, it is at least as bad for the federal government. For, while the federal government was ultimately able to investigate Enron, who will watch the watchers? If the federal government had to quantify and account for this contingent liability in its budget, it would materially reduce Congress' ability to increase net spending.

Fannie and Freddie Should Be Privatized

There are four broad positions regarding the appropriate role of Fannie and Freddie in the housing finance market. First, Fannie and Freddie are generally doing the job that they were designed to do, although their powers and that of their regulators should be tweaked. Second, Fannie and Freddie are generally doing their job, but they

are retaining too much of the value of the government guarantee for the benefit of shareholders and management at the expense of their affordable housing goals. Third, Fannie and Freddie should be nationalized because the federal government has taken on most of the risk associated with them already. And finally, Fannie and Freddie pose a systemic risk to the financial system, unfairly benefit from their regulatory privilege and do not create net benefits for the American people: they should therefore be privatized.

One taking the first view—that Fannie and Freddie are generally doing the job that they were designed to do—might argue that there is no need to extricate the federal government from its relationship with Fannie and Freddie because the government has similar regulatory relationships with many other private companies. Most of the proposals floated in the last few years fall into this category of limited reforms. They include

- limiting the size of their mortgage portfolios;
- limiting their debt issuance;
- stripping the two companies of some of their unique privileges to signal to the market that the implied guarantee has been weakened;
- freezing the conforming loan value to limit the size of mortgages they can buy, thereby limiting their overall size;
- requiring them to obtain ratings for their debt issuances that discount the implied guarantee;
- imposing user fees; and
- strengthening their subordinated debt programs.

Such a view simply fails to appreciate the unparalleled political influence that Fannie and Freddie are able to marshal. In combining elements of public instrumentalities and private companies, public-private hybrids like Fannie and Freddie can assert outsized influence in Washington. If any of the above half-measures were adopted, Fannie and Freddie's lobbying juggernaut would be sure to undercut them as soon as Congress' focus moved on to another pressing issue.

Affordable housing providers and advocates often take the second position: Fannie and Freddie are pretty much doing their job of making housing more affordable to Americans, but they are retaining too much of the value of the government guarantee for the benefit of the shareholders and management, at the expense of their affordable housing goals. Thus, these parties favor proposals that redirect some of the excess profits

of Fannie and Freddie from their shareholders and management to affordable housing programs.

Indeed, in a plan subsequently suspended by federal conservatorship, Congress had recently implemented an affordable housing fund in which the two firms would have deposited upwards of \$500 million of their income each year. These monies were to be invested in affordable housing projects throughout the country. Affordable housing advocates saw this as a painless way to dramatically increase the supply of affordable housing. The ongoing bailout of the two companies demonstrates that the initiative was not painless, just pain deferred.

The third position, nationalization, has only begun to be taken seriously as the Fannie and Freddie bailouts become more and more likely. Indeed, then-Treasury Secretary Paulson had raised the idea, one which would seem to be anathema to a fiscal conservative like himself. Paulson proposed merging the two companies with the Federal Housing Administration, a government agency, which already insures certain mortgages. He did note, however, that such a plan would place much of the underwriting in the hands of the government, which is unlikely to do that task well (not that the private sector has done so either in recent years!).

I advocate for the fourth view: Fannie and Freddie pose a systemic risk to the financial system, unfairly benefit from their regulatory privilege and do not create meaningful net benefits for the American people. Fannie and Freddie are holdovers from an earlier era of government action, one that has seen its day come and go. Indeed, if one were to create from scratch a new system of federally-supported residential mortgage finance, it is quite clear that the model would not be Fannie and Freddie, which are relatively inflexible and centralized solutions to the complex and fluid problems posed by the housing finance market. And while there is an argument to be made that Fannie and Freddie are market-oriented and incentive-based, it is a stronger argument to say that they are beneficiaries of regulatory privilege with incentives that have benefited their own management teams disproportionately.

Some commentators have pointed out that privatization is not a panacea for all systemic risk in the secondary mortgage market. They note that taxpayers have been held liable for bailing out private actors as much as GSEs during the recent crisis. However,

in any systemic crisis comparable to the present one, the federal government will necessarily play the role of lender of last resort. Under more common market conditions, privatization is a far superior alternative to private companies extracting monopolistic rents by exploiting a government-granted regulatory privilege.

Four Paths to Privatization

Four concrete plans have been recently proposed to fundamentally change Fannie and Freddie's structure, each involving different degrees of government involvement. First, convert them into cooperatives owned by lenders. Second, break the companies up into a number of smaller companies (or charter a number of similar competitors). Third, leave them intact, but regulate them like public utilities. Fourth, convert them into generic financial holding companies.

The first proposal, converting Fannie and Freddie into cooperatives, has precedent. There are two other privately-owned GSEs that are cooperative lenders: the Federal Home Loan Bank System (FHLB System) and the Farm Credit System. Some commentators have called for the FHLB System to take over Fannie and Freddie. This proposal has some initial attraction as it might attenuate the short term profit-maximizing culture that characterizes publicly-traded corporations like Fannie and Freddie. But history does not give comfort that such a GSE structure is superior to that of Fannie and Freddie. Indeed, Congress had to bail out the Farm Credit System in 1987. And there are rumblings that the FHLB System may soon face problems similar to those of Fannie and Freddie.

The second proposal, chartering additional housing finance competitors, has some initial attraction. Indeed, one might consider the Federal Deposit Insurance system to be a model for this approach: numerous recipients of regulatory privilege (access to federally guarantee insurance) who must compete amongst themselves. If the Fannie/Freddie duopoly could be diluted with enough similar competitors, the amount of economic rent that Fannie and Freddie retain from their government guarantee subsidy should reduce significantly. In addition, one might think that a more competitive market would spread risk among more firms.

Upon further reflection, however, this proposal also reveals significant flaws. The benefit of GSE competition is less compelling now that we have experienced a bubble where so many financial institutions demonstrated herd-like behavior in their business models. And, as with the first proposal, the American taxpayer is still left with the contingent liability of the government guarantee.

The third proposal, regulating them like utilities, appears to be favored by Paulson and to be taken seriously by the likes of Federal Housing Finance Agency Director Lockhart. One worries however, how the common regulatory problem of capture would be avoided here where the two companies to be regulated are so clearly skilled in the art of politics.

The fourth proposal, converting them into generic financial services holding companies along the lines of institutions like Citigroup, J.P. Morgan and Bank of America, has the attraction of simplicity. It also terminates the contingent liability of the government guarantee and allows the conforming mortgage market to function like other sectors of the overall mortgage market. There is also a precedent for this approach: Sallie Mae was successfully converted from a GSE to a privatize company. This approach would also send the message that the American mortgage markets have grown up and are now to be integrated with the rest of the financial sector.

This proposal has its own limitations which must be addressed if it were to be implemented. First, because Fannie and Freddie can offer at least a short term stabilizing role in the residential mortgage markets, the federal government would need to implement other policies to address that need. Possible policy responses to market disruptions could include providing targeted federal mortgage guarantees, authorizing the Treasury to make mortgage-backed securities purchases and allowing mortgage lenders to access the Federal Reserve's discount window. There would also need to be a high degree of standardization and quality control across the multiple market players to ensure the secondary mortgage market remains attractive to institutional investors. Policies like these can ensure that the residential mortgage market can function during a panic.

Second, homeowners will pay slightly higher interest for conforming mortgages if the two companies were privatized. If Congress determines that this increase were too much, particularly given the current condition of the economy, it could reduce the burden

by modifying the deduction for mortgage interest or by providing a tax credit relating to mortgage interest. While such a strategy will decrease federal revenues it will be offset by the liability that Fannie and Freddie impose on the federal government, a liability that is already on its way to costing taxpayers hundreds of billions of dollars as part of the current bailout.

Third, if the federal government wanted to increase funding for affordable housing as contemplated in the Act, it would need to do so through direct expenditures. Again, this direct cost would be offset (in reality, if not in terms of federal budget accounting) by terminating the contingent liability of the government guarantee.

Finally, Fannie and Freddie have imposed pro-consumer terms on the prime conforming mortgage market. These must be maintained and built upon through new consumer protection regulations in order to avoid the nasty and brutish environment that took root in the subprime mortgage market. And, indeed, it is hard to imagine that privatization would be politically feasible if such protections were not built into the privatization proposal.

Notwithstanding these limitations, the full-privatization proposal has the most going for it. It avoids the problem of the government guarantee that remains with the other three proposals. It leaves to the private sector what the private sector is supposed to do best: evaluate risk. And it leaves to the government what it is supposed to do best: protect against systemic risk; provide affordable housing to those who could not otherwise afford it; and protect consumers.

I. Conclusion

The main problem with GSEs is well-documented: they take on a life of their own and can survive well after they have achieved the purposes for which they are created. The typical result of poor GSE design is that the GSE ends up driving much of the legislative and regulatory agenda regarding their own fates. Fannie and Freddie reflect what is worst in GSE design. After fulfilling their purpose of creating a national mortgage market, they have taken on monstrously large lives of their own. In the midst of their bailout, Congress should take the opportunity to convert them to fully private status. Congress should also enact appropriate financial regulation, affordable housing

programs and consumer protection legislation. And Congress should remember the lessons of Fannie and Freddie when it considers using the GSE as a tool of government in the future.