

# A More Competitive GSE Sector

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The Chicago Home Loan Bank has for years advocated the view that the best way for Congress to insure that GSE charter advantages are passed through to local mortgage lending and homeownership, is to encourage competition among the three housing GSEs. We believe the market forces of competition and innovation are the best disciplines for all enterprises, including GSEs. We also recognize that, due to their special advantages, the only viable competitor for a GSE is another GSE.

The Mortgage Partnership Finance® Program, which was developed by the Chicago Home Loan Bank and in which ten of the twelve Home Loan Banks currently participate, is putting these concepts into practice. MPF® adds much-needed competition to the secondary mortgage market to benefit our local financial institution members and their homebuying customers. The innovative risk sharing structure of the MPF Program also disperses the credit risk of mortgages among the hundreds of participating lenders, rather than concentrating them in the GSEs.

We believe competition among the GSEs increases the benefits to community lenders and homebuyers. On the regulatory side of this topic, the current structure of three Federal agencies regulating various aspects of three GSEs leads to disparate regulations, capital requirements and regulatory burdens. We propose that the three housing GSEs should have a common set of regulatory principles. This will benefit the American mortgage system and the participants in the housing finance process.

We suggest the following related points.

## 1. Definition of Mission

The mission of the three housing GSEs should be to promote sound, economical and readily available home mortgage finance throughout America by creating wholesale, capital market-based financing opportunities for mortgage lenders. The "GSE deal" requires respecting this rather narrowly conceived mission in exchange for GSE advantages.

## 2. Statement of Intent to Promote Competition

On the political side, we recommend that it should be the intention of the Congress to promote competition by treating all three housing GSEs as equally as practicable for regulatory and supervisory purposes.

## 3. Role of GSE Regulators

The functions of all regulators, including GSE regulators, should be clearly limited and defined, in this case, to regulate safety and soundness of three GSEs and approve new programs

consistent with their mission as defined by Congress. The answer to GSE issues is not more voluminous regulation, but more robust competition.

#### 4. Leverage and Risk-Based Capital Ratios

Today, Fannie Mae and Freddie Mac have a competitive advantage because of their lower capital requirements, which do however more closely reflect true economic risks of mortgages than FHLB or depository institution capital standards do. The FHLB Modernization Act, enacted last fall as part of the Gramm-Leach-Bliley Act, establishes a leverage floor of 4% for the Home Loan Banks while Fannie Mae and Freddie Mac are allowed a 2.5% capital to assets ratio. A more competitive GSE sector should include the same required leverage capital ratios for all three GSEs.

Differing regulatory treatment for Freddie Mac and Fannie Mae, on the one hand, and for the Home Loan Banks on the other, as for example continued by Congressman Baker's current bill H.R. 3703, is also apparent in risk-based capital requirements. Obviously, different risk-based capital requirements structurally advantage one or the other GSE competitor. We recommend that the risk-based capital requirements for the GSEs be based on the same economically correct risk-based factors, so that among all three GSEs, equivalent risks give rise to the same risk-based capital requirements. Indeed, the risk-based principles should logically be extended to all holders of mortgage risks. Current depository institution risk-based capital requirements significantly overstate the capital requirement for residential mortgage credit.

#### 5. Permanent Capital

During the consideration of the Gramm-Leach-Bliley Act last year, the Chicago Home Loan Bank consistently proposed giving the FHLBs the authority to create non-redeemable, permanent capital. True permanent capital is particularly appropriate now that all membership in the FHLB System is voluntary. The Chicago Home Loan Bank continues to believe that permanent capital and equal capital standards should apply to all three housing GSEs.

#### 6. Innovation

The three housing GSEs should be encouraged to create innovative programs, consistent with their high credit quality, which profitably serve their defined housing finance mission. Schumpeterian competition through innovation, in addition to classic competition through prices and cost efficiencies, will pass the value of GSE benefits on to local lenders and homebuyers.

#### 7. Tax Status

Currently, Fannie Mae and Freddie Mac are subject to federal corporate income taxes. The Home Loan Banks do not pay federal income taxes, but instead pay the Resolution Funding Corporation (REFCorp) obligation and statutorily mandated Affordable Housing Program contributions, which result in a very high de facto rate of taxation of FHLB earnings. We recommend making the REFCorp obligation and the mandated AHP expenses tax credits, while applying federal corporate income taxes to the FHLBs. This would make FHLB taxation equivalent to the other housing GSEs.

## Overview

In the broadest perspective, there are three possible outcomes of the GSE sector:

1. Monopolistic Market Domination
2. Privatization
3. Competitive GSEs

The first is certainly possible. The second is theoretically attractive, but in most people's view, of minimal probability. The third is both desirable and practical. We plan to continue making it increasingly real.