American “Housing GSEs”: Past Triumphs, Present Tensions, Possible Futures

By Alex J. Pollock

As is well known, the American housing finance system is notable for the predominant role played by the “Housing Government-Sponsored Enterprises,” called for short the “GSEs.” These are principally Fannie Mae and Freddie Mac, but also include the Federal Home Loan Banks (FHLBs). All are for-profit corporations owned by private shareholders, but each is chartered by a specific Act of the U.S. Congress, dating respectively from 1938, 1970 and 1932, which grants it special privileges and advantages. Estimates of the economic value of these advantages vary, but they are unquestionably worth billions of dollars a year.

In particular, Fannie and Freddie are usually (and correctly) described as operating an extremely profitable, government-created duopoly in the huge American secondary mortgage market. The GSEs are among the largest issuers of debt securities in the world, and their bonds and notes are widely held on a global basis. The GSEs represent a very large financial sector: their combined assets plus off-balance sheet guarantees of mortgage-backed securities (MBS) total about US$ 5 trillion.

Past Triumphs

A good statement of the overall goal of a housing finance system is to *help create and support a property-owning democracy*. Obviously, different countries and times choose different ways to pursue this goal. The most fundamental choice in housing finance structure is whether the predominant funding for mortgage loans will be provided by *deposits* or *bonds* – in other words, by financial institution balance sheets or by capital markets.

The GSEs can best be understood as representing a historical “paradigm shift” in American housing finance from a deposit-based to a bond-based system. The key transition year can be considered to be 1980, symbolizing the downfall of the U.S. savings and loans and the rise of the GSEs. This shift is summarized in Exhibit 1.

American housing finance from the 1940s to about 1980 was based primarily on savings and loan associations, in which savings deposits financed long term, fixed rate mortgage loans. As many observers have pointed out, this funding mismatch was an inherently unstable structure, extremely vulnerable to large increases in interest rates. The vulnerability was increased by governmental ceilings on the interest rates which could be paid on deposits, so that when rates increased, the deposits were withdrawn, which caused cyclical “credit crunches” or rationing of mortgage funding. Nonetheless, during the time of the savings and loan paradigm, the U.S. homeownership rate increased from 43% in 1940 to 65% in 1980.

The ultimate collapse of the savings and loan system in the 1980s is a story too well known to need retelling.

Exhibit 1: A Financial Paradigm Shift in U.S. Housing Finance

Post-War Structure →	Current Structure
Deposits	Capital Markets
Savings & Loans	GSEs
Interest Rate Ceilings	No Interest Rate Ceilings
Bretton Woods/Fixed Exchange Rates	Floating Exchange Rates/Fiat Currencies
Domestic Capital Markets	Globalized Capital Markets
Housing Finance Credit Crunches	Housing Finance Robust

1980

It was the insolvency and crisis of the savings and loans which made possible the rise to greatness of Fannie and Freddie, as the two GSEs filled the competitive space formerly held by several thousand savings and loans. The new GSE-based system was a distinct improvement in the housing finance structure, because it meant that long term, fixed rate mortgages could be financed with long term, fixed rate bonds and MBS. The GSEs thus represented a far better approach to the management of interest rate risk.

The interest rate risk of a mortgage finance system cannot be made to disappear – it can only be moved to one economic party or another. Exhibit 2 considers the relationship of mortgage finance elements to who bears the interest rate risk. Variable rate mortgage loans or fixed rate loans with heavy prepayment fees put the interest rate risk on the household borrowers—on average, the economic actors least well equipped to cope with it. Bond-based systems, including the use of MBS, move the interest rate risk to capital market investors, who are much better able to address it. Finally, it must be noted that by setting up deposit insurance or GSEs, the government moves interest rate risk to itself. (This may be considered just, since it is the monetary behaviour of the government in a fiat currency system which creates the extremes of interest rate risk.)

Exhibit 2: Who Has the Interest Rate/Prepayment Risk?

- Variable Rate Mortgages
- Mark-to-Market Prepayment Fees

} Households

- Bond-Based Systems
- Pass-Through MBS

} Capital Market Participants

Also:

- Deposit Insurance
- GSE Balance Sheets

} Government

The fundamental source of interest rate risk is the money printing behaviour of the government's central bank.

Exhibit 3: Pricing Power

Due to their market position, Fannie and Freddie are able to charge lenders, particularly small banks, excessively high "guarantee fees" in relation to the credit losses of the mortgages they originate.

	2003 Fannie Mae	2002* Freddie Mac
Average G-Fee	20.2 bps	22.0 bps
Credit Losses	0.6 bps	0.7 bps
Multiple of Losses	33.7 x	31.4 x
"Loss to Premium" Ratio	3%	3%

*Figures as of 12/31/02, revised 11/21/03

This capital market-funded housing finance structure blossomed in the U.S. after 1980. It never had any interest rate ceilings to contend with. Moreover, it developed along with the globalization of capital markets, making GSE securities available to investors worldwide. Mortgage finance no longer experienced periodic "crunches," but operated robustly. Throughout economic and financial cycles, long term, fixed rate mortgage credit was routinely and easily available to American households.

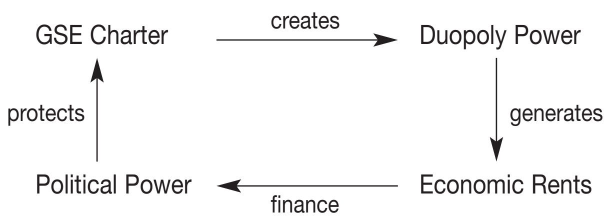
These were real achievements of the GSE-based system.

However, the achievements came at the price of creating a non-competitive, implicitly colluding duopoly which concentrated both economic and political power. The financing advantages derived from their government support allowed the two GSEs to amass a dominating market share, up to approximately 70% of the huge American market for "conforming" mortgage loans (that is, standard loans less than a certain amount, currently about US$ 360,000).

Market power or the ability to enforce high prices for their services has been evident in the GSEs' guaranty fees ("g-fees"). This is the annual charge they receive for guaranteeing the credit performance of MBS. Average g-fees are five times the long run average credit loss rate on mortgage loans, and in recent years have been more than thirty times credit losses on an annual basis, as shown in Exhibit 3. The estimated return on equity for the GSEs' guaranty business is about 28% after tax.

All of this is possible only because the American government, by granting special franchises which were masterfully exploited by Fannie and Freddie, created a non-competitive secondary mortgage market. Small banks and thrifts suffer the most from this situation, because they tend to deliver the lowest risk mortgage loans, but pay the highest guaranty fees. These small institutions would benefit the most from creating more competition. The situation

Exhibit 4: A Self-Reinforcing GSE Dynamic



GSEs are "political finance"

was probably not the intent of Congress, but was certainly the outcome of its actions.

This leads to the political side of the story. Under the banner of homeownership, which increased from 65% to 69% between 1980 and 2003, the exceptional profits of Fannie and Freddie have allowed them easily to finance large political lobbying forces and activities. This includes regularly recruiting into their government relations departments significant political figures and relevant members of Congressional staff. The political activity protected the economic advantages, which enhanced the profits and the means to carry on the political activity.

This self-reinforcing historical GSE dynamic is shown in Exhibit 4.

The capital market funding relationships of the GSE-based system have grown complex. An example of this, which is also touched with paradox, is shown in Exhibit 5, the "Circle of Value."

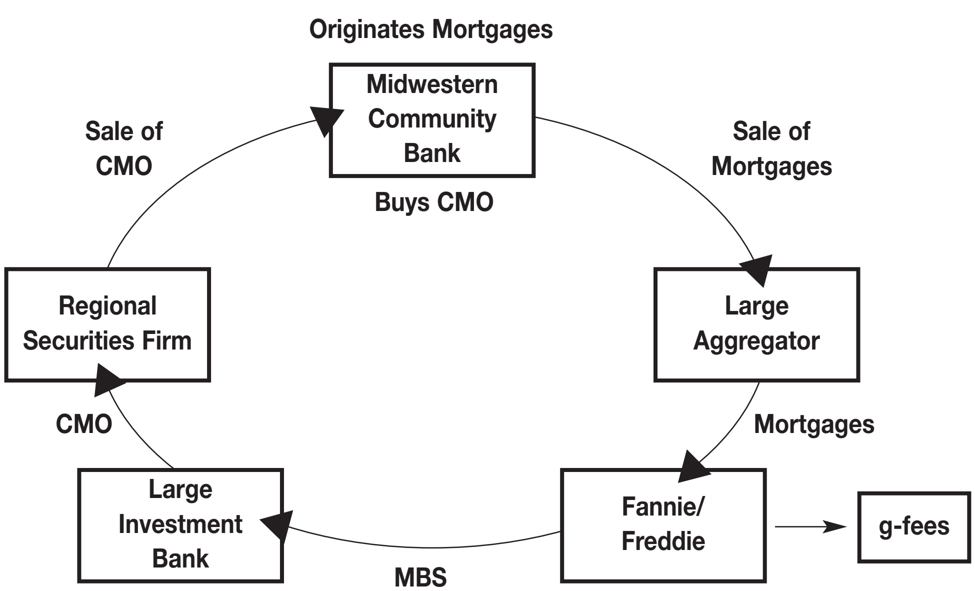
Starting at the top of the circle, consider a typical small bank (a "community bank" in American banking jargon), which underwrites and originates standard fixed rate mortgage loans. In the GSE-based system, these loans will be originated to standards set by Fannie and Freddie, very likely using underwriting software they provide. The bank does not (and should not) keep the loans in portfolio, since this would be an obvious mismatch against its deposit-funding base. Instead it will typically sell the loans to a larger mortgage banking operation, known as an "aggregator."

The aggregator in turn bundles the mortgage loans into Fannie or Freddie MBS, the source of g-fees paid to Fannie or Freddie for the life of the loans.

The MBS might well be bought by a large Wall Street investment bank, which would "slice and dice" the cash flows in order to structure Collateralized Mortgage Obligations (CMOs). The CMOs would be marketed to investors through a syndicate of investment banks including regional securities firms.

Such a regional firm might well sell the CMO to – guess who: the small bank which originated the loans in the first place! So the

Exhibit 5: U.S. System – A "Circle of Value"



principal asset ends up where it began, but only after traversing a circle in which at each point a slice of value is extracted by other financial actors. Notably, high g-fees are paid to Fannie and Freddie as the mortgage loans pass by to become MBS.

As the "Circle of Value" suggests, a highly complex infrastructure filled with highly compensated traders, lawyers and salesmen is required to maintain the GSE-based system.

Exhibit 6: Regarding the GSE of Its Day

"Admit that the bank ought to be perpetual, and as a consequence the present stockholders will be established a privileged order, clothed both with great political power and enjoying immense pecuniary advantages from their connection with the government. It is easy to conceive that great evils to our country and its institutions might flow from such a concentration of power.

If we can not at once make our government what it ought to be, we can at least take a stand against grants of monopolies and exclusive privileges."

Andrew Jackson
Veto Message, 1832

Present Tensions

Changes very surprising to most observers have occurred in the GSE system during the last two years. Fannie and Freddie find themselves in a defensive posture which would have been considered unimaginable a few years ago. The top managements of both have involuntarily "retired"—that is, been forced out, along with many other senior managers. Fannie especially is burdened by onerous regulatory restrictions. Freddie has spent more than $ 150 million revising its accounting and restating its financial reports, although its financial reports are still not current. Financial report restatements by Fannie are in process.

Two key factors appear to have triggered these changes. One is that the Executive Branch of the U.S. government became very critical, one might even say hostile, to Fannie and Freddie after they blocked the Administration's proposed GSE reform legislation in 2004. The other is that an unexpected source of vulnerability for the GSEs was created by a new accounting rule, and this vulnerability was fully exploited by their critics. Of course, Fannie and Freddie remain extremely large and important companies with a good deal of political support.

Consider the pattern of a U.S. President who is very popular in the South and West, while much resented on the East Coast, particularly in "elite" circles, leading his Administration against a large, elite, government-sponsored financial power. This could be Andrew Jackson 170 years ago rejecting the rechartering of the Second Bank of the United States, the GSE of its day. Or it could be George W. Bush and the humbling of Fannie and Freddie. An intriguing parallel!

In any case, Jackson's thoughts as he vetoed the rechartering bill in 1832, as shown in Exhibit 6, are quite apt when applied to the problems posed by GSEs today. We have the same problems of privileges for shareholders, government-sponsored profits, concentration of power, and monopolistic grants as Jackson opposed. But the focus in the current GSE debates has instead been accounting issues.

Owning fixed rate mortgage loans which are prepayable without penalty requires intensive hedging and the extensive use of derivative instruments, such as interest rate swaps and option contracts. Financial Accounting Standard 133 (FAS 133), addressing accounting for derivatives, is the new accounting rule which played such a prominent role in bringing down the managements of both Fannie and Freddie.

FAS 133 was contentious from the outset, and still is. Everybody always knew it would be complex and costly, but its effects on the GSEs have been much more impressive than anyone expected, especially the managements of Fannie and Freddie. Freddie has restated its after-tax profits since 2001 to increase them by an aggregate $ 5 billion. Fannie will have to restate its after-tax profits over the same period to reduce them by $ 9 billion in the aggregate.

These are big numbers, to be sure! Of course, the accounting result is to make Freddie appear even more profitable than before, and Fannie is still very profitable even after the subtractions. But do the FAS 133 adjustments reflect economic reality? This continues to be debated.

Neither Fannie nor Freddie strictly followed the requirements of FAS 133. While everyone agrees they should have, virtually everyone also agrees that FAS 133 is overly complex, convoluted and difficult to apply. Along with its official interpretations, it runs to more than 800 pages.

In addition to being enormously expensive to implement, FAS 133 tends in the judgment of many to make financial statements less clear, less understandable for investors, and more divergent from economic reality. In a recent survey of financial professionals, 86% said FAS 133 made financial statements less clear, 97% that it was too complex, and over 90% that is should be significantly revised or replaced. The managements of Fannie and Freddie clearly shared these views.

It appears that one source of Freddie's accounting problems was its management's conviction that FAS 133 so distorted the

Exhibit 7: GSE Legislation in 2005?

Four Possible Outcomes of Legislation:

1. Status quo.
2. Reorganize: a new regulator, which strengthens implicit guaranty and GSE status.
3. GSEs put on the road to greater competition.
4. Possible ultimate privatization.

reported results that it made sense to structure shell transactions to adjust them. That did not make sense (as truncated careers attest), but the effects of correctly applying FAS 133 to Freddie's financial statements were probably to create misleading accounting artifacts.

FAS 133 is widely considered to be a kind of "metaphysical bookkeeping," which is convoluted and confusing, distorts economics, obscures performance, and is conceptually wrong. But whatever its merits or lack thereof, it has proved to be the "soft underbelly" of regulatory and political vulnerability of Fannie and Freddie. Quite an ironic outcome.

An additional element of potential change in the GSE-based system is the "other GSE": the Federal Home Loan Banks. The FHLBs have the same government-sponsored advantages as the better-known GSEs, which allow them to compete equally with Fannie and Freddie in the debt and hedging markets. Taking advantage of this, in 1997, the FHLBs introduced a competitive secondary mortgage finance program, "Mortgage Partnership Finance" or "MPF" as an alternative to MBS.

Over 1,000 mortgage-lending institutions now participate in the FHLBs' secondary mortgage programs. An important question in GSE sector evolution is whether this competitive alternative can realize its potential. (I confess a strong bias here, being the originator of the MPF concept.) Will the GSE sector remain duopolistic or can it become truly competitive?

Possible Futures

In the wake of the accounting embarrassments and management departures at Fannie and Freddie, the main response of the Congress has been to consider changes in regulatory structure. In the U.S. Senate, the "Federal Housing Enterprise Regulatory Reform" bill was introduced earlier this year. Senator Shelby, the Banking Committee Chairman, has called GSE legislation a "top priority." The House Financial Services Committee is also planning to take up regulatory reform.

Virtually everyone involved agrees with the provisions of the Senate bill which would abolish the Federal Housing Finance Board (the FHLB regulator) and the Office of Federal Housing Enterprise Oversight (OFHEO – the Fannie and Freddie regulator), and replace them by a new combined regulator. Both the Finance Board and OFHEO have regulatory domains too narrow to make sense—they are equally unable to see the whole picture of the GSE sector and its global issuance of government-sponsored debt securities. Creating an overall view of the entire $ 5 trillion housing GSE sector is a good idea.

However, creating stronger regulation in and of itself may have an ironic unintended consequence: actually increasing the general confidence in the government's commitment to the GSEs, strengthening even further the bond market's so far unshakeable belief in the implied government guaranty, helping sell GSE bonds and MBS at tight spreads, and supporting GSE profits.

In other words, the unintended result of strengthened regulation by itself could be to enhance the government-linked status and duopoly power of Fannie and Freddie.

To address this problem, GSE reform legislation needs to become clearly pro-competitive, consistent with the fundamental principle that all regulatory reforms should be designed to be explicitly pro-competitive. The U.S. experience since the 1970s is that greater productivity and consumer benefits have been created in many industries by forcing competition on hitherto comfortable oligopolies. A notable contrast to this positive trend has been the duopoly in the huge American secondary mortgage market.

In order to achieve a competitive outcome, any GSE reform legislation might include provisions like the following:

- It could simply state that the goal of Congress, in addition to safety and soundness, is also to enhance competition. In the American setting, no one should be able to disagree with this as a fundamental principle.
- It could instruct the new combined GSE regulator that the development of regulations should include the goal of ensuring a competitive GSE sector.
- It could include a provision adding securitization to the explicit legal powers of the FHLBs. (Although it can be argued that they already have this as an implied power, such a provision would avoid any debate on the matter.) This provision would directly attack the duopoly power and excessive g-fees of Fannie and Freddie, give customers more attractive pricing, and add choice to the secondary mortgage market.
- It could mandate studies by the new GSE regulator, the Federal Reserve Board and the Treasury Department of whether the secondary mortgage

market is duopolistic or competitive, and since the conclusion of such studies is in little doubt, what could be done to enhance its competitivenenss.

As shown in Exhibit 7, there are four basic outcomes possible from current proposals for GSE reform legislation.

One is that nothing will happen in the end and the status quo will prevail, while working through the GSE accounting scandals.

The second is the creation of stronger regulation by itself, which may end up strengthening GSE status and duopoly power.

The third is in addition to a new regulator, to put the GSE sector on the road to greater competition, with the benefits of enhanced market choice, innovation, price competition and efficiency that would bring.

Lastly, there is the possibility of privatization. This is highly unlikely in any near term, but is an idea whose time may ultimately arrive. The triggering event would probably be that in the fullness of time, the GSEs themselves decide that the economic advantages of their special charters are no longer worth the regulatory restrictions and burdens they entail. That will be a story for a future day.

As of 2005, the GSE-based housing finance paradigm has been dominant in America for a generation. The immediate future provides a major opportunity which may or may not be seized. This opportunity is to begin the transition to a new housing finance paradigm: one built on competitive secondary markets instead of a government-sponsored duopoly.

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