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Fannie Mae and Freddie Mac: Implications for Credit Unions

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Deeply embedded in the credit union tradition is an ongoing search for better ways to understand and serve credit union members. Open inquiry, the free flow of ideas, and debate are essential parts of the true democratic process.

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Before joining Brooklyn Law School, Reiss was a visiting clinical associate professor at the Seton Hall Law School Center for Social Justice. Previously, he was an associate in the New York office of Paul, Weiss, Rifkind, Wharton & Garrison in its real estate department and an associate in the San Francisco office of Morrison & Foerster in its land use and environmental law group. He also served as a law clerk to Judge Timothy Lewis of the U.S. Court of Appeals for the Third Circuit. Prior to attending law school, he worked for a not-for-profit that helps people with psychiatric disabilities make the transition from shelters and hospitals to independent living. He holds a JD from New York University and a BA from Williams College.

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Deal, or no deal? On the TV show, contestants periodically test their nerve by considering a guaranteed payout or risking that payout for the chance at a bigger prize. Fannie Mae and Freddie Mac are two government-sponsored enterprises (GSEs) that provoke a similar question for lenders, laymen, and lawmakers. We know their warts and we’re getting to know their costs. In light of all of that, are they a good deal?

Whether as a citizen, a consumer, or a credit union leader, your opinion of Fannie Mae and Freddie Mac probably depends on how much they’ve helped you lately. As a citizen, do you resent the implicit guarantee that has become all too explicit as the two companies have entered conservatorship, or do you sleep better knowing that the government is the final backstop in this mortgage mess? As a consumer, are you glad you got a better price on your mortgage because of Freddie Mac’s borrowing power, or would you prefer more mortgage options with a broader range of choices? As a credit union leader, are you eager to keep the GSEs around because they make selling your conforming loans easy, or would you prefer a system in which you had more options for keeping or selling your loans?

What Is the Research About?

*Fannie Mae and Freddie Mac: Implications for Credit Unions* engages the work of legal expert David Reiss to break down the benefits, purported and real, that Fannie Mae and Freddie Mac bring to the mortgage market and the credit union system. This research is critically important for credit unions, because:

- *The reform discussion has already begun.* The Dodd-Frank reform act attacked the gamut of systemic financial shortcomings, while deferring a debate about the GSEs until 2011. Though the public wrangling has yet to begin, now is the time for credit unions as small mortgage lenders to make their wish lists for a redesigned secondary mortgage market.

- *The cost of the bailout is staggering.* Whether as managers or simply as citizens, credit union leaders should care about the long-term effects of the GSEs’ conservatorship. The Federal Housing Finance Agency reports that the two have drawn $148 billion (B) from the treasury since 2008, and a projected worst-case scenario could mean a total of $363B in total bailout costs. Even lenders that have enjoyed the GSEs’ rates and simple pipeline for mortgage sales know now that that system has proven very expensive indeed.
Credit unions lend based on the structure of the secondary mortgage market. Whatever happens to Fannie Mae and Freddie Mac will weigh heavily on mortgage lending everywhere. A continuation of the status quo would be the simplest (although not necessarily the best) outcome, but any substantive changes to the GSEs’ regulatory privileges would almost certainly mean a newly competitive secondary market. That could in turn mean a change in expectations and demand from consumers for different mortgage options (shorter terms, new prepayment options, etc.).

What Are the Credit Union Implications?

This research brief proposes four reasonable options for the future of Fannie and Freddie:

1. **Status quo.** This approach would play around the edges of the GSEs, probably calling for a preemptive workout plan and identifying tolerable loss levels for future crises. If you're enamored with the current secondary mortgage system, this option is the easy one.

2. **Redirecting profits.** This approach would aim at the unfair advantages (and undue profits) the GSEs receive by requiring them to spend more on affordable housing and make defined payments in return for an explicit government guarantee. The effects of this approach on credit unions would be very similar to the proposal above.

3. **Nationalization.** Though politically unpalatable, the GSEs have been effectively nationalized since 2008. A solution that formalized this would force the government to make more explicit decisions about homeownership policy, demand a new way to finance and account for mortgage losses, and require new government infrastructure for utility-like regulation. The outcomes for credit unions are unclear.

4. **Privatization.** Under this option, the GSEs would be forced to compete as pure market players, which would likely allow more competition into the secondary mortgage market and eliminate the “conforming loan” designation. This scenario offers the greatest risk and reward for credit unions, as it would open the market up for innovation, new secondary market players, and much more competition.

Reiss concludes that Fannie and Freddie should be privatized, and the benefits that the two companies produce in the residential mortgage market should be maintained through alternative means, including financial regulation, consumer protection legislation, and increased subsidies for affordable housing. Credit unions benefit
from the access to the secondary market that Fannie and Freddie provide, but they could be better served by a secondary market with more competition so long as they maintain their access on par with that of larger financial institutions.

So, are the GSEs a good deal for the American credit union system? The author argues no, and we invite you to consider his arguments and make your own decision. For credit unions, the deal plays just like a TV show, and it’s stark: Better the devil you know, or the devil you don’t?
Introduction
The Obama administration has made it clear that it will release a proposal to reform Fannie Mae and Freddie Mac in the next few months. Many organizations have been offering their own reform plans in an effort to shape the debate that is taking place within the administration. Industry players such as Credit Suisse, the Mortgage Bankers Association, and the Housing Policy Council of the Financial Services Roundtable have offered various plans, as have think tanks such as the Center for American Progress (CAP) and e21.

As of this writing, however, the political climate in which these proposals will be considered remains cloudy. Leading Democrats have begun to stake out their reform agendas. But Republicans have gained control of the House of Representatives, and any legislative reform plan will need to address their long-standing concerns about these two entities. Credit unions, as originators of residential mortgages, will be affected by changes, large or small, that radiate from reforms of Fannie and Freddie.

Notwithstanding the Obama administration’s reticence regarding details of its reform proposal, Michael Barr, the former Assistant Treasury Secretary for Financial Institutions, has already stated that the administration’s plan will seek to achieve four goals:

1. Ensuring the availability of mortgage credit.
2. Ensuring housing affordability.
3. Protecting consumers.

Representative Barney Frank (D-MA), the former chair of the House Financial Services Committee and an ardent supporter of Fannie and Freddie before the financial crisis, has now called for them to be abolished in their current form. He has said that there should be no hybrid public/private entities like Fannie and Freddie but that there should be some kind of secondary mortgage market support put in their place.

On the other side of the aisle, Congressional Republicans wrote in their “Pledge to America” that they “will reform Fannie Mae and Freddie Mac by ending their government takeover, shrinking their portfolios, and establishing minimum capital standards” (Republicans in Congress 2010, 22). All of these political statements are, of course, very broad, so the devil will most certainly be in the details. But one thing is clear: There is a strong likelihood that the basic structure of American housing finance policy will make a radical break from the current system that was first put into place some 40 years ago.
This research brief is intended to inform credit union executives about the recent history of Fannie and Freddie, to provide a theoretical framework in which to evaluate their role in American housing finance policy, and to set forth and explain the major policy directions that a reform agenda may take. Credit unions will be dramatically affected by any change in the direction of American housing finance policy, and this brief should help the industry formulate its own positions on housing finance reform.

As part of its response to the ongoing credit crisis, in 2008 the federal government placed Fannie Mae and Freddie Mac, the government-chartered, privately owned 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 US mortgage market and to achieve certain affordable housing goals. How the two companies should exit their conservatorship is of key importance to the future of federal housing finance policy. Indeed, this question is of pressing importance, as the Obama administration has signaled that it will rely heavily on Fannie and Freddie as part of the short-term response to the foreclosure epidemic that has swept across America in the last couple of years. Once the acute crisis is dealt with, however, the administration will need to put American housing finance policy on the right track for the long-term health of the system. This will require a framework for analyzing the needs of that system, a framework that this brief provides.

Fannie and Freddie are extraordinarily large companies: Together, they own or guarantee more than 40% of all the residential mortgages in the United States. This amounts to over $5.4 trillion 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 ($417,000 in 2009 and significantly higher in high-cost areas). 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 advantages is the federal government’s implied guarantee of Fannie and Freddie’s debt obligations. The implied guarantee has allowed Fannie and Freddie to borrow funds more cheaply than their fully private competitors and thereby offer the most attractive pricing in the conforming market. As the two companies have grown and grown, numerous commentators and government officials have called for their reform. Fannie and Freddie’s powerful lobbying forces, however, kept these reformers mostly at bay until the two entered conservatorship.
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. At first, many commentators believed that Fannie and Freddie would ride out the crisis relatively unscathed, but it turned out that their exposure to the problems in the toxic subprime and Alt-A portions of the mortgage market was much greater than they had let on in their public disclosures.

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 had trouble complying with the capital requirements set by their regulator. Their problems began to spiral out of 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 (the Recovery Act) in the summer of 2008. Soon thereafter, Paulson decided that the two companies were flirting with insolvency and placed them in conservatorship, pursuant to the Recovery Act.

While the American taxpayer will be required to fund a bailout of the two companies that will likely 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. Though the need for reform is evident, few scholars have considered the issue systematically. Scholars have, however, built up a significant base of knowledge about what works well and what does not work well with public/private hybrids like Fannie and Freddie.

Contemporary theories of regulation persuasively argue that special interests work to bend the tools of government to benefit themselves. This brief, relying on regulatory theory, provides a framework with which to conceptualize the possibilities for reform by viewing Fannie and Freddie as creatures of regulatory privilege. A critical insight of regulatory theory is that regulatory privilege should be presumed to be inconsistent with a competitive market unless proven otherwise. 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 the federal government. As such, regulatory theory offers a fruitful resource for academics and
policymakers who are considering reform of Fannie and Freddie’s privileged status, because it clarifies how Fannie and Freddie have relied on their hybrid public/private structure to obtain and protect economic rents at the expense of homeowners as well as Fannie and Freddie’s competitors. Economic rent is a return in excess of opportunity cost and is typically associated with a lack of competition.

Once analyzed in the context of regulatory theory, Fannie and Freddie’s futures seem clear. They 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 naive until the current credit crisis, it is now a serious option that should garner additional attention once its rationale is set forth.

In an earlier study (Reiss 2008), I provided a comprehensive analysis of the regulatory privilege that Fannie and Freddie enjoy. This brief builds on that work to situate that privilege within a broader understanding of regulatory theory and to explain the rare, hybrid public/private nature of the privilege that Fannie and Freddie enjoy. In doing so, this brief argues that the existing regulation of the two companies should be brought in line with our current understanding of how government should be deploying its power in the private sector.

This brief argues that the existing regulation of Fannie Mae and Freddie Mac should be brought in line with our current understanding of how government should be deploying its power in the private sector.

This brief proceeds as follows. Section I describes Fannie and Freddie’s role in the secondary market for residential mortgages. After describing what happened to the two companies in the credit crisis that commenced in 2007, it outlines the key provisions of the Recovery Act, which authorized the federal government to place Fannie and Freddie in conservatorship.

Section II then shifts to construct a theoretical framework with which to evaluate Fannie and Freddie. Section II A presents Fannie and Freddie’s assessments of their own roles in the secondary residential mortgage market. Section II B reviews how other scholars have conceptualized the roles of Fannie and Freddie in the housing finance market. Section II C then evaluates the operation of Fannie and Freddie in the context of six policy goals that derive from contemporary regulatory theory: (1) maintaining competition, (2) efficiently allocating society’s goods and services, (3) promoting innovation, (4) preventing inappropriate wealth transfers, (5) preserving consumer choice, and (6) preventing an overly concentrated
economy. It offers credit union context for each of these goals. And, separately, it finds that Fannie and Freddie come up short under nearly all of the policy goals.

Based on the conclusion of section II that Fannie and Freddie no longer have a net positive impact, section III argues that the two companies should be privatized. It also argues that the benefits that Fannie and Freddie produce in the residential mortgage market should be maintained through alternative means, including financial regulation, consumer protection legislation, and increased subsidies for affordable housing.

I. Fannie and Freddie and the Credit Crisis
This section begins by explaining what Fannie and Freddie do in the mortgage markets. It then describes how they fared in the credit crisis that commenced in 2007. This brief history opens with the early phase of the credit crisis in which the two companies were perceived as potential white knights, mounting a defense of the distressed secondary mortgage market. It then details their own troubles that led to the enactment of the Recovery Act. It concludes with the government placing them in conservatorship as the financial condition of the two companies rapidly disintegrated.

Fannie and Freddie’s Business
Fannie and Freddie have two primary lines of business. First, they provide credit guarantees so that groups of residential mortgages can be packaged as residential mortgage-backed securities (RMBSs). Second, Fannie and Freddie purchase residential mortgages and related securities with borrowed funds. Because of the federal government’s implied guarantee of their debt securities, Fannie and Freddie have been able to profit greatly from this second line of business. This is because they 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’s charters restrict the types of mortgages they may buy. In general, they may only buy mortgages with loan-to-value ratios of 80% or less unless the mortgage carries mortgage insurance or other credit support, and they may not buy mortgages with principal amounts greater than a certain amount set each year. Loans that Fannie and Freddie can buy are known as conforming loans. 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 that securitize (1) jumbo mortgages and (2) sub-prime mortgages that Fannie and Freddie cannot or choose not to guarantee or purchase for their own portfolios.
Because Fannie and Freddie have so dominated the conforming sector of the mortgage market, they have standardized that sector by promulgating buying guidelines that lenders must follow if they want to sell their mortgages to either of the two companies. Such standardization has led to increases in the liquidity and attractiveness of mortgages as investments to a broad array of investors.

The government guarantee of Fannie and Freddie’s debt obligations is a regulatory privilege that arose from Congress’s efforts to create a national secondary residential mortgage market in the 1960s and 1970s. It is the characteristic that allows them to borrow more cheaply than other financial institutions. It is the characteristic that allows them to 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 must therefore properly account for it in order to understand Fannie and Freddie.

Unlike true monopolists, Fannie and Freddie’s market power is limited by the nature of their competitive advantage: In an otherwise efficient market, the maximum amount they can retain as economic rent is the spread between the interest rates they must pay and those that their competitors must pay. Nevertheless, Fannie and Freddie share a key characteristic with government-granted monopolies: a legally created and overwhelming competitive advantage in a particular market, which translates into higher prices for consumers than would exist if Fannie and Freddie did not retain a portion of their economic rent for themselves.

Because of their government guarantee, Fannie and Freddie were thought to be well situated when the current credit crisis commenced. As other lenders began to fail and the secondary market for subprime mortgages dried up in 2007, a Citigroup report suggested that Fannie and Freddie could easily ride out the turmoil in the mortgage markets (Hagerty 2007). Further, some commentators were arguing that Fannie and Freddie would be able to bail out other mortgage market players by buying additional mortgages. At the same time, however, some were raising the alarm that Fannie and Freddie could face some of the same problems that other mortgage lenders had been facing. But this view was overtaken in 2007 by the more dominant one, which saw Fannie and Freddie as saviors of the mortgage markets.
This was a happy development for Fannie and Freddie because it meant that the terms of the debate regarding their appropriate role in the mortgage markets went from one in which the executive branch was beating the drums to limit their growth to one in which politicians and mortgage executives were calling for their role to be significantly expanded. Fannie and Freddie quickly tried to capitalize on this change in their political fortunes, advocating for an increased role in the crisis. At the earliest stage of the credit crisis, the Bush administration continued to oppose an expansion of Fannie and Freddie’s roles. As the crisis progressed, the regulator of the two companies began to signal that it was considering some expansions in Fannie and Freddie’s roles. The Federal Reserve, which had been calling for limitations on Fannie and Freddie before the credit crisis struck, also began to publicly consider a greater role for the two firms.

The Crisis Deepens
As Fannie and Freddie’s political star began to appear ascendant, troubling accounts of possible losses started to surface: Their underwriting models had been too optimistic and had not accounted for the possibility of severe reductions in housing prices across the nation. 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. The large losses led both companies to seek infusions of fresh capital. By this point, the federal government was now concerned with Fannie and Freddie’s viability as well as with the health of the overall market. Nonetheless, the federal government was running out of policy responses to the credit crisis, and Fannie and Freddie were seen as being among the remaining possible agents that could execute federal policy.

By the beginning of 2008, the Bush administration and Congress were seriously considering various initiatives to create more funding for mortgages, a number of which were implemented. As part of the Economic Stimulus Act of 2008, enacted in February 2008, Fannie and Freddie were temporarily allowed to buy or guarantee mortgages with principal amounts as high as $729,750 in order to restore liquidity to at least a portion of the jumbo sector. In addition, Fannie and Freddie’s safety and soundness regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), lifted Fannie and Freddie’s portfolio accounts caps and repeatedly lowered capital requirements in order to help respond to the housing slump and expand the supply of credit for mortgages.
These steps seemed to have the intended effect of increasing the supply of credit available for mortgages. Some commentators, however, were still warning that Fannie and Freddie continued to be heavily exposed to losses resulting from the housing slump that they were supposed to be alleviating. The market also began to worry about Fannie and Freddie’s solvency, as the yields on their debt widened by 30 basis points (bps) to trade at a historically high 40 bps above LIBOR in mid-March. By May, more and more parties were concerned about the solvency of the two companies, and Congress and the Bush administration were seriously negotiating an overhaul of Fannie and Freddie’s safety and soundness regulator, OFHEO, to increase its ability to oversee and regulate the two companies.

By mid-July, the market’s serious concerns about Fannie and Freddie’s viability were reflected in their stock prices, which were at their lowest levels in more than 16 years. The federal government, on the heels of the Bear Stearns bailout, took decisive action to prevent another acute crisis in the financial markets. The Treasury announced that it was seeking broad authority from Congress to support Fannie and Freddie through the acquisition of its debt and equity securities. At the same time, the Federal Reserve announced that it was authorizing emergency lending to the two companies on the same terms that it had historically lent to its regulated banks and, since the Bear Stearns bailout, to primary dealers. The Bush administration kept up the pressure to move the bailout plan forward, even in the face of Republican hostility in Congress based on opposition to a taxpayer bailout of the two entities. The bailout plan was enacted as part of the Recovery Act in 2008. While this gave confidence to debtholders that they would be bailed out in the case of insolvency, shareholders could not share that confidence, particularly since Fannie and Freddie’s massive portfolios were still in trouble. It also did not offer much hope to those who had counted on Fannie and Freddie to support the housing market.

**Congress Responds: The Housing and Economic Recovery Act of 2008**

The Recovery Act was one of the major legislative responses to the credit crisis that had begun in 2007. Among other things, the Recovery Act revamped the regulatory oversight for Fannie and Freddie and provided the Treasury with the authority to bail out Fannie and/or Freddie if they faced insolvency. Prior to the passage of the Recovery Act, Fannie and Freddie’s financial safety and soundness regulator was OFHEO, an independent agency located within the Department of Housing and Urban Development (HUD). OFHEO had limited power over Fannie and Freddie to establish capital standards, conduct financial examinations, determine capital levels, and appoint conservators.
Two provisions of the Recovery Act are most relevant here: (1) one that strengthens Fannie and Freddie’s financial safety and soundness regulation and (2) one that temporarily increases government support for the two companies.

**Improved Financial Safety and Soundness Regulation**

The Recovery Act replaces OFHEO with a new independent Federal Housing Finance Agency (FHFA). FHFA has general regulatory authority over the two companies and the Federal Home Loan Banks (FHLBanks). FHFA’s role mirrors that of OFHEO but grants it significantly more power to regulate financial safety and soundness issues. FHFA is intended to be a top-notch financial regulator along the lines of the Federal Deposit Insurance Corporation (FDIC).

FHFA is run by a director appointed by the president, with the advice and consent of the Senate. The director’s mandate is to ensure that both entities operate with sufficient capital and internal controls, with a mind toward the public interest, such that Fannie and Freddie accomplish their purpose of providing liquidity to the mortgage markets. The director is assisted in his or her duties by the Federal Housing Finance Oversight Board, which advises the director about strategies and policies. In addition to the director, the board includes the Secretary of the Treasury, the Secretary of Housing and Urban Development, and the Chairman of the Securities and Exchange Commission.

The Recovery Act addresses the possible actions to be taken by FHFA should Fannie and/or Freddie become undercapitalized, significantly undercapitalized, or critically undercapitalized. As with credit unions, an undercapitalized entity falls under greater monitoring and restriction of activities. A significantly undercapitalized entity may have its board replaced and/or executive officers fired. This is also grounds to withhold executive bonuses. A critically undercapitalized entity may have FHFA named as conservator or receiver.

**Temporary Government Support**

The Recovery Act temporarily authorizes the Secretary of the Treasury to make unlimited equity and debt investments in Fannie and Freddie securities. This appears to be the first time the Treasury has been authorized to invest in the equity of privately held companies. This will only be done by mutual agreement between the relevant GSE and the Secretary of the Treasury. In order to purchase obligations, an emergency determination must be made by the Secretary of the Treasury. This determination must address whether such actions are necessary to provide stability to the financial markets, prevent
disruptions in the availability of mortgage finance, and protect the taxpayer.

The director of FHFA must consult with, and consider the views of, the chairman of the Board of Governors of the Federal Reserve System, with respect to the risks posed by the regulated entities to the financial system. Such consultations must take place prior to issuing any proposed or final regulations, orders, and guidelines with respect to the exercise of the additional authority provided in the Recovery Act regarding prudential management and operations standards for; safe and sound operations of; and capital requirements and portfolio standards applicable to, Fannie and Freddie.

In addition to the two provisions discussed above, the Recovery Act has two more that are of some importance to this discussion. These two provisions relate to how the two firms may seek to expand their market share and how they engage in political horse-trading to achieve their ends, which are topics that relate to the argument in favor of privatization set forth in section III below. The first provision provides funding for affordable housing through an assessment on Fannie and Freddie. The second provision increases the conforming loan limits. This increase has expanded the companies’ market and increased the availability of mortgage credit during the credit crisis.

The Recovery Act requires that Fannie and Freddie “set aside an amount equal to 4.2 basis points for each dollar of the unpaid principal balance of its total new business purchases” (Housing and Economic Recovery Act of 2008, codified at 12 U.S.C. §1337). When the Recovery Act was passed, it was generally agreed that this provision would raise upwards of $500 million (M) each year for affordable housing initiatives, but this set-aside was suspended once the two companies entered conservatorship.

The Recovery Act also raises the conforming loan limits in some areas. Such limits are increased in areas for which 115% of the median house price exceeds the conforming loan limits, to the lesser of 150% of such loan limit or the amount that is equal to 115% of the median house price in the area.

**Fannie and Freddie Enter Conservatorship**

Within days of the passage of the Recovery Act, Fannie and Freddie faced demands to raise more capital, demands 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 continued to increase.
One important consequence of conservatorship is its impact on the 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. How the two companies exit their conservatorships will help shape the nature of the government guarantee as well.

As the credit crisis unfolds, there is much speculation as to what form Fannie and Freddie should take upon exiting conservatorship once the credit crisis has passed. Section II proposes a theoretical framework to help determine the answer to that question.

II. Evaluating Fannie and Freddie

There is very little controversy over the overwhelming benefits that Fannie and Freddie brought to the national mortgage market during the 1970s. Indeed, they, along with Ginnie Mae, effectively created it. But at least since the early 1990s, there has been much disagreement with Fannie and Freddie’s claims that they continue to provide overwhelming benefits to America’s homeowners. There has also been an exploration of the costs that the two companies impose on the American government and on the mortgage markets. This section begins by reviewing how Fannie and Freddie claim to benefit the residential housing finance market and how independent scholars evaluate their success at reaching these goals. It then draws on theories of regulation and monopoly to propose a more comprehensive mode of evaluation, which untangles their hybrid public/private structure to demonstrate how that structure gives them extraordinary benefits that undercut competition in the mortgage markets as well as their statutorily mandated public missions.

A. Fannie and Freddie’s Self-Assessment

Fannie and Freddie set forth four standards by which they believe they should be judged: (1) they lower overall interest rates for homeowners, (2) they bring systemic stability and liquidity to the market, (3) they increase the supply of affordable housing, and (4) they have increased consumer protection in the residential market. I will review evidence for each of these claims in turn. I find that independent research challenges some of these claimed benefits. Moreover, these four standards are ad hoc and fail to account for many other impacts that the two companies have on the housing market.

Lower Overall Interest Rates for Homeowners

Fannie and Freddie claim that they lower interest rates for homeowners. There is nearly universal agreement that this is true. While Fannie and Freddie describe these lower rates as significant, independent scholars describe them as modest.
Various studies have measured the benefit to conforming borrowers as being between 24 and 43 bps. Assuming an increased 34-bp spread (halfway between the two figures) on a $200,000 mortgage, a borrower would pay an additional $57 per month in interest without the GSEs. This figure, while significant for the average American homeowner, is not an extraordinary benefit, particularly for those who can itemize their home mortgage interest deduction to further reduce the after-tax bite of such interest payments.

Moreover, Froomkin (1995, 618) identifies a hidden cost that the Fannie and Freddie financing model imposes: In many ways, the federal government is borrowing at a higher cost than it needs to if it wants to subsidize residential mortgages. Instead of borrowing through a GSE, the federal government could act directly at a lower cost to assist favored constituencies like homeowners. For instance, the government could directly provide or guarantee certain kinds of mortgages at a lower cost than Fannie and Freddie, much like it directly provides student loans at a lower cost than private educational lenders. This hidden cost has come into sharper relief during the current credit crisis, where Fannie and Freddie’s borrowing costs remained stubbornly high for quite some time, even after they entered conservatorship. Thus, the Fannie and Freddie model may not be the most cost-effective means by which the government can achieve the goal of lower interest rates for homeowners.

**Systemic Stability and Liquidity**

Congress gave Fannie and Freddie the task of providing liquidity and stability to the secondary mortgage market. In 2003, OFHEO issued a report titled “Systemic Risk: Fannie Mae, Freddie Mac and the Role of OFHEO” that evaluated their role in the broader financial markets. The report argued that the systemic implications of Fannie or Freddie’s financial difficulties would depend on the circumstances: “Any systemic disruption would likely be minimal as OFHEO took prompt corrective action and other market participants filled the short-term market void. Alternatively, in the unlikely circumstance that an enterprise experienced severe financial difficulties, they could cause disruptions to the housing market and financial system” (OFHEO 2003, 1).

While the secondary mortgage market generally functions well and without liquidity crises, the credit crunch of 2007–2009 has provided a rare opportunity to evaluate the impact of Fannie and...
Freddie on liquidity. At early stages in the crisis, Fannie and Freddie promoted themselves as white knights and lobbied for access to a broader swath of the mortgage markets 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 had led to the insolvency and massive write-downs of private mortgage lenders, until the government stepped in quite forcefully to bolster the government-supported mortgage market.

In early 2008, the federal government authorized Fannie and Freddie to purchase loans with significantly higher principal amounts in high-cost areas like New York and California, again in order to provide additional liquidity. But at around the same time, Fannie and Freddie revealed that they faced billions of dollars in losses caused by their poor underwriting. Fannie Mae issued additional shares to raise billions of dollars of capital to ensure that they complied with the OFHEO capitalization requirements, and Freddie Mac planned to do the same. But, as noted above, Fannie and Freddie ultimately required a bailout in order to prevent a crisis that would have spread far beyond the American residential mortgage market to infect the entire global credit market, if left unchecked. The net effect is that Fannie and Freddie did provide some temporary liquidity and stability. But their long-term impact has been very harmful to the broad financial system, and it will likely cost the American taxpayer many tens of billions of dollars to resolve the harm they ultimately caused.

**Affordable Housing Goals**

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 established three affordable housing goals for Fannie and Freddie: those for (1) low- and moderate-income housing, (2) special affordable housing, and (3) central cities, rural areas, and housing in other underserved areas. Pursuant to this statute, HUD is responsible for monitoring, adjusting, and enforcing these housing goals. These goals represent what should be the percentage of housing units financed by Fannie and Freddie each year.

Fannie and Freddie typically meet these goals, although they sometimes may use financing shenanigans (such as buying a portfolio of loans solely to meet affordable housing goals) to do so. Independent research, however, has challenged whether these goals actually increase the net amount of affordable housing. A number of studies have indicated that Fannie and Freddie actually cannibalize the
Federal Housing Administration (FHA) loan market by lending to borrowers who would have otherwise received FHA mortgages. The US General Accounting Office has also questioned whether Fannie and Freddie, notwithstanding their particular affordable housing mandate, do any more than other lenders to promote affordable housing.

**Consumer Protection**

Fannie and Freddie argue that they have helped standardize the conforming mortgage to the benefit of consumers. Many, including this author, have praised this standardization as a positive, something that on the whole reduces bad options for consumers. This generally positive development is not without some costs to consumers, however, as it reduces the financing choices available to them. For instance, Fannie and Freddie have effectively banished prepayment penalties from the prime conforming mortgage market, which sounds like a good thing for consumers. But some consumers might prefer to take a loan with a prepayment penalty if it meant that the loan would have a lower interest rate.

Moreover, recent news about Freddie’s role in the subprime and Alt-A markets undercuts Fannie and Freddie’s consumer protection argument to some extent. Apparently, the two firms had a much greater exposure to the disastrous Alt-A subsector than they had previously let on. In Congressional testimony in late 2008, Fannie Mae’s former chief credit officer reported that the two companies “now guarantee or hold 10.5 million nonprime loans worth $1.6 trillion—one in three of all subprime loans, and nearly two in three of all so-called Alt-A loans, often called ‘liar loans’” (Browning 2008). As these two sectors were rife with predatory lending practices, Fannie and Freddie may be seen as having been complicit with these practices even though they did not engage in them directly.

**B. Existing Theories of the Government-Sponsored Enterprises**

Alice Rivlin, as then-director of the Office of Management and Budget (OMB), has stated that “GSEs were created because wholly private financial institutions were believed to be incapable of providing an adequate supply of loanable funds at all times and to all regions of the nation for specified types of borrowers” (OMB 1995, App. I, 14). This is certainly the primary reason that Congress employs GSEs, even if, as Thomas Stanton notes, “market imperfections are much more difficult to find today” than they were when Fannie and Freddie were created (Stanton 2002, 10).

Froomkin (1995, 557–59) has suggested four additional reasons behind Congress’s decision to create federal government corporations.
like Fannie and Freddie: (1) they are believed to be more efficient at achieving market-related goals, (2) they are believed to be more insulated from politics than a division of a large federal agency, (3) they are believed to be effective at delivering targeted subsidies, and (4) they are a useful subterfuge for Congress because their borrowing is typically not counted as part of the federal deficit. As seen in this brief, there is good reason to doubt that the first three reasons are as compelling as Congress would have liked. There is also good reason to believe that Congress was spot-on regarding the fourth. Rivlin and Froomkin outline the major reasons that Congress creates GSEs, but they do not offer a comprehensive theory of the GSE. Existing efforts to do that are reviewed below.

Finance and economics scholars have proposed a variety of cost/benefit frameworks with which to evaluate Fannie and Freddie, although this is no mean task. These frameworks often rely on various ad hoc metrics, such as whether Fannie and Freddie actually lower interest rates for homeowners or how much of the Fannie/Freddie subsidy is passed on to homebuyers. There is general agreement that the two companies do lower interest rates to some extent and that they do so by passing on to homeowners a portion of the subsidy that derives from the government’s guarantee of their obligations.

Fannie and Freddie, of course, argue that they still provide an array of benefits, while others vigorously dispute this claim. Fannie and Freddie know that the debate is fundamentally one about their right to exist as GSEs. Their critics have become increasingly strident in their criticism of the Fannie and Freddie business model as these companies have grown way beyond the expectations of anyone who studied them in the 1970s and 1980s.

While this body of literature has provided many insights into Fannie and Freddie, it does not provide an overarching theoretical framework that would help determine their value. Such a framework should describe the environment in which Fannie and Freddie operate as well as the incentives and structural limitations that drive the development of the two companies. It should also provide guidance as to how they should be treated going forward.

C. Fannie and Freddie Evaluated through the Lens of Regulatory Theory

Given Fannie and Freddie’s monstrous size and market power, there are no comparable public/private hybrid entities. As products of regulation, however, they fit well within existing theories of regulation. This section evaluates their value as agents of public policy through the lens of regulatory theory.
Two oft-stated objectives of government economic policy are to maintain and encourage competition among firms in order to increase “the material welfare of society” (Brodley 1987, 1023) and to maximize consumer welfare “through lower prices, better quality and greater choice” (US Department of Justice 2010). Cass Sunstein has rightfully noted that many regulatory regimes therefore reflect “a belief that regulatory enactments might simultaneously promote economic productivity and help the disadvantaged” (Sunstein 1990, 3). But Sunstein has also noted, along with many others, that one of the main criticisms of regulation is that it is “[o]nly purportedly in the public interest” and that it “turns out on inspection to be interest-group transfers designed to protect well-organized private groups . . . at the expense of the rest of the citizenry” (Sunstein 1990, 32).

Indeed, modern theories of regulation stem from the insight that firms attempt to use regulation as a device “to establish or to enhance monopoly power” (Crew and Rowley 1989, 6–7). Assessing the role of regulation in a particular market is necessary to understand whether that market is functioning competitively and equitably. Fannie and Freddie, although born of regulation themselves, claim to act competitively. Theories of regulation thus provide a useful framework with which to understand the market in which Fannie and Freddie operate, one that allows us to evaluate whether the companies increase “the material welfare of society” and maximize consumer welfare. This section will analyze Fannie and Freddie as creatures of regulatory privilege within the context of regulatory theory.

The core of Fannie and Freddie’s regulatory privilege is the government’s guarantee of their obligations, which was initially granted to create a national secondary residential mortgage market. This implied guarantee drives any competition from the conforming mortgage market because the two companies can borrow money so much more cheaply than their competitors. Their lower cost of funds means that Fannie and Freddie can outcompete fully private financial institutions in the conforming market, thereby keeping the conforming sector to themselves.

The government guarantee is a variant on the long-standing government practice of spurring private investment in various arenas by granting some privilege or monopoly power to a party that will 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.

Unlike true monopolists, Fannie and Freddie are limited by the nature of their competitive advantage: In an otherwise efficient market, the maximum amount that they can retain as economic rent is the spread between the interest rates they must pay and those that their competitors must pay. Notwithstanding this cap on profits, Fannie and Freddie share an important characteristic with government-granted monopolies: a legally created and overwhelming competitive funding advantage in a particular market that derives from their special charters. This advantage translates into higher prices for consumers than would exist if Fannie and Freddie did not retain a portion of their economic rent for shareholders and management.5

Regulatory theory identifies six goals that are relevant to a study of Fannie and Freddie, including (1) maintaining competition, (2) efficiently allocating society’s goods and services, (3) promoting innovation, (4) preventing inappropriate wealth transfers, (5) preserving consumer choice, and (6) preventing an overly concentrated economy. The first three goals relate to economic efficiency concerns. The last three goals address additional public policy objectives. As will be seen below, Fannie and Freddie do little to effectuate these goals. Indeed, in some cases they act contrary to them. When it comes to their relationship with credit unions in particular, the analysis is slightly different, but the net result is the same—Fannie and Freddie do not appear to have created the most ideal marketplace for the mortgages that they originate.

Maintaining Competition
Maintaining competition is one of the most important goals of economic regulation. But applying this goal to Fannie and Freddie’s activities is a bit difficult as there was no real national mortgage market when they were created. Indeed, they were formed in order to create something new: a fungible mortgage security. So, to begin with, there was barely any competition with which Fannie and Freddie could interfere. And now, because of their funding advantage, they have no competitors in the prime conforming market. This state of affairs presents two questions regarding competition in the modern residential mortgage market: (1) should there be more
competition in the conforming mortgage market? and (2) should Fannie and Freddie be allowed to expand the markets in which they compete while maintaining their funding advantage?

As to the first question, it is not controversial to answer that competition is considered healthy in almost all markets, except for those that are better suited to natural monopolies, like the utilities market. While Fannie and Freddie maintain that they compete with each other, independent commentators describe their behavior more as that of duopolists than competitors. As to the second question, again it is not controversial to state that introducing subsidized firms like Fannie and Freddie into a generally efficient nonsubsidized mortgage market like the jumbo market would distort pricing in that market.

And Fannie and Freddie are entering that jumbo market: The rapidly increasing size of the conforming loan limit, a product of furious lobbying by the two firms, allows Fannie and Freddie to claim more of the overall mortgage market for themselves as opposed to their jumbo-originating competitors. As Fannie and Freddie both operate without competition in the conforming market and expand their markets through political action, they seem to operate contrary to the goal of maintaining competition.

Moreover, if one believes that Fannie and Freddie were created primarily to develop the national mortgage market, then it follows that their government-granted privilege should be abolished now that they have completed that task. That is, Fannie and Freddie’s regulatory privilege should be treated more like the privilege granted to patents—allowing for a temporary monopoly for the express purpose of encouraging innovation—rather than the privilege granted to a natural monopoly such as utility companies, which are typically regulated in perpetuity because they have no potential competition.

Regarding credit unions in particular, Fannie and Freddie offer a well-established vehicle for the purchase of credit union–originated mortgages. Because of the attractive terms they can offer as a result of the implied guarantee, their dominant role in the conforming market limits the possibility for competitors that might otherwise offer a secondary market for credit union mortgages. It is uncertain, therefore, what a more competitive market for credit union–originated mortgages would like, although one must assume that it would look quite different from the one that exists today under the Fannie/Freddie duopoly.
Efficiently Allocating Society’s Goods and Services

In a productively efficient system, each unit of a product is produced at the lowest possible cost. If a producer in a competitive market fails to produce its product at the lowest possible cost, it will likely fail. This result does not typically apply to a monopolist because a monopolist does not face competition in its market. Monopolists thus typically “lack sufficient incentive to hold production costs at low levels” (Breyer 1982, 16).

The competitive advantage provided by Fannie and Freddie’s regulatory privilege is limited, as discussed above, by the fact that they would face competition if the price (interest rate and fees) in the conforming market were equal to or higher than the price in the private-label market. But so long as they keep their price lower than the price in the private-label market, they are able to extract some economic rent. Thus, they are not efficiently allocating society’s goods and services.

Regulatory privilege imposes certain additional social costs. Its beneficiaries incur costs to retain and expand it, often through campaign contributions, lobbying, and bribery. Such firms are also more likely to dissipate their rents through expenditures such as advertising in order to protect their privileged status. Fannie and Freddie are thus best understood as rent-seekers that expend resources to obtain favorable regulation in order to obtain rents.

The presence of Fannie and Freddie in the marketplace helps credit unions and other small lenders offer standard mortgage products like the 30-year fixed-rate mortgage. Such products would probably be different or might not be as widely available without Fannie and Freddie’s secondary market operations. That being said, there are other ways of structuring the secondary market that would end their privileged place in it while retaining potentially socially valuable benefits like a market for long-term mortgages.

Promoting Innovation

Recipients of regulatory privilege may have less impetus to innovate because of their competitive advantage. Fannie and Freddie claim, however, that they continue to innovate as the secondary market matures. Indeed, they have introduced a number of innovations that allow them to profit from aspects of the mortgage market that had traditionally fallen outside the scope of their activities. These include, for instance, the development of automated underwriting systems and underwriting guidance systems for third parties. It is no coincidence that these innovations allow the two companies to enter new markets, thereby pushing against the limitations on their expansion into new markets contained in their charters. The Mortgage Bankers Association argues that in the area of underwriting technology,
Fannie and Freddie have actually squelched the innovations of others, much as Microsoft has squelched its competitors by tying new products to its operating software.

Private-label competitors have innovated at a far greater rate than Fannie and Freddie, introducing a dizzying array of products for consumers and securities for investors, although much of that innovation now seems foolish, greedy, and wrongheaded. At a minimum, there is no evidence that Fannie and Freddie innovate more than they would if they faced a marketplace filled with many competitors. That being said, as the subprime crisis unfolds, the once-vaulted innovation of private-label lenders has taken on a morbid pall. Engel and McCoy (2007) demonstrate quite convincingly how the business model of these private-label lenders led directly to much of the abusive lending of the last 10 years. One could argue that this goal of regulatory theory should weigh in favor of Fannie and Freddie, if they themselves had not invested so heavily in subprime and Alt-A mortgages originated by the very same private-label lenders that engaged in such dangerous innovations.

While credit unions do benefit from the existence of Fannie and Freddie’s established secondary market operations, it is likely that a more competitive market would provide more options for small organizations like credit unions. A market with a variety of competitive players would, presumably, encourage products, distribution channels, and even ownership structures that could be more beneficial for credit unions. The incentives for such enterprises are negligible in an environment where two dominant players have both the inclination and the economic and political clout to protect the status quo products and systems.

**Preventing Inappropriate Wealth Transfers**

Monopolists are willing to forgo sales for increased profits. Similarly, Fannie and Freddie forgo offering the lowest possible price for mortgages; they do this by retaining a portion of their subsidy, instead of passing it on to borrowers as they would in a perfectly competitive market. This is reflected in the outsized profits that Fannie and Freddie have historically enjoyed as compared to other financial institutions. It may also be reflected in the generous pay packages that management awards itself before turning over the remainder of the economic rent to shareholders.

Furthermore, monopoly pricing dissuades some buyers who would have purchased a good at a competitive price from doing so at the
monopoly price, which is allocatively inefficient. Fannie and Freddie’s retention of a portion of their subsidy likewise keeps some potential borrowers from borrowing.

In a market with no government guarantee, it would be unlikely that credit unions could find pricing for their mortgages that was as attractive as the pricing currently offered through Fannie and Freddie. This would be true even if a highly competitive market ended inappropriate wealth transfers. That is not to say that alternatives that do not rely on the regulatory privileges enjoyed by Fannie and Freddie should not be evaluated. The cooperatively owned FHLBank System offers one alternative that reduces some of the opportunities for inappropriate wealth transfers, as does a strictly private competitive secondary market.

**Preserving Consumer Choice**

Government regulates businesses that operate in markets that are not fully competitive, in part, to achieve fairness for consumers. Because of their competitive advantage in the conforming loan market, consumers effectively only have the choice of Fannie or Freddie. As noted above, Fannie and Freddie argue convincingly that they have helped to standardize the prime, conforming mortgage to the benefit of consumers.

There is no question that private-label firms would enter the conforming market if they were able to borrow funds at rates comparable to those at which Fannie and Freddie can borrow. The pros and cons of those private-label firms have been well documented in the jumbo and subprime markets: They expand consumer choice but often at the expense of the consumer protection inherent in a standardized marketplace. More competitors would, of course, mean more consumer choice in lenders. It would also likely mean more choice in mortgage products. But in the context of mortgage lending, more consumer choice is a double-edged sword, as the implosion of the subprime market attests.

Fannie and Freddie also argue that they implement the government’s policy of increasing homeownership; indeed, Fannie Mae’s slogan is “Our Business Is the American Dream.” They claim that they have helped the nation achieve a great increase in the rate of homeownership. This claim is undercut in a variety of ways. First, the credit crunch has made some question whether homeownership is a good in and of itself for all households. Second, some scholars argue that America overinvests in housing and that Fannie and
Freddie are part of that problem. Third, it is unclear whether Fannie and Freddie actually help to fund affordable housing for low- and moderate-income homeowners, who should presumably be the main beneficiaries of such a government initiative. Fourth, the amount that the typical homeowner saves because of Fannie and Freddie is relatively modest.

The dominance of Fannie and Freddie in the secondary market and the popularity of their preferentially priced 30-year fixed-rate mortgage products mean that most lenders feel obligated to offer those products, often to the detriment of products like shorter-term, lower-rate loans that would be better for lenders’ balance sheets (and their interest-rate risk considerations) as well as for homeowners. But as long as the 30-year fixed-rate mortgage maintains its preferential pricing because of the implied guarantee, it will maintain its allure in the eyes of homeowners, even when shorter-duration products might actually be a better choice for them.

Preventing an Overly Concentrated Economy
Regulation may be employed to reduce over-concentrations of market power. Fannie and Freddie argue that their vast size provides stability to the mortgage market; independent scholars disagree. Recent events further disfavor the Fannie/Freddie perspective. Fannie Mae and Freddie Mac each present an over-concentration of risk that is perhaps unsurpassed by any other private firm operating anywhere in the world. Because the two companies have an identical, undiversified business model, that risk is only magnified. Thus, any substantial operational risk or mistaken hedging strategy at either firm poses a systemic risk to the international economy, a risk that has already become a reality.

The relationship among Fannie Mae, Freddie Mac, and credit unions in regard to preventing an overly concentrated economy is complex. As mentioned previously, Fannie and Freddie are established and efficient liquidity vehicles for thousands of small and medium-sized credit unions. They allow credit unions to quickly shed conforming loans and receive cash in return. But that liquidity role comes at a cost to the financial system.

In the years leading up to the credit crisis, credit unions, as well as other financial institutions, were incentivized to originate mortgages that were not sustainable, because they were able to quickly pass them off to Fannie and Freddie. But because of the gargantuan size...
of the Fannie and Freddie portfolio, and because of their extraordinarily large exposure to credit risk in their mortgage-backed securities (MBS) insurance business, they posed a “too big to fail” risk to the global economy. So while credit unions can be glad that some of the bad conforming loans they originated during the boom years are now on Fannie and Freddie’s books instead of their own, the American taxpayer was left holding the bag on these unsustainable mortgages once the two entities became insolvent. Thus, though Fannie and Freddie can be seen as supporting the highly unconcentrated credit union industry, their own highly concentrated business model cuts in the other direction.

Fannie and Freddie do not do well when these six regulatory goals are taken together. As to the three economic efficiency goals, the conforming market is not as competitive or efficient as it would be if there were more competitors. There is also no evidence that the market is more innovative than it would be if there were more competitors. Thus, merely on economic efficiency grounds, Fannie and Freddie’s regulatory privilege does not serve the public interest. Nor do Fannie and Freddie do particularly well with the other public policy goals. The two companies engage in rent-seeking, limit consumer choice, and keep other firms from competing with them.

The two areas where Fannie and Freddie seem to offer some clear and significant benefits are (1) providing short-term liquidity and stability to the mortgage market during an acute crisis and (2) promoting consumer protection, at least in the prime, conforming sector. This second point isunderscored by the events leading up to the credit crisis, which have demonstrated that too much consumer choice in the mortgage arena can lead to horrible results. If the benefits offered by Fannie and Freddie could be undertaken through alternate means, one might conclude that Fannie and Freddie are not particularly beneficial agents of public policy.

In sum, regulatory theory helps to untangle Fannie and Freddie’s intended market function from their intended public mission and to explain how the two purposes do not work well individually or taken together. Because Fannie and Freddie are creatures of federal regulatory privilege, not independent firms operating in a relatively unregulated market, the federal government has broad latitude in
setting new goals for these two firms and modifying the regulatory privileges awarded to them.

III. Fannie and Freddie’s GSE Status Should Be Terminated

Identifying the weaknesses of Fannie and Freddie as agents of public policy is very different from identifying what should be done with them. The two companies have two of the most powerful lobbying machines in Washington. Moreover, the nature of Fannie and Freddie’s privileges makes it unlikely that they will be revisited by Congress with any regularity. Because Fannie and Freddie are poor agents of public policy and are political powerhouses with unmatched influence, the two companies should be fully privatized.

Fannie and Freddie Are Political Powerhouses

Koppell (2003, 97–121) has thoroughly documented how Fannie and Freddie have been able to exercise unparalleled influence in Washington. Mirroring the hybrid analysis in this brief, he concludes that it is the combination of elements of public instrumentalities and private companies that gives them the “best of both worlds”—in terms of the political influence the two companies can marshal. Thus, any policy proposals relating to the two companies must be evaluated in the context of the political environment in which they operate.

Given that Fannie and Freddie have outsized influence in Washington, one must be cautious in recommending half-measures in reaction to their limitations as agents of public policy. Unfortunately, most of the reforms floated in the last few years seem to fall within this category. 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 from rating agencies for their debt issuances that discount the implied guarantee.
- Imposing user fees.
- Strengthening their subordinated debt programs.

If any of these half-measures were adopted, however, Fannie and Freddie’s lobbying juggernaut would be sure to undercut them as soon as Congress’s focus moved on to another pressing issue.
The Government Guarantee Is a Reckless Budgeting Device

Froomkin (1995, 618), among others, has identified the encouragement of federal budget shenanigans as a hard-to-quantify cost of the Fannie and Freddie hybrid business model. This is because the federal government’s contingent liability for its guarantee of Fannie and Freddie’s obligations is 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 watches the watchers? Indeed, if the federal government had to quantify and account for this contingent liability in its budget, it would most certainly reduce Congress’s ability to increase net spending.

Fannie and Freddie thus pose four serious budgetary problems. First, the cost of the government’s guarantee is hidden because it is historically treated as off-budget. Second, the cost of the guarantee is particularly difficult to quantify. 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 10 years or so.

Block (2003–2004, 900–04), in her work on the federal tax budget, proposes a set of principles that should guide the budget legislative process. These principles are built on those relied upon by the General Accounting Office and are (1) budget formation as a democratic exercise, (2) enforceability, (3) accountability, (4) transparency, and (5) openness and durability. These five principles help to clarify the manner in which the contingent liability of the government’s guarantee should be treated in the federal budget process.

The government’s guarantee of Fannie and Freddie’s obligations, when viewed as an item in the legislative budgetary process, fails to abide by any of these principles. Because the government guarantee of Fannie and Freddie’s obligations was created decades ago, it is generally not part of the annual debate surrounding the budget. Because the size of the guarantee is uncapped and contingent, it fails the enforceability and accountability principles: It operates outside of the budget, its cost is hard to estimate, and the trigger for the federal government’s obligation to make good on it is in itself an unexpected event. Similarly, the guarantee, because of its contingent nature, is quite confusing to those outside of the budget process. Finally, it fails to meet the openness and durability principles because it is not typically part of the annual budget deliberations.
In sum, the budgetary implications of the government’s guarantee provide an additional public policy argument against Fannie and Freddie’s hybrid structure, one that even on its own weighs heavily against them as agents of public policy.

**Fannie and Freddie Should Be Privatized**

There are four broad positions regarding the appropriate role of Fannie and Freddie in the housing finance market. The first position is that Fannie and Freddie are generally doing the job that they were designed to do, although their powers and those 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, the fourth position is that 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.

This brief takes the fourth position. In particular, it argues that the government guarantee should be terminated and the two companies should be privatized. Until they entered conservatorship, this position was considered a political nonstarter, particularly because Fannie and Freddie have many allies in the Republican and Democratic parties. Due to recent events, it is now one of the options on the table for a post-conservatorship Fannie and Freddie.

**Status Quo**

Someone taking the first view—that Fannie and Freddie are generally doing the job that they were designed to do—might argue that “[t]he penetration of competitive markets by laws and regulations is a highly durable and robust intrusion in the US economy . . . [which] is arguably as tightly regulated as the more socialistic economics of Western Europe” (Crew and Rowley 1988, 163). Thus, there is no need to extricate the federal government from its relationship with Fannie and Freddie because the government has similar relationships with many other private companies. Proponents of this view, including trade industry powerhouses like the National Association of Realtors, typically recommend limited reforms like those outlined above.

The key characteristics of such an approach should be:

- A commitment to identifying what went wrong with Fannie and Freddie in the subprime boom.
- An identification of a tolerable level of losses from future bailouts.
The development of a workout plan that can be implemented for the inevitable bailout that will come at some point in the future.

Credit unions and small mortgage lenders would of course find this path very familiar. They would continue to have access to the secondary mortgage market through RMBS securitization and GSE portfolio purchases. They would avoid the cost, particularly the investment in new information technology, that any substantial change would impose. And they could be confident that the enormous financial institutions could not box them out of the primary mortgage markets.

Redirecting Excess Profits

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 shareholders and management, at the expense of their affordable housing goals. Given the shared agenda of Fannie and Freddie on the one hand and affordable housing providers and advocates on the other, this position should not come as a surprise to a student of regulation. 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.

And, indeed, in a plan subsequently suspended by federal conservatorship, Congress had implemented an affordable housing fund into which the two firms would deposit upwards of $500M 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.

Fannie and Freddie supported this proposal in exchange for an expansion of their market. This expansion was implemented by increasing the conforming loan limit in high-cost parts of the country, which allowed the two companies to expand into the bottom part of the jumbo market. It is of note, of course, that Fannie and Freddie’s support for such an extraordinarily costly initiative as the affordable housing fund came at a time when their public prestige was at a low point, and the deal was widely seen as a political compromise that brought together a broad set of special interests whose goals are aligned with those of Fannie and Freddie. These interests included affordable housing advocates, local governments, and the construction industry.
The key characteristics of this approach should be the same as the first, but with these additional ones:

- A commitment to identifying how to extract funds for affordable housing from the Fannie/Freddie business model without undercutting their fundamental safety and soundness as financial institutions.
- The development of a cost/benefit analysis of the affordable housing trust fund that would help to identify (and limit) the extent to which Fannie and Freddie would need additional regulatory privileges (such as the expansion of the conforming loan limit) to compensate them for the burdens of such a proposal.

The dynamics of this position are complex. Housing advocates are concerned with the sustained lack of attention that federal and state governments have paid to affordable housing policy and see any dedicated housing dollars as a long overdue priority. Implicit in this view is that the risk of a Fannie and/or Freddie bailout to the typical American taxpayer is worth the benefit of the affordable housing dollars that the affordable housing fund would direct to low- and moderate-income families. The real debate, from this perspective, is how much of the golden egg of the economic rents resulting from the implied guarantee (as revealed by Fannie and Freddie’s profits, which consistently and greatly exceed the industry average) can be redirected to these affordable housing objectives without killing the Fannie and Freddie geese.

Credit unions and small mortgage lenders should find this approach to be roughly the same as the first one: just a riff on the status quo.

The implementation of an affordable housing trust fund should not affect their access to the secondary mortgage market because it would likely be a levy on Fannie and Freddie’s revenue or income. Thus, it would not affect credit unions’ competitive posture vis-à-vis other financial institutions. That being said, credit unions would want to ensure that any affordable housing mandate for Fannie and Freddie would be sustainable so that the American housing finance system could avoid future crises triggered by an unduly burdensome mandate. The levy in place for the FHLBanks provides a model for a sustainable mandate.

**Nationalization**

The third position, nationalization, had only begun to be taken seriously as the Fannie and Freddie bailouts progressed. Indeed,
then-Secretary Paulson raised the idea, one that would seem
anathema to a fiscal conservative such as himself. Paulson proposed
merging the two companies with the FHA, which already insures
certain mortgages (Hagerty 2009). He did note, however, that such
a plan would place much of the underwriting in the hands of the
government, which would be unlikely to do that task well (not that
the private sector has done so either in recent years!). Jaffee (2009)
has developed one such proposal that advocates for the creation of
a government agency along the lines of the FHA to serve the con-
forming market in lieu of Fannie and Freddie. In a slightly different
vein, Hancock and Passmore (2009) propose the creation of a federal
government bond insurer for mortgage-related bonds created by
Fannie Mae, Freddie Mac, and other authorized issuers. This insurer
would charge risk-based premiums in exchange for an explicit federal
government guarantee against credit losses.

Since taking office, the Obama administration has indeed looked to
the GSEs as an extension of the federal government and a lever for
carrying out its housing policies. Fannie Mae and Freddie Mac, as
conduits of federal bailout money, have effectively propped up the
US housing market; the two GSEs accounted for roughly 75% of all
new mortgage originations in the second quarter of 2009, with the
FHA basically accounting for the remainder (DeMarco 2009). Fan-
nie and Freddie are also centerpieces of the administration’s foreclo-
sure prevention efforts, refinancing and modifying mortgage loans
they hold and guarantee, and further serving as the government’s
administrator and compliance agent in managing other industry par-
ticipants in the program. Most recently, the Treasury employed the
GSEs to support affordable housing programs, channeling money
through the GSEs to purchase and securitize state and local hous-
ing agency bonds that were in demand by private investors in more
flush economic times. This is not to suggest that nationalization of
the GSEs is a fait accompli; in the months before Fannie and Freddie
entered conservatorship, former Treasury Secretary Lawrence Sum-
mers suggested that under an emergency scenario, the government
could “operate the GSEs as a public corporation for several years . . .
to extend credit where appropriate to support resolution of the hous-
ing crisis” before dividing their functions into public and private
components once the crisis had passed (Summers 2008).

Because this approach would radically change the entire nature of the
American housing finance system, the characteristics of this approach
should be much more far-reaching:

• The enunciation of a broadly held philosophy of government
  intervention in homeownership policy that would guide any
  nationalization approach.
• The selection of the appropriate mode of government intervention (e.g., MBS insurer, MBS securitizer, or direct lender like in the student loan market).

• The determination of the political independence of the government instrumentality that implements such a nationalized housing finance policy (e.g., an arm of the executive branch, as with post-conservatorship Fannie and Freddie, or something more independent like the Federal Reserve Board).

Credit unions and small mortgage lenders would have to watch the development of any such plan with the greatest of care. Significant changes in their operations and those of their competitors could be easily worked into such a large-scale change to the housing finance system, either intentionally by lobbyists or unintentionally (as happens with all revolutionary changes to something as complex as the housing finance system). The greatest concern for credit unions would be to protect their competitive position relative to larger financial institutions. Any change that favors heavy originators will likely disfavor most credit unions and other small mortgage lenders.

Privatization

As noted above, this brief advocates for the fourth view: Fannie and Freddie pose a systemic risk to the financial system, unfairly benefit from their regulatory privilege, and no longer create meaningful net benefits for the American people. In speaking of regulatory reform, Sunstein (1990, 109) notes that a good first step “would be to adopt a presumption in favor of flexible, market-oriented, incentive-based, and decentralized regulatory strategies. Such strategies should be focused on ends . . . rather than on the means of achieving those ends.” Fannie and Freddie are holdovers from a philosophy of government action 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 shareholders and management disproportionately.
Privatization is needed to remedy this state of affairs. Notwithstanding Fannie and Freddie’s potency in Washington, this is not merely some fanciful policy proposal. Theories of regulation and rent-seeking identify erosions of government-granted monopolies over time as part of their natural life cycle. And, as the credit crisis continues to worsen, more and more previously unthinkable solutions are being taken quite seriously. Because this brief advocates some form of privatization, I will address it at further length below.

**Privatization Options**

Four concrete plans have been proposed to fundamentally change Fannie and Freddie’s structure, each involving different degrees of government involvement. The first proposal is to 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 (FHLBank) System and the Farm Credit System. Some commentators have called for the FHLBank 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’s. Indeed, Congress had to bail out the Farm Credit System in 1987. And there are rumblings that the FHLBank System may face problems similar to those of Fannie and Freddie.

The impact of such a proposal on credit unions and other small mortgage lenders depends on the nature of the cooperative arrangement. If small originators with a small equity investment in the cooperative were guaranteed access to a secondary mortgage market that was comparable to that which exists today, then the impact on credit unions would not be particularly negative. If larger members of the cooperative had qualitatively different access, they might be able to box credit unions out of the primary mortgage market.

The second proposal, chartering additional housing finance competitors, has some attraction. The Center for American Progress (CAP; 2009), the Mortgage Bankers Association (MBA; 2009) and the
National Association of Home Builders (NAHB; Judson 2010) each have a variant of this proposal. CAP proposes the creation of privately owned, monoline Chartered Mortgage Issuers that could issue MBS guaranteed by the federal government. The MBA proposal anticipates creating “mortgage credit-guarantor entities” that would have a federal government guarantee of MBS issued by them. The NAHB proposes the creation of conforming mortgage conduits that would play a similar role. Under these proposals, insurance premiums levied on the MBS would be paid to the federal government in exchange for the guarantee. Such premiums would be designed to protect taxpayers from future bailouts.

Indeed, one might consider the federal deposit insurance system to be a model of this type of proposal: numerous recipients of regulatory privilege (access to federally guaranteed insurance) that must compete among themselves. If the Fannie/Freddie duopoly could be diluted with enough similar competitors, the amount of economic rent that Fannie and Freddie retained from their government guarantee subsidy should reduce significantly. In addition, one might think that a more competitive market would spread risk among more firms. And, indeed, credit guarantees have played a central role in American housing policy since the 1930s. The guarantee protects against credit risk but leaves investors with interest rate risk and prepayment risk. Investors have various tools to hedge against those risks.

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.

In all likelihood, such a proposal would work well for credit unions and small mortgage lenders. With meaningful competition, some of the secondary market entities should cater to those lenders. And so long as those secondary market entities are all on somewhat equal footing with each other vis-à-vis the secondary market, they should be able to provide sufficiently flexible access to the secondary market to meet the diverse needs of those smaller lenders.

The third proposal, regulating the GSEs like utilities, appears to be favored by former Treasury Secretary Paulson and taken seriously by the likes of former Federal Housing Finance Agency Director James Lockhart. The Housing Policy Council of the Financial Services Roundtable, for instance, proposes the creation of one MBS issuing facility that would work with a small number of heavily regulated mortgage securities insurance companies, which would originate a
limited set of plain-vanilla mortgages that could only be securitized in simple MBS structures by the MBS issuing facility (Dalton 2010). The Credit Suisse plan also has some of these utility-like characteristics: a reformed Fannie and Freddie that would only issue federally guaranteed MBS containing plain-vanilla mortgages (Hassan and Swaminathan 2009).

In theory, appropriate regulation could help set proper pricing and control risk taking under this utility model. One worries, however, that the common regulatory problem of capture would be difficult to avoid here, where the two companies to be regulated are so clearly skilled in the art of politics. One also worries that useful innovation would be stemmed with such highly regulated players.

Credit unions and small mortgage lenders should be able to protect their access to the secondary market if Fannie and Freddie become highly regulated utilities. Credit unions have successfully protected themselves from attempts by other subsectors of the financial services industry to strip them of their tax-exempt status and other regulatory privileges. Making the case for equal access to the secondary market for originators of all sizes should be relatively easy to do in a regulatory environment, particularly one that has become sensitized to “too big to fail” concerns.

The fourth proposal, converting the GSEs 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 private 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 would have to 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 take on that role. Possible policy responses to market disruptions could include providing targeted federal mortgage guarantees, authorizing the Treasury to make MBS purchases, and allowing mortgage lenders to access the Federal Reserve’s discount window. Policies like these would ensure that the residential
mortgage market could function during a panic. Donald Marron and Phillip Swagel (2010) have proposed something along these lines, where a fully privatized, but regulated, Fannie and Freddie and their potential competitors would be able to purchase MBS guarantees from the federal government. Under such a scenario, the MBS would benefit from the federal guarantee, but the firms and their debt would not. As always, the devil is in the details: Assuring that the cost of the federal guarantee matched the government’s actuarial risk would be no small task, and the failure to do that correctly could lead to future federal bailouts.

Second, homeowners will pay slightly higher interest for conforming mortgages if the two companies are privatized. If Congress determines that this increase is 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 would decrease federal revenues, it would be offset by the liability that Fannie and Freddie imposed 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 Recovery Act, it would need to do so through direct expenditures. Again, this direct cost would be offset by terminating the contingent liability of the government guarantee.

Fourth, 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 regulation in order to avoid the nasty and brutish environment of 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.

Finally—and of special concern to credit unions—Fannie and Freddie’s role as a gateway to the secondary market would end or be materially changed. This path presents great risks for small retail financial institutions because they would face some increased competitive disadvantages with the removal of the GSEs and their conversion to large competitors. Without any GSEs, small retail financial institutions would have a very hard time offering long-term fixed-rate mortgages, and that would put them at a competitive disadvantage to the very large financial institutions with which they compete. Thus, small retail financial institutions would certainly want to see the GSE gateway function transferred to a new set of
entities to ensure ongoing access to the secondary market. This is of key importance to such financial institutions, but it is also important to the “too big to fail” agenda—if a privatized Fannie and Freddie continue in anything like the size they are in now, they will continue to pose a systemic risk. Thus, smaller financial institutions should continue to be active participants in the secondary market in order to spread credit risk over a larger number of institutions.

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, protect consumers, and provide affordable housing.7

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 were created. Alice Rivlin, in her then-capacity as director of the OMB, stated that “GSEs should only be created with a clearly articulated ‘exit strategy’ and an express sunset date in their charter” (OMB 1995, App. I, 14). Unfortunately, this is almost never the case.

The typical result of poor GSE design is that the GSE ends up driving much of the legislative and regulatory agenda regarding its own fate. Stanton and Moe (2002, 105) argue that this can lead to “increasing dominance over the governmental process” by GSEs; the inability “of the government to supervise GSE safety and soundness and the government’s resulting financial exposure”; and government inability “to induce GSEs to serve public purposes that conflict with the interests of shareholders.”

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, consumer protection legislation, and affordable housing programs. And Congress should remember the lessons of Fannie and Freddie when it considers using the GSE as a tool of government in the future. It should reflect on the appropriate design for such a hybrid tool, a design informed by a theoretical understanding of the GSE based on regulatory theory and sound federal budget policies.

When it comes to credit unions, the main benefit they would be at risk of losing if Fannie and Freddie were privatized is their ready access to the secondary market on par with larger financial institutions. Credit unions would also see a marginal increase in mortgage rates on the conforming products they offer, but this would be true for all originators. If Fannie and Freddie were to be privatized, as this brief suggests, credit unions would want to advocate for a more competitive secondary market whose intermediaries would be more amenable to the needs of a variety of originators and that would likely offer more innovation over the long run that would benefit both originators and homeowners.
1. Fannie and Freddie are just two of a number of GSEs, each with its own enabling statute. Others include the Financing Corporation (FICO), the Resolution Funding Corporation, and the Federal Home Loan Bank (FHLBank) System, as well as the related entities the Farm Credit System and Farmer Mac. GSEs have a mixed history when it comes to surviving without financial assistance from the federal government. The first two were created to deal with the aftermath of the savings and loan crisis. When concern grew that FICO might default on its bonds, Congress enacted a law that reduced the risk of default. The mission of the FHLBank System overlaps to some extent with that of Fannie and Freddie. While there had been some concern about the financial health of many of the FHLBanks during the credit crisis, they appear to have come through it without the need for a bailout. The Farm Credit System and Farmer Mac were created to do the same for farms as Fannie and Freddie do for the residential real estate market. Congress bailed out the Farm Credit System in 1987.

2. Fannie and Freddie have directly or indirectly funded most of the research that pertains to them. That research typically supports Fannie and Freddie’s own agendas. In addition, many of the scholars writing about Fannie and Freddie have worked or do work for one of the two companies. Again, much of their research is supportive of the two companies. I use the terms “independent scholars” and “independent research” to distinguish scholarly work produced by those without a connection to the two firms as well as research by Fannie- or Freddie-affiliated researchers that does not appear to have a pro-Fannie-and-Freddie bias.

3. It is of no small interest to compare the gross annual savings on interest for homeowners with the likely cost of the Fannie/Freddie bailout. In the years leading up to the subprime crisis, homeowners saved more than $3B a year in interest because of this 34-bp savings, whereas the bailout will cost many tens of billions of dollars, if not hundreds of billions of dollars (OFHEO 2007, 11; reporting annual non-jumbo, prime conventional mortgage originations).

4. Fannie and Freddie had their own definitions of “subprime” that were more limited than those that were generally in use in the industry. They were thus able to veil the extent of their exposure to that subsector.

5. To be clear, Fannie and Freddie do pass a portion of their economic rent on to homeowners, as reflected in the 34-bp savings that homeowners benefit from when they have a Fannie
or Freddie mortgage. But homeowners do not receive all of the economic rent—the remainder appears to go in large part to dividends and executive compensation that exceeds industry averages.

6. Fannie and Freddie have spent over $170M on lobbying since 1998 and gave $1.5M to Congressional campaigns in the 2008 election cycle (Williamson 2008). Fannie and Freddie were among the top 20 lobbyists from 1998 to 2008; if their spending were combined, they would rank third (Center for Responsive Politics 2010).

7. This brief does not evaluate some interesting alternatives that are more radical departures from the current mortgage finance system. These include replacing MBS with covered bonds and adopting the Danish model of mortgage finance. For a discussion of those options and more, see Hancock and Passmore (2009).


Fannie Mae and Freddie Mac: Implications for Credit Unions

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