Is it Time for Fannie Mae and Freddie Mac to Cut the Cord? *

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Background

It is common to find that government programs, when spawned from periods of rapid change when economic markets are deemed to be leading to socially undesirable and uncertain outcomes, typically out-live their useful purpose. This is clearly the case with Fannie Mae and Freddie Mac. These Government Sponsored Enterprises (GSEs) were started when mortgage markets were less liquid, the U.S. banking system was regionalized and substantially less capitalized, financial markets were less developed, and during pushes for more affordable housing.

No one can doubt the benefits that the securitization of mortgages, associated with the rise of Fannie Mae and Freddie Mac as financial institutions, has had in the development and deepening of financial markets in the United States. Nor can one doubt the fundamental importance and necessity of housing in our everyday lives. <u>But the benefits that Fannie Mae and Freddie Mac currently bring to the housing finance market would continue unabated if the perceived "implicit guarantee" that they currently receive were to be removed.</u> Households would still be able to choose among a variety of competitive, financial options to finance their housing. Savers would be able to benefit from holding mortgage backed securities. Fannie Mae

* This text has been prepared for the Fall 2002 meeting of the Shadow Open Market Committee.

and Freddie Mac would be able to earn profits: though based on their performance, rather than on their government sponsored advantages. And the U.S. taxpayer would remove a large potential liability from its balance sheet for which it receives no benefit. It's time to cut the cord.

What They Do

Fannie Mae and Freddie Mac perform as intermediaries in the market for housing mortgages. As such, they provide a useful function. They purchase and hold mortgages originated by banks and then bundle packages of these mortgages together and sell them as mortgage backed securities (MBSs) with a guarantee to investors. Importantly, by "guaranteeing" the securities, these GSEs are assuming the credit risk associated with the underlying mortgages which they hold in their portfolios, and they are off-loading the interest rate risk to the investors. Presumably, given the diversification benefits of risk pooling, these GSEs can diversify the household-specific and region-specific credit risks that are inherent to the housing market.

The Problem

Fannie Mae and Freddie Mac, given their standing as GSEs, maintain a number of advantages over other financial institutions. Some particularly helpful privileges as outlined by Wallison and Ely (2000) are:

1. The U.S. Treasury Secretary is authorized to purchase up to $2.25 billion of their securities.
2. They are exempt from State and Local Taxes.

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3. They do not need to register their securities with the Securities and Exchange Commission (SEC).
4. The Federal Reserve Board can conduct open market operations with their debt securities.
5. Under the Basel Accord of risk-based capital standard, their securities are given substantially lower risk weighting as compared to the debt of other private companies on banks' asset sheets.

Taken together, these privileges have been interpreted by market participants as an implicit guarantee by the Federal Government that these institutions will not be allowed to default on their debts. In turn, given their direct tax advantages as well as the enhanced desirability of their securities, Fannie Mae and Freddie Mac have posted exceptionally strong growth and profitability.

However, the perceived implicit guarantee by the Federal Government of these GSEs liabilities shrouds these institutions in a cloud of moral hazard. Indeed, if Fannie Mae's and Freddie Mac's liabilities are protected from downside risk, what is to stop them from acting imprudently? Of course, while many economists fear that the "Too Big to Fail Doctrine" applies to many financial institutions in the U.S., aggressive banking supervision, Basel risk-based capital standards, reserve requirements, etc… have been used to directly address this moral hazard issue. Such safeguards have been limited and late in coming to Fannie Mae and Freddie Mac.

The State We're In

As I have already discussed, the distinct advantages that these GSEs have received has led to their strong profitability. Unfortunately, the current situation with these GSEs has two

major problems. First, their advantages are exposing the Federal Government to unnecessary risks. As forcefully argued by William Poole (2002), President of the Federal Reserve Bank of St. Louis, Fannie Mae and Freddie Mac's required capital adequacy ratios are woefully low as compared to those that other financial institutions face. For example, as established in the Federal Housing Enterprises Financial Safety and Soundness Act of 2002, the core capital requirement of on-balance sheet items is 2.5% and 0.45% of outstanding MBSs and other off-balance sheet obligations. In stark contrast, government securities dealers hold about 5% in capital and Federally Insured Banks hold equity capital and subordinated debt of about 11% of total assets. <u>As the comparison suggests, Fannie Mae and Freddie Mac are getting off easy by being allowed to hold substantially less capital to help buffer shocks to the market value of its assets.</u>

The only rationale for giving Fannie Mae and Freddie Mac a reduced capital standard is if they were to have an unblemished record of at managing their risks. Unfortunately, this is not the case. For instance, the secular decline in mortgage rates has left these institutions facing substantial numbers of pre-payments, which dramatically affects their asset base. Consequently, Fannie Mae reported in August that due to the refinancing rush, a measure of its ability to manage interest rate risk, the Duration Gap, exploded to minus 14 months. The Duration Gap, which measures the difference between the percent change in the value of an institution's assets in response to a 1% increase in market interest rates and the percent change in the value of an institution's liabilities in response to a 1% increase in market interest rates. The key concept is that longer duration assets are proportionately more affected by changes in market rates than are shorter term assets. <u>Thus a large negative duration gap indicates that the maturity structure</u>

of Fannie Mae's assets is substantially shorter than its liabilities. Such a maturity mismatch exposes the institution to great risk from interest rate changes, which would seem to be at direct odds with its stated goal as a provider of intermediation and liquidity to the mortgage market.

Second, much of the activity that drives the GSEs profitability no longer comes from purchasing mortgages, bundling them and selling them as assets to the private institutions and individuals. Rather, one of the main tactics of these GSEs is to buy back their own mortgage back securities. Indeed, as pointed out by Jaffe (2002), in 1991 Fannie Mae and Freddie Mac retained approximately 2% of their total issued MBSs, while by 2001 this number rose to 33%. This trend is not a one time aberration. For example in 2001, these two GSEs repurchased 50% of their newly issued MBSs.

The strategy by Fannie Mae and Freddie Mac to buy back their own mortgage securities is done purely for profit. By repurchasing their own mortgage back securities, these GSEs are betting that they can make expected profits off the interest rate spread of their own securities over the interest they must pay off from issuing debt. That's not a bad thing if they were facing the additional interest risk on their own -- but they are not! Given their perceived implicit guarantee, their portfolio strategy amplifies the moral hazard issue: if the strategy succeeds Fannie and Freddie win, and if it does not, we lose.

The frustrating thing is that, by repurchasing their own securities, Fannie Mae and Freddie Mac now retain substantial interest rate risk. Evidence that these bets can go bad is evidenced by Fannie Mae's current duration gap problem. Mortgage borrowers, who are designed to be the main beneficiary of the government sponsored mortgage intermediation services of Fannie Mae and Freddie Mac simply do not gain from this market play.

Reform is Good …

It is clear that these GSEs have begun to respond positively to their critics. Of course, this sudden conversion is due to the increased scrutiny and pressure that they have felt, rather than from their catching a sudden case of enlightened benevolence. As noted by Peter Wallison (2002) of the American Enterprise Institute, these GSEs have made a number of positive changes since 2000. These improvements can be broadly categorized in two areas:

1. **Lessening the Moral Hazard Issue:** Given the substantial moral hazard associated with the direct advantages that the GSEs receive from the Federal Government, there have been continued calls to limit unnecessary risk taking that the Federal Government could potentially be held liable for. Two particular solutions to this problem have been recently adopted by these GSEs, namely, the issuing subordinated debt and subjecting their financial positions to more stringent tests of safety and soundness. The former helps in that it creates a set of stakeholders in the company who, given their subordinate status in case of a bankruptcy, would vote for more prudent behavior by the company. The latter aids in solving the moral hazard issue as it can point the companies to hold more capital if additional stress tests on their portfolios point to additional unknown downside risks.

2. **Improving Corporate Transparency:** Given the inherent advantages that these GSEs have obtained from the Federal Government, the moral hazard issue discussed above, and their rising prominence in financial markets, their has been a push towards making these corporations more transparent. Indeed, some improvements toward this end have

been made. In particular, since 2001 Fannie Mae has published their full proxy statement on-line, rather than only selectively reporting these details to all but their investors. Furthermore, in order to improve corporate governance, Fannie Mae has agreed to report the buying and selling of securities by directors and managements.

… But Better Just to Solve the Problem

To date, the recent reforms by Fannie Mae and Freddie Mac are a step in the right direction -- at least seemingly so. These reforms, however, suffer from the fundamental illusion that if you only address the symptoms of the problem, the problem will somehow be fixed. By this I mean that the reforms only attack the consequences of the implicit guarantee, i.e. moral hazard, not the problem itself.

Making Fannie Mae and Freddie Mac hold a little bit more capital (but less than what others are required to hold) and report a little more about their activities (yet once again less than others) are not bad things in and of themselves. Yet the U.S. taxpayer still remains financially exposed to the risks undertaken by these government- protected, for-profit institutions. Better just to leave them for-profit, explicitly remove the implicit guarantee, and fix the problem once and for all.

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