Could the colossal mortgage GSEs begin taking even greater risks than they already are?

Competition for Fannie Mae and Freddie Mac?

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The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are the two dominant entities in the finance of residential mortgages. Their rapid growth in the 1990s began attracting political attention earlier this decade. An increase in Fannie Mae's exposure to interest rate risk in 2002, followed by a widely reported accounting scandal at Freddie Mac in 2003, sharpened political concerns about the strength of the regulatory regime that surrounds the two entities.

Less widely recognized are two emerging and potentially powerful sources of new competition for Fannie Mae and Freddie Mac: an expanded mortgage finance program by the Federal Home Loan Bank System and new bank risk-based capital standards that are likely to be implemented in 2006. More competition should generally be welcomed. But this heightened competition could create incentives for Fannie Mae and Freddie Mac to take greater risks, with potentially unfavorable consequences for U.S. taxpayers. As a result, unless the two firms were to be privatized quickly (which is highly unlikely), enhanced regulatory scrutiny will be in order.

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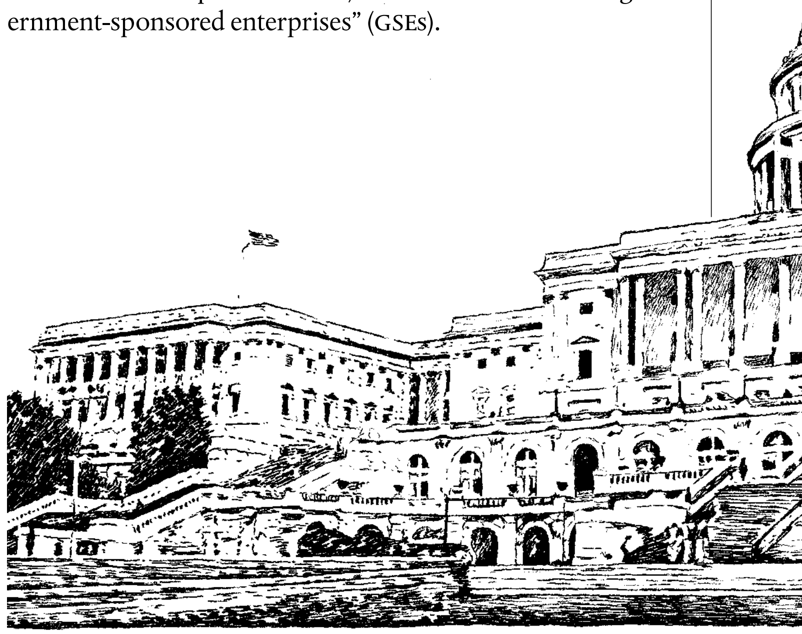
BACKGROUND

Though both Fannie Mae and Freddie Mac are publicly traded companies, they are the creations of the federal government, having been established by specific acts of Congress. Consequently, they (along with the Federal Home Loan Bank System and a few other special entities) are often described as "government-sponsored enterprises" (GSEs).



The specific activities of Fannie Mae and Freddie Mac are virtually identical and consist of two components:

- They issue mortgage-backed securities that carry corporate guarantees with respect to the credit (default) risk on the underlying residential mortgages.
- They invest in large portfolios of residential mortgage-related assets (whole mortgages and their own mortgage-backed securities) that are funded almost entirely (about 96–97 percent) with debt raised in the securities markets.

Table 1 shows the year-end amounts of Fannie Mae and Freddie Mac's mortgage-backed securities outstanding and their mortgage-related assets held in portfolio for 2003 and selected earlier years of the past two decades. As can be seen, their growth has been breathtaking. Ranked by assets on their balance sheets, Fannie Mae and Freddie Mac currently are among the five largest firms in the United States.

PRIVILEGES AND LIMITS Fannie Mae and Freddie Mac enjoy a number of special privileges as part of their federal charters: They are exempt from state and local income taxes; they are exempt from Securities and Exchange Commission (SEC) securities registration requirements and attendant fees; they each have potential lines of credit with the U.S. Treasury of up to $2.25 billion; their securities can be purchased by the Federal Reserve for open-market operations; they can use the Fed as their fiscal agent; and their securities can be purchased in unlimited quantities by banks and thrift institutions. As an indicator of the "federalness" of their charters, the president can appoint five of their 18 board members. Also, as a practical recognition of their specialness, the financial pages of daily newspapers usually list prices and yields of Fannie Mae and Freddie Mac's debt issuances (along with those of other GSEs) in a special box labeled "government agency issues" that is usually located immediately adjacent to the box showing the prices and yields of Treasury debt.

Some of Fannie Mae and Freddie Mac's special privileges (e.g., tax exemptions, fee exemptions) have a direct effect in reducing their operating costs. However, the largest source of savings arises because their charter attributes (plus some important history) strongly suggest to the financial markets that, in the event that either company experienced serious financial difficulties, the federal government would likely not allow their creditors to suffer financial losses. Known as the financial markets' belief in an "implied guarantee," this belief has allowed Fannie Mae and Freddie Mac to borrow huge sums

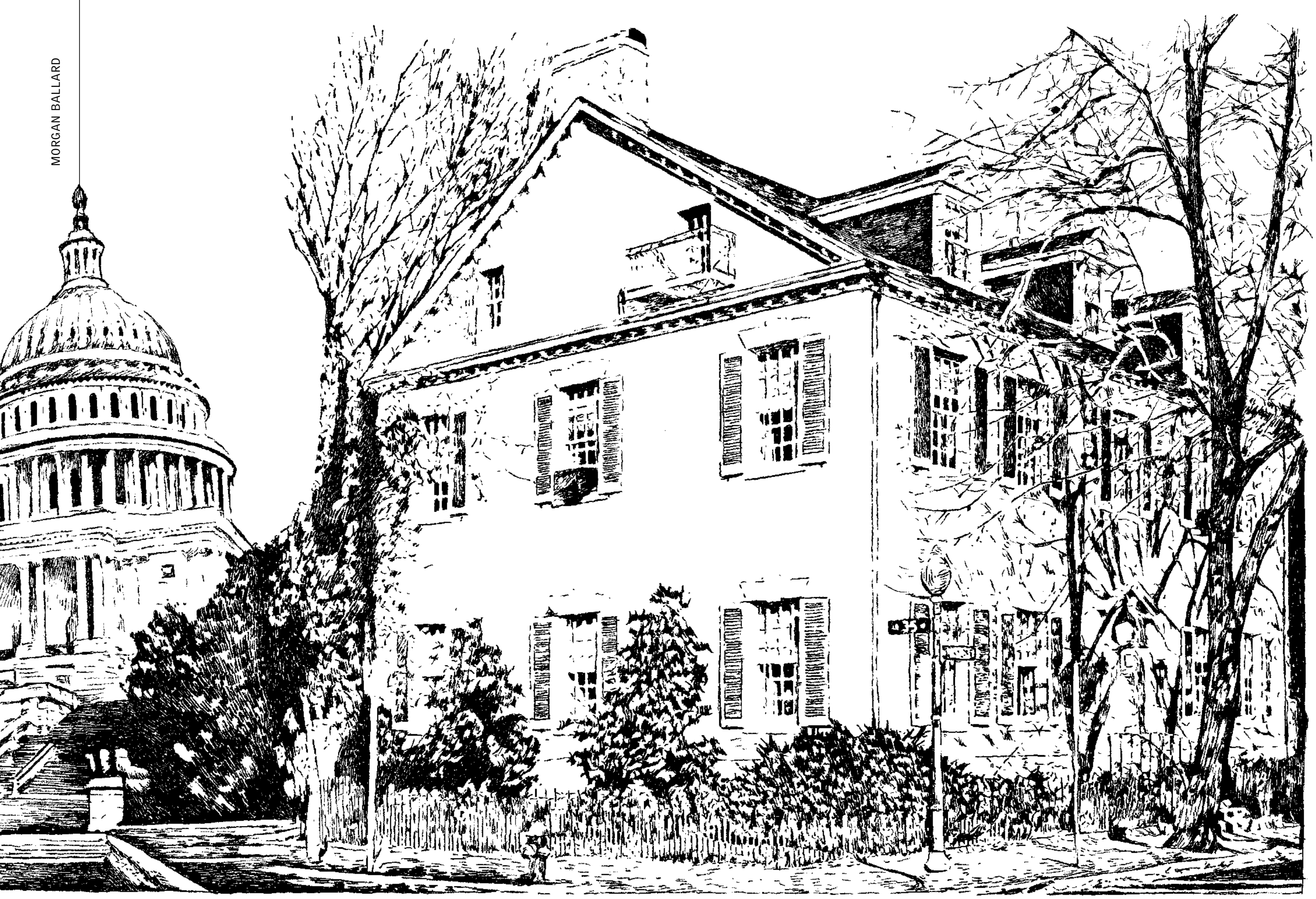


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TABLE 1

GSE Growth

Residential mortgages held and mortgage-backed securities outstanding, Fannie Mae and Freddie Mac, 1980-2003 ($billions)

Year	Fannie Mae		Freddie Mac		Total residential mortgage market
	Mortgage portfolio	MBS outstanding	Mortgage portfolio	MBS outstanding	
1980	$56	$0	$5	$17	$1,105
1990	114	288	22	316	2,907
2000	608	707	386	576	5,543
2002	801	1,030	590	749	6,842
2003	902	1,300	660	769	7,715

Sources: OFHEO; Federal Reserve; Freddie Mac.

at rates that are more favorable than their stand-alone credit rating (about AA-) would warrant. A common estimate of this borrowing advantage is about 35–40 basis points, although the differential varies with time and financial conditions, and with the specific characteristics of their debt instruments. (The extent of this borrowing advantage continues to be an active matter for academic and political debate.)

There are, however, also special limits on their activities. Their charters restrict Fannie Mae and Freddie Mac to residential mortgage finance, and they cannot originate mortgages. They are subject to a maximum size of mortgage, linked to an index of housing prices. In 2004, this maximum mortgage for single-family residences is $333,700. The mortgages that they finance must also either be supported by a 20 percent down payment or have an external credit enhancement like mortgage insurance. Fannie Mae and Freddie Mac are subject to "mission" regulation by the Department of Housing and Urban Development, which mandates that they provide housing finance for low- and moderate-income households. And they are subject to safety-and-soundness regulation by the Office of Federal Housing Enterprise Oversight (OFHEO), an independent agency lodged within HUD. This safety-and-soundness regulation is a reflection of the federal government's concern about the likely political reality of the implied guarantee; paradoxically, this regulation may also strengthen the financial markets' belief in an implied guarantee.

The political reason for Fannie Mae and Freddie Mac's special privileges is the American polity's intent to reduce the financing costs of residential mortgages. It appears that about two-thirds of the borrowing advantages of Fannie Mae and Freddie Mac are passed on to borrowers in the form of lower interest costs — about 25 basis points lower — on conforming mortgages. (That figure, too, is the subject of much debate.) Though the political appeal of this apparent free lunch is readily apparent — there is no on-budget entry for this benefit — the potential liability to taxpayers from the implied guarantee is the true counterbalance.

From a larger perspective, because our society already heavily subsidizes the production and consumption of housing through a wide variety of programs at all levels of government, the social benefits from the additional stimulus that flows through Fannie Mae and Freddie Mac are questionable. Though there are good theoretical arguments for encouraging home ownership, and a growing empirical literature supports those arguments, that line of reasoning calls for a narrowly focused, on-budget program that would subsidize low- and moderate-income households that are on the cusp of renting or buying. In reality, the programs that focus on lowering the costs of home ownership (e.g., the absence of capital gains taxes on most home sales, the deductibility from taxable income of mortgage interest and real estate taxes) are extremely broad in scope, tend to favor higher income households, and tend largely to encourage those households to buy larger and better-appointed homes and to buy second homes. The home-purchase encouragement provided through Fannie Mae and Freddie Mac is clearly in this broad-brush category and does little to raise the overall level of home ownership. The two GSEs do not show any appreciably different record with respect to providing mortgage finance to low- and moderate-income households as compared to traditional lenders' efforts.

The rapid growth of Fannie Mae and Freddie Mac portrayed in Table 1 is surely the result of many factors. The growth of their securities business stems from the innovation and spread of the mortgage-backed securities process itself (which dates only to 1970) and the superior liquidity attributes of those securities. Favorable regulatory risk-based capital requirements — banks and thrifts are required to hold 4 percent capital against a prime residential mortgage but only 1.6 percent against Fannie Mae and Freddie Mac's securities (or against any AA-rated mortgage-backed securities) — surely fueled the expansion as well. As for the growth of the portfolio holdings of Fannie Mae and Freddie Mac, conscious business-model decisions by both companies to expand their portfolios in the early 1990s were a large part of the story, but their favorable borrowing costs (vis-à-vis non-depository borrowers) also contributed. (Whether the two GSEs have had a funding and/or regulatory advantage vis-à-vis depository institutions is more controversial; for one view, see Robert Van Order's article "A Microeconomic Analysis of Fannie Mae and Freddie Mac" in the Summer 2000 issue of *Regulation*.)

COMPETITION

As we noted in the introduction, Fannie Mae and Freddie Mac face two emerging, potentially powerful sources of competition: the Federal Home Loan Bank System and new bank risk-based capital standards. Below, we look at those competitors carefully.

FHLB The Federal Home Loan Bank (FHLB) System consists of 12 "wholesale" banks that provide finance (in the form of loans, usually termed "advances") for more than 8,000 banks and thrifts that are members (and also shareholder-owners) of the system. Like Fannie Mae and Freddie Mac, the FHLBs are a GSE, with similar benefits and limits embedded in a congressional charter. They enjoy favorable borrowing rates in the financial markets and they pass on much of that advantage to members in the form of reduced interest rates on advances.

In 1997, the Federal Home Loan Bank of Chicago began purchasing pools of residential mortgages originated by members. Termed the "Mortgage Partnership Finance" program, the arrangement left most of the credit risk in the hands of the originator (in return for a credit enhancement fee paid to the originator) while the FHLB received the stream of interest and principal payments and managed the interest-rate risks associated with the pool. The program, and a second one similar to it, has since expanded. All 12 FHLBs currently participate in one or both of the programs. At year-end 2003, the FHLBs collectively held $113 billion in residential mortgage pools that had been purchased through the programs. The FHLBs are enthusiastic about expanding the programs, so long as they can arrange for the additional capital to support their mortgage holdings. Another potential route for expansion would be for the FHLBs to decide to securitize the mortgage pools and sell the resulting mortgage-backed securities.

The programs' expansion means that the FHLBs are becoming rivals to Fannie Mae and Freddie Mac in the holding of residential mortgages. If the FHLBs were to decide to securitize their holdings, they would become rivals to Fannie Mae and Freddie Mac in the issuance of mortgage-backed securities. And the FHLB members who are originating and selling the mortgage pools to the FHLBs are becoming rivals to Fannie Mae and Freddie Mac in the issuance of credit guarantees on mortgage pools.

BASEL II In 1988, the Basel Committee on Banking Supervision, meeting under the auspices of the Bank for International Settlements and representing the major industrial countries of the world, issued a set of capital guidelines for banks. The guidelines, known as "Basel I," became the accepted standard for most countries. A decade later, the committee issued a draft revision that updated the capital guidelines and greatly broadened their scope. The revision, known as "Basel II," has been revised a number of times since its issuance in 1999 and is currently scheduled to be implemented later this decade.

Under Basel II, there are three alternative approaches to the setting of banks' risk-based capital requirements. The "standard" approach largely continues the Basel I framework, and the capital requirement for holding prime residential mortgages will continue to be 4 percent. A second approach, known as the "foundation internal ratings–based approach," allows banks to use their own internal risk models for the determination of required capital, but regulators specify some of the parameters. The third approach, known as the "advanced internal ratings–based approach" (AIRB), permits banks to use their own internal risk models and parameters for the determination of required capital (subject to overall supervisory review).

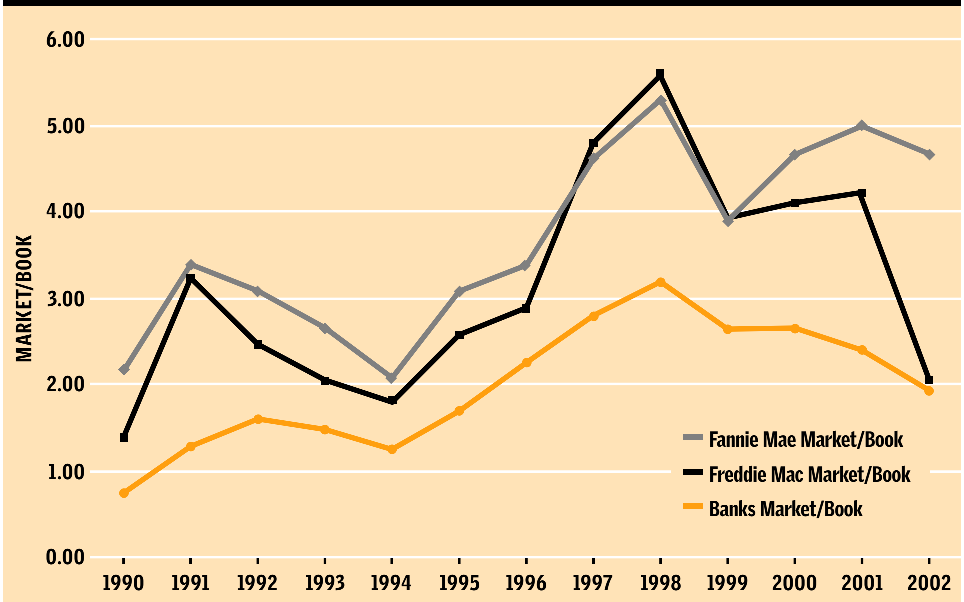
A longstanding complaint about the Basel I requirements is that the required "risk-based" capital levels for various assets are only loosely related to their underlying risks. That complaint has been especially relevant to prime residential mortgages, where the credit risks have been appreciably below the 4 percent capital requirement specified in Basel I. The AIRB approach could yield capital requirements for residential mortgages that are in the 1–2 percent range. The 10 largest U.S. banks are likely to be required to use the AIRB approach, and the next 10 largest banks are likely to adopt the approach voluntarily. (The remaining U.S. banks will continue to use the Basel I system.) Those 20 large banks account for about two-thirds of U.S. banking assets and about one-half of residential mortgage assets held by banks.

Accordingly, under Basel II, the 20 banks will have enhanced incentives to retain mortgages in their own portfolios rather than sell them to Fannie Mae and Freddie Mac. The banks will also have greater incentives to compete with the two GSEs in purchasing mortgages from other originators. Because the large banks already

FIGURE 1

Fannie, Freddie and the Banks

Franchise value (market/book of common equity) for Fannie Mae, Freddie Mac, and the top 10 U.S. banks, 1990-2002.



account for a sizable fraction of residential mortgage activity, the expansion of competition from those banks could well be substantial.

THE CONSEQUENCES

Expansion of the FHLBs' mortgage programs and the implementation of the AIRB approach of the Basel II capital requirements for large U.S. banks will mean expanded competition for Fannie Mae and Freddie Mac. Such competition will affect their main lines of business: issuing credit guarantees on mortgage-backed securities and holding portfolios of residential mortgage–related assets. In turn, the expanded competition will likely mean narrower profit margins and reduced franchise values for Fannie Mae and Freddie Mac.

The experience of the past decade, as portrayed in Figure 1, shows that Fannie Mae and Freddie Mac have enjoyed substantial franchise value (as indicated by the ratio of market value to equity book value), as compared to the top 10 U.S. banks. The market's recognition of the GSEs' franchise value is not surprising, given their special (and substantial) advantages described above and the limited competition that they historically faced.

The new competition and the consequent reduced franchise value have important implications for the safety-and-soundness regulation of the two GSEs. An essential component of safety-and-soundness regulation is the requirement of adequate capital levels on the part of the regulated institution. Adequate capital not only provides a direct assurance that the level of assets will be adequate to cover the institution's liabilities, but it also provides a disincentive for the owners (or the managers operating on behalf of the owners) to take undue risks. Because the capital of the institution corresponds approximately with the owners' equity in the enterprise, more capital means that the owners have more to lose from the "downside" of risk-taking. With regard to that disincentive — what the owners have to lose from undue risk-taking — the appropriate measure of their stake in the enterprise encompasses the market value of their equity position and thus includes the franchise value of the institution.

The reduced franchise value for Fannie Mae and Freddie Mac that will follow from the heightened competition from the FHLBs and the Basel II banks will thus erode their effective capital and increase their incentives for risk-taking — perhaps through less-than-complete hedging of interest-rate risks, less resources devoted to vetting credit risks, entry into riskier lines of residential mortgage finance, or perhaps even through newly created methods of risk-taking that we cannot imagine today. Though rational managers would forsake such measures when profits are high, shareholder unhappiness and pressures during abnormal times might well cause managers to come closer to the edge. Indeed, the accounting fiasco at Freddie Mac in 2003 can be interpreted as an example of the consequences of similar shareholder pressures (in that case, the pressures for smoothly rising reported earnings).

In principle, the safety-and-soundness regulatory system established by the OFHEO is supposed to detect and deter undue risk-taking. But the overall capabilities of the OFHEO have recently been called into question, as Congress and the Bush administration have mulled over, and also sparred over, a potential restructuring of the GSEs' regulation. And the expansion of risk-taking could well be subtle and difficult to detect. Costly "accidents" have been known to happen in the safety-and-soundness area, and they could well happen again.

In a perfect world, the American polity would realize that the social benefits of continuing Fannie Mae and Freddie Mac (and also the FHLBs) as GSEs fall short of the social costs, and true privatization of those enterprises would readily follow. With the disappearance of the "implicit guarantee," safety-and-soundness regulation could also disappear and private creditors would address the issues of heightened competition and the incentives for expanded risk-taking. But in our actual world, privatization of the GSEs is an unlikely event. Consequently, given the continued presence of the "implied guarantee," the appropriate focus must be on enhanced safety-and-soundness regulation (despite the paradoxical strengthening of the guarantee that might accompany enhanced regulation).

For all of those reasons, the scenario that we have outlined — expanded competition, the likely reduction in Fannie Mae's and Freddie Mac's franchise values, and the concomitant increased incentives for risk-taking by the GSEs — should be a wake-up call for heightened scrutiny by the OFHEO or whatever safety-and-soundness regulatory agency replaces it. The failure to heed this call could well prove costly to taxpayers. R

READINGS

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