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Fannie Mae and Freddie Mac: Privatizing Profit and Subsidizing Loss

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Abstract: This book chapter describes the role of Fannie Mae and Freddie Mac in the ongoing financial crisis. The chapter first explains the hybrid public-private nature of Fannie and Freddie, which are what is known as Government Sponsored Enterprises (GSEs). Fannie and Freddie were originally chartered by the federal government to create a national mortgage market. The chapter then explains how the two GSEs morphed into extraordinarily large companies that profited enormously from their special relationship with the federal government, while providing only modest benefits to American homeowners. In what turned out to be a disastrous trade-off for American taxpayers, Fannie and Freddie ended up needing a bailout measured in the hundreds of billions of dollars. Ultimately, Fannie and Freddie exhibited the common failings of poor GSE design—after fulfilling their original purpose, they took on monstrously large lives of their own that defied political oversight. The chapter concludes that Fannie and Freddie should be privatized, with their remaining public functions assumed by pure government actors.

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As part of its response to the ongoing credit crisis, in the fall of 2008 the federal government placed the Federal National Mortgage Association (typically referred to as "Fannie Mae") and the Federal Home Loan Mortgage Association (typically referred to as "Freddie Mac") in conservatorship. While they are for-profit, privately owned mortgage finance companies whose shares trade on the New York Stock Exchange, Fannie Mae and Freddie Mac are also two of the few companies directly chartered by Congress, so called Government Sponsored Enterprises (GSEs). The federal government has given them the mission of providing liquidity and stability to the United States residential mortgage market and achieving certain affordable housing goals.

The privileges attendant to this special relationship with the federal government allowed Fannie and Freddie to pass on certain savings to American homeowners but also to extract monopoly profits in the American residential mortgage market. Meanwhile, their hybrid public-private status enabled them to exert outsized political influence and drive much of the legislative and regulatory agenda regarding their own fates. Thus while Freddie and Fannie's early success made the U.S.'s secondary residential mortgage

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market the envy of other nations for quite some time, the two companies took on monstrously large lives of their own that well surpassed their original purpose. It would take the greatest financial crisis of our lifetime, and a bailout to be measured in the hundreds of billions of dollars, before Fannie and Freddie's extraordinarily privileged status would be seriously challenged.

Congress has a long history of relying upon GSEs to spur private investment. Indeed, the special privileges accorded a GSE are variants on the longstanding government practice of spurring private investment in various arenas by granting some privilege or monopoly power to a party that could infuse the activity with needed capital or bring focused attention to it. For example, government-granted monopolies can take the form of a charter granting a monopoly on trade, such as the one granted by Queen Elizabeth I to the English East India Company in 1600 in order to increase English trade with Asian nations. They can take the form of a system such as that governing American patents, granting patent-holders the sole right to exploit a patent for a certain period in order to encourage innovation. Or they can take the form of a regulated natural monopoly, like a utility company, that is regulated not only to protect consumers from monopoly pricing but also to ensure that the company can make a fair return on its investment.

Fannie and Freddie Create the Modern Secondary Mortgage Market

Mortgages have always been bought and sold by investors, but until relatively recently, the secondary mortgage market has been an informal arrangement. The introduction of residential mortgage-backed securities in the 1970s changed that; once

mortgages are converted into residential mortgage-backed securities (RMBS), they can be easily traded on the secondary market with comparatively few transaction costs. In the simplest terms, this is how it works:

1. Borrowers get mortgages from lenders in the primary market;
2. primary market lenders then sell these mortgages to secondary mortgage market firms and use the proceeds to originate more mortgages in the primary market; and
3. the secondary mortgage market firms then sell securities backed by the mortgages that they purchased to investors and use the proceeds of the sale to purchase more mortgages from primary market lenders.

In the late 1970s, RMBS securitization took off as traditional lenders could not keep up with the demand for home mortgages. The most important factor in the development of the modern secondary mortgage market has been the creation of Fannie and Freddie. While Fannie Mae had created a secondary market for government guaranteed and insured residential mortgage loans in the 1930s, the broad secondary market began in earnest with the chartering of Freddie Mac in 1970 and the decision to allow both GSEs to purchase and securitize conventional mortgages as well as government-insured or guaranteed mortgages.

Unlike nearly every other financial institution in the 1970s, Fannie and Freddie's businesses were not geographically restricted and they could develop a truly national market for mortgages. As the dominant purchasers of residential mortgages, these GSEs have effectively standardized prime residential mortgages by promulgating buying guidelines. Such standardization has led to an increase in the liquidity and attractiveness of mortgages as investments to a broad array of investors.

After Fannie and Freddie established the secondary mortgage market as a profitable enterprise, investment in RMBS exploded again as institutional investors entered the market. Starting sporadically in the late 1970s, non-federal-related issuers, such as commercial banks and mortgage companies, began to issue RMBS. These "private label" RMBS are issued without the type of guarantee that Fannie or Freddie would give, and they are typically backed by subprime and/or jumbo loans.

The Foundation of the Fannie/Freddie Business Model is Their Regulatory Privilege

Fannie and Freddie have two primary lines of business. First, they help mortgage originators package their mortgages into RMBS by providing credit guarantees for those securities in return for a fee paid to the GSE. The credit guarantees help maintain a stable and liquid market for RMBS. Second, the two companies raise capital by issuing debt securities and use those funds to purchase mortgages and related securities. Because of the privileges provided to them as government sponsored enterprises, Fannie and Freddie have been able to profit greatly from this second line of business.

By statute, Fannie and Freddie's operations are limited to the "conforming" sector of the mortgage market, which is made up of mortgages that do not exceed an annually adjusted threshold. Loans that exceed the loan amount limit in a given year are known as "jumbo" loans. Most of the remainder of the RMBS market belongs to "private label" firms which securitize (i) jumbo mortgages and (ii) subprime mortgages that Fannie and Freddie cannot or choose not to guarantee or purchase for their own portfolio. The two companies effectively have no competition in the conforming sector of the residential mortgage market because of advantages granted to them by the federal government in

their charters. The most significant of these advantages has been the federal government's implied (and, since their bailout, not-so-implied) guarantee of their debt obligations. The guarantee allowed Fannie and Freddie to borrow funds more cheaply than its fully-private competitors. They then can make money on the spread between their low cost of funds and what they must pay for the mortgage-related investments in their portfolios.

Fannie and Freddie and the Credit Crisis

Fannie and Freddie are extraordinarily large companies: together, they own or guarantee more than forty percent of all the residential mortgages in the United States. As of early 2009, the two companies had a combined $5.36 trillion in mortgage-related obligations, which is of roughly the same magnitude as the $5.81 trillion of federal government debt held by the public at that time.

As the two companies have grown immense, numerous commentators and government officials called for their reform. However, in combining elements of public instrumentalities and private companies, public-private hybrids like Fannie and Freddie can assert outsized influence in Washington. Fannie and Freddie's powerful lobbying forces have kept these reformers mostly at bay.

As a result, Fannie and Freddie continued to grow at a rapid rate through the early 2000s, until they were each hit by accounting scandals. In response to those scandals, Congress and the two companies' regulators began to take various steps to limit their growth. But once they stabilized in 2007, the current credit crisis commenced and their market share began to increase once again as other lenders could not raise capital to lend

to borrowers. Because of their government guarantee, Fannie and Freddie were thought to be well situated in a landscape where other lenders began to fail and the secondary market for subprime mortgages dried up. Some prominent financial analysts suggested that Fannie and Freddie could easily ride out the turmoil in the mortgage markets. Even more, some commentators were arguing that Fannie and Freddie would be able to bail out other mortgage market players by buying additional mortgages.

As Fannie and Freddie's star began to appear ascendant, troubling accounts of possible losses started to emerge: their underwriting models had been too optimistic and had not accounted for the possibility of severe reductions in housing prices across the nation. Further, the two industry giants had much more exposure to the problems in the toxic subprime and Alt-A portions of the mortgage market than they had let on in their public disclosures. These fears were confirmed soon thereafter, as Fannie and Freddie began to report very large losses. These losses meant that Fannie and Freddie did not have the capital to expand their role in the mortgage markets and that their political star began its fall once again.

Because of their poor underwriting, the two companies started posting quarterly losses in 2007 that ran into the billions of dollars, with larger losses on the horizon. As a result, they were having trouble complying with the capital requirements set by their regulator. Their problems began to spiral out of the control along with those of the rest of the financial sector until then-Secretary of the Treasury Henry M. Paulson. Jr. asked that Congress give the Treasury the authority to take over the two companies if they were not able to meet their financial obligations. Congress, with remarkable alacrity, passed the Housing and Economic Recovery Act of 2008 which granted that power to the Treasury.

Within days of the passage of the Housing and Economic Recovery Act, Fannie and Freddie faced demands to raise more capital, pressures that they would not be able to meet. Within a few weeks, the markets were expecting the federal government to bail out the two companies. And within a couple of months, Paulson announced that he was placing the two companies in conservatorship because they were not able to raise the capital they needed to continue operating. Throughout the credit crisis, their reported losses have only continued to increase.

Fannie and Freddie Are Generating a Poor Return on the Nation's Investment

Fannie and Freddie have attempted to justify their existence by pointing to the benefits they provide to the American public, primarily: (1) offering systemic stability and liquidity to the market; (2) increasing the supply of affordable housing; (3) increasing consumer protection in the residential market; and (4) lowering the overall interest rate for homeowners.

These claims have been contradicted to a great extent, however, by independent research as well as by recent events. First, during the crisis Fannie and Freddie provided only limited stability and liquidity before full-scale government intervention was required to bail them out. Second, while Fannie and Freddie typically do meet minimal affordable housing goals set forth by the government, a number of studies have indicated they hit their target by cannibalizing other federal programs and are not particularly effective in this regard when compared to other financial institutions. Third, in the field of consumer protection, Fannie and Freddie's reputation also took a blow when it became clear that, while refusing to directly securitize mortgages born of predatory lending, they

readily bought up suspect subprime and Alt A RMBS issued by other companies. Finally, Fannie and Freddie's highly touted impact on the interest rate for homeowners amounts to a modest reduction for the typical borrower. Considering the extraordinary profits received via Fannie and Freddie's government-granted privileges, this is not an extraordinary benefit to the average homeowner, one that is measured in the tens of dollars a month. This is particularly true when compared to the price tag for the taxpayer bailout of the two companies which is being measured in the hundreds of billions of dollars. This has turned out to be a disastrous trade-off for the American public.

Budgetary implications of the government's guarantee provide an additional argument against Fannie and Freddie's special relationship with the federal government. First, the cost of the government's guarantee has been hidden because it has been off-budget—if the government had to quantify and account for this contingent liability in the federal budget, it would trigger debt ceiling limits and materially reduce Congress' ability to increase net spending. Second, the cost of the guarantee is particularly difficult to quantify because it depends on the companies' ever-changing exposure to mortgage obligations. Finally, 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.

Conclusion

The federal government's special treatment of Fannie and Freddie is an extraordinary regulatory privilege in terms of its absolute value, its impact on its competitors and its cost to taxpayers. 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. GSEs should, as a general rule, be created with a sunset clause that would ensure that they would expire once they achieve their Congressionally-mandated goal. Unfortunately, this is almost never done.

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. With Fannie and Freddie, and our nation, at a crossroads, Congress should seize the opportunity to terminate their GSE privileges and convert them to fully private status. Congress should also enact appropriate financial regulation, consumer protection legislation and affordable housing programs to fill the breach that a fully-privatized Fannie and Freddie would leave behind. And Congress should remember the lessons of Fannie and Freddie when it considers using the GSE as a tool of government in the future.