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What's the deal with Fannie & Freddie?

By Jack C. Harris

Fannie Mae and Freddie Mac own millions of home mortgages yet are largely unknown to homeowners. In fact, many in the housing industry are only vaguely familiar with these financial giants.

Both companies have been targets of unflattering media coverage. The attention began in 2003 when Freddie Mac officials were forced to restate earnings because of accounting irregularities. The company had understated earnings in an effort to smooth out what they expected to be volatile results in the future. But the situation came to light at a time when many companies were under scrutiny for bogus accounting practices, giving Freddie Mac an air of suspicion. Fannie Mae has since been cited for similar accounting problems.

Early in 2004, Federal Reserve Chairman Alan Greenspan cautioned investors and taxpayers of the risk represented by these huge, rapidly growing companies. Greenspan worried that investors were acting as if these companies could not fail because the government would not let that happen. Both are "government sponsored entities" (GSEs) created by the federal government but with private shareholders.

Many investors who buy the companies' mortgage-backed securities may think the government stands behind the issues, but there is no formal agreement to that effect. In fact, Treasury Secretary John Snow has gone to considerable effort to clarify that the GSEs enjoy no special access to government assistance.

Why would federal officials be so concerned about these pillars of the mortgage market? Housing and mortgage markets have been among the best performing sectors of the economy

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for a number of years. Fannie Mae and Freddie Mac stocks are frequently mentioned as solid investments.

Fannie and Freddie issue bonds and use the proceeds to buy mortgage loans, many of which are insured against default. This would appear to be relatively safe.

Rapid growth brings its own risks, however, and tends to place resources under the control of a small number of decision makers. Additionally, the mortgage business has become more complicated as the entities have grown, and this has introduced additional risks.

Why Should Anyone Care?

As housing and mortgage markets have grown, so have the GSEs. The agencies either own or have securitized more than three-fourths of all mortgage loans in the United States. Securities issued by the GSEs are a big part of the portfolios of commercial banks, equal to about 12 percent of their total assets.

The most important role played by the GSEs is to add liquidity to the mortgage market, making mortgage loans more attractive and less risky business for lenders. This, in turn, makes home financing more readily available and less expensive. Mortgage interest rates also are lowered because the GSEs are able to borrow at submarket rates, largely because of investors' perceptions of federal backing.

The GSEs are unquestionably important to the mortgage market, which is vital to the housing market. The question is, how essential are they? A study by an economist at the Federal Reserve Bank concluded that the activities of the GSEs lower mortgage interest rates by only 7 basis points (100 basis points equal 1 percentage point).

This extremely modest result is in spite of a federal subsidy estimated by the Congressional Budget Office to be $11 billion per year. The subsidy is the product of special privileges enjoyed by the GSEs, such as exemption from securities regulation and bond registration fees. Critics charge that the bulk of the subsidy flows to the benefit of employees and investors rather than to borrowers.

Nevertheless, many in the housing industry would hate to see Fannie or Freddie scaled back or privatized. They feel the impact of the agencies goes beyond anything that can be simply quantified.

The president of the National Association of Home Builders urged Congress to devise a regulatory system that would protect the GSEs' "ability to spur innovative solutions to increase homeownership." Those innovations include programs such as affordable housing loans that reduce down payment obligations and broaden qualifying criteria, as well as programs that help older homeowners retain their homes.

Fannie and Freddie present two types of risk to the housing market and the economy: risks created by their size and domination of the mortgage market and risks caused by the financial techniques used by the companies.

The only constraint on the growth of the GSEs is the limit on the size of loan they can purchase.

History of GSEs

Fannie Mae and Freddie Mac are private companies that sell stock on the public exchanges. At the same time, they enjoy the status of GSEs because they were created by the federal government and fulfill both a public and private role. They are expected to make a profit for stockholders but also promote the public goal of increasing availability of affordable home financing.

Fannie Mae began as a federal government agency but was privatized in 1968. Several federal officials still sit on its board of directors. Freddie Mac was created by the Federal Home Loan Bank (which has since been abolished) to organize a secondary market for member lending institutions.

At first, the two agencies took somewhat distinctive positions within the secondary mortgage market, buying different types of loans and issuing different types of securities. Today, however, there is little difference in the way the two operate or raise funds. Fannie Mae is perceived as more governmental than Freddie Mac, possibly because it is a more vocal advocate of its public mission.

The 1980s transition from a mortgage market dominated by depository institutions (such as savings and loan associations) to mortgage banking firms spurred the growth of the GSEs. By offering a direct link to the capital markets, the GSEs largely insulated homebuyers from the collapse of the savings and loan industry in the 1980s. Subsequently, the GSEs were in an ideal position to grow as the housing market boomed in the late 1990s.

The price of one share of Fannie Mae stock grew from less than $1 in 1981 to almost $90 in late 2000; Freddie Mac posted similar growth, increasing from less than $3 in 1990 to around $70 in 2000. The companies sell more mortgage-backed securities each year than the Treasury sells bonds.

The success of the GSEs is more than just a case of being in the right place at the right time. The two companies enjoy special advantages granted by their quasi-governmental status. They do not have to pay state and local taxes and are exempt from registration and disclosure rules applied to publicly traded firms. More importantly, investors believe that the federal government implicitly stands behind the debt of the companies. This allows the GSEs to raise money at a lower rate of interest than other financial firms.

The importance of these benefits is underscored by the fact that the companies spend $25 million each year lobbying Congress. Some claim that Fannie's partnership offices and the Fannie Mae Foundation — both a part of the firm's efforts to promote homeownership — work to protect the company from its political detractors.

How GSEs Operate

Fannie Mae and Freddie Mac originally were intended to develop a secondary market for mortgages that would provide lenders liquidity in their portfolios. Lenders faced with declining deposits could sell mortgage loans to balance their accounts. Lenders with surplus deposits could buy market securities backed by pools of mortgages from the GSEs. This tends to balance supply and demand for mortgage debt geographically.

One of the major risks any lender faces is changing interest rates. Not only do rates go up and down, but long-term rates often behave differently than short-term rates. So the problem of rate change is magnified for lenders who fund long-term mortgage loans with short-term deposits. The process of *securitization* (turning loans into securities) transfers this risk to investors who buy the securities.

Fannie and Freddie make money from securitization by charging fees. The problem is that it is hard to maintain a growing revenue stream and rising stock price merely from fee income. So the companies began purchasing mortgage securities issued by others and themselves to create *retained mortgage portfolios*. They make money on these portfolios when the yield on the securities exceeds their cost of borrowing. In the last few years, that margin has exceeded 1 percentage point. By 2001 the companies derived more than three times as much income from their retained portfolios as from securitization fees.

While the retained portfolios have been profitable, the practice essentially amounts to using short-term borrowed money to make long-term investments, which is what started the savings and loan crisis of the 1980s. Fannie and Freddie officials recognize the risk and attempt to reduce it through an elaborate hedging strategy. The objective is to make their short-term liabilities behave like long-term debt.

Hedging reduces income from the portfolio, as Fannie and Freddie incur costs to create the hedge. A perfect hedge could even sap the whole profit from the retained portfolios. Consequently, Fannie and Freddie do not hedge their entire risk.

This hedging strategy has risks of its own, which are more apparent when interest rates become especially volatile. Hedges shift risk onto *counterparties* (those whose liabilities form the hedge investments). If those parties default, the GSEs may find it difficult and expensive to reestablish their positions.

Second, hedging does not free Fannie and Freddie from having to renew their short-term debt (which represents more than one-third of total assets) each year. A disruption in the market may make that impossible. Finally, an unusual change in rates could exceed the coverage of the hedging strategy and turn around the profitability of the portfolios.

Fannie Mae and Freddie Mac are exempt from many disclosure requirements imposed on other firms.

Moves to Reform

These issues have raised enough concern to fuel a serious reform effort. Essentially, the two main reform thrusts include legislation to change the way the companies are regulated and an array of efforts aimed at limiting the companies' growth and promoting largely private alternatives.

Fannie Mae and Freddie Mac are exempt from many disclosure requirements imposed on other firms. Instead, they are monitored by The Office of Federal Housing Enterprise Oversight (OFHEO). OFHEO was created in 1992 in response to the increasing size and influence of the GSEs.

OFHEO's mission is to serve as a watchdog to prevent the agencies from overstepping their statutory authority and as an auditor to oversee their accounting procedures. But it was not an OFHEO inquiry that prompted Freddie Mac to admit manipulating income on its books in 2003, leading some to believe the oversight is largely for appearance's sake — something to make Congress and investors feel that a mechanism is in place to keep the GSEs out of trouble.

The watchdog agency lacks power to enforce financial standards on the GSEs. However, since the revelation of Freddie Mac's accounting manipulations, the agency has publicly called Fannie Mae to task for accounting violations and forced Freddie Mac to replace top management involved in their accounting brouhaha. In December 2004, Fannie Mae's CEO resigned as a result of the agency's problems.

Despite these actions, there is a movement in Congress to replace OFHEO with a newly created, and more powerful, regulator. It is thought that the power would be given to the Treasury Department, which is not known for its interest in housing finance.

Some suspect the effort to reform GSE regulation is an attempt to limit the growth of Freddie and Fannie. However, there are several more overt moves to do just that. The only extant constraint on the growth of the GSEs is the limit on the size of loan they can purchase. However, this limit is sufficiently high to make most of the home loan market fair game. Congress raises the limit each year in accordance with home price trends. Still, this leaves the market for "jumbo" mortgages to private conduits.

The Bush Administration recently obtained the power to limit the amount of debt that can be issued by the GSEs. Exercise of this power could effectively control the growth of the firms. Also, proposed legislation would subject Fannie and Freddie to the same disclosure laws as other financial entities. These threats to the special status of the GSEs could leave more of the business to private firms.

The practice of giving private companies special government privileges because they serve a public purpose can cause problems. In the pressure to compete, it is difficult for companies to avoid exploiting advantages in ways not envisioned by GSE creators. That indeed may be what is going on with the housing GSEs.

Are the risks imposed by the growth and practices of Fannie Mae and Freddie Mac serious enough to risk derailing the housing boom? Or should observers recognize that the operation of these financial hybrids is an experiment, and everything tried will not be successful? The trick is making changes despite a political environment that hampers the ability to do so.

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