

Fannie Mae and Freddie Mac:
The Houseguests that Stayed Too Long

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Just over a year ago, September 6, 2008, the Federal Government placed the Government Sponsored Enterprises Fannie Mae and Freddie Mac in conservatorship. It was an end that many had predicted¹, based on warnings that too few policymakers heeded.

The problems were clear. Fannie Mae and Freddie Mac had distinct market advantages that their purely private sector competitors did not enjoy. First, Fannie Mae and Freddie Mac's debt was viewed by many to be implicitly guaranteed by the Federal Government. Turns out they were right. Consequently, Fannie Mae and Freddie Mac had a long term funding advantage that allowed them to borrow on credit markets at lower rates of interest. Second, Fannie Mae and Freddie Mac were also permitted to hold lower capital reserves than their commercial bank competitors. Turns out they had insufficient capital when adverse conditions took hold in financial markets though, granted, they were not alone. Third, the securities that they issued also received favorable treatment in the calculation of risk based capital standards. As such, these securities were in high demand by banks. These GSE's received higher prices for their securities and hence they paid out lower yields than their competitor's could. Not a bad business model: namely, have access to lower costs for your inputs and higher prices for your outputs. Profitability should follow, and it did.

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¹ See my SOMC contribution for May 2004, "Can We Avert the Next Financial Crisis?" available at the SOMC website: http://www.cmc.edu/somc/2004_05/hess_0504.pdf

However, having a funding advantage on the debt side, an enhanced demand for their product on the sell side, and the sense of being relatively unburdened to hold sufficient cushion on their balance sheets was not enough for these two public-private enterprises. Fannie Mae and Freddie Mac one-upped these advantages and enjoyed a potent cocktail of accounting scandals, lobbying and leverage. For instance, the Office of the Federal Housing Enterprise Oversight in September of 2004 disclosed persistent accounting irregularities dating back to at least 1999 that, in some cases, directly led to top officers receiving larger performance bonuses.² Moreover, Fannie Mae and Freddie Mac from 1998 to 2008 spent over \$200 million on lobbying and campaign contributions, and concentrated much of their giving to influential members of the House and Senate that oversaw key committees.³

Explaining leverage is a little more complicated. Why? The reason is that these GSE's were not intended to be highly leveraged institutions. In theory, Fannie Mae and Freddie Mac were designed to help facilitate and deepen a national market for mortgages. As intermediaries, they were designed to purchase mortgage loans, package them and sell these new securities off as well diversified savings vehicles. There's not much of a leverage story here. Unfortunately, as I mentioned earlier, these GSE's had access to cheap long term credit which they used to buy back their own mortgage products, and then held it on their own balance sheets. This leverage amplified the credit and interest rate risks that were on the GSE's books. In turn, this leverage likely caused undue fragility to financial markets during the recent financial crisis.

Of course, by creating a liquid pool of securitized mortgage assets, Fannie Mae and Freddie Mac delivered huge benefits to U.S. financial markets -- until they didn't. One could argue that U.S. financial markets needed public-private partnerships in order for this market to originally develop and flourish. While I don't agree with this infant industry argument, I can't disprove the claim. However, I believe it's clear that whatever government assistance that Fannie Mae and Freddie Mac may have needed to help develop a national housing finance market, that need expired a long time ago. In turn, our

² See <http://www.washingtonpost.com/wp-dyn/articles/A41165-2004Sep22.html>.

³ See <http://www.politico.com/news/stories/0708/11781.html>

financial crisis could have been reduced, perhaps greatly reduced, if the implicit subsidies to Fannie Mae and Freddie Mac had ended much earlier. They over-stayed their welcome, and now we are all paying the bill. We should admit and accept these mistakes and vow not to repeat them.

Looking ahead, simple solutions for resolving Fannie Mae's and Freddie Mac's current plight are not easy to come by. Surely in the future these entities will be reduced in size and privatized, but it may take awhile until we get there – a long while. What can we do now? I would start the reform process by advocating transparency for all aspects of the GSE's, their assets and their liabilities. For instance, the Federal Reserve has been forthright about its super-sized holdings of GSE instruments. They have purchased over \$850 billion of mortgage backed securities this year through the middle of September, and have a declared a limit of purchasing \$1.25 trillion which they are likely to accomplish by around March of 2010. Of course, the Federal Reserve has not been overly descriptive about how they plan to unwind this asset position without collateral damage to financial markets and/or the economy. That's the trillion dollar question.

As importantly, the Federal Government needs to acknowledge that Fannie Mae and Freddie Mac are now part of U.S. Government activities, warts and all. But there are consequences to this recognition. In the August 2009 Budget and Economic Outlook: An Update,⁴ the Congressional Budget Office (CBO) determined that Fannie Mae and Freddie Mac should be accounted for as federal activities. The CBO report states, "On the basis of projections of the entities' assets and liabilities over the long term, CBO estimates that including their operations in the budget will increase the federal deficit by \$291 billion this year and by about \$100 billion cumulatively between 2010 and 2019." While higher deficit numbers are certainly unpopular with Capital Hill, owning up to owning Fannie Mae and Freddie Mac is certainly a step in the right direction of greater transparency. And since these houseguests have overstayed their welcome, making them live in glass houses is likely the only way we will ever get them to leave.

⁴ <http://www.cbo.gov/ftpdocs/105xx/doc10521/08-25-BudgetUpdate.pdf>