

**National Mortgage Associations:  
An Alternative Approach to GSE Reform**

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**I. Introduction and Overview**

The public costs of the largest GSEs – Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System – are increasing and their public benefits are decreasing. The public costs include a concentration of financial risk in three of the largest financial institutions in the United States and, in the case of Fannie Mae and Freddie Mac, market power that is reshaping the American system of mortgage finance on the basis of government subsidies rather than open competition. Past public benefits of the GSEs included many contributions to overcoming imperfections in the mortgage market, for example through standardizing mortgage forms. However, most imperfections have ceased to exist in today's efficient financial markets.<sup>1</sup>[1]

From the perspective of the housing sector, perhaps the major function of the GSEs today is to convey a multibillion-dollar federal subsidy to the housing market in a way that is not accountable to the federal budget process. Because they serve this function, the GSEs have been able to claim that any effort to reduce potential public costs, say by increasing GSE capital requirements, or to increase public benefits, say by imposing truly significant affordable housing requirements, amounts to a so-called "tax" on housing. Thanks to their market power, the GSEs can protect their shareholders from the effects of policy changes merely by increasing the amount of the federal subsidy that they keep for themselves, compared to the amount that flows to the housing sector.

One way to address the problem of a changing balance between public benefits and public costs would be for the government to design and implement an exit strategy so that the three housing GSEs could give up their government sponsorship and become completely private companies without special tax or regulatory benefits and without the ability to borrow in the federal agency debt market.<sup>2</sup>[2] This solution has not been feasible, because of objections from the housing sector, reinforced by the immense

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[1] One market imperfection that still exists in significant form relates to housing discrimination. Yet here, the GSEs lag rather than lead the market. HUD Assistant Secretary William Apgar recently testified about Fannie Mae and Freddie Mac that, "their share of the affordable housing market is substantially smaller than their share of the total conventional conforming market. Lower income families, certain minorities, central-city residents, and immigrant populations continue to be underserved by Fannie Mae and Freddie Mac." Testimony before the House Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, March 22, 2000.

[2] See, e.g., U.S. Department of Housing and Urban Development, *Studies on Privatizing Fannie Mae and Freddie Mac*, prepared for U.S. General Accounting Office, U.S. Department of Housing and Urban Development, U.S. Department of the Treasury, and U.S. Congressional Budget Office, May 1996; and John E. Dean, Saul L. Moskowitz, and Karen L. Cipriani, "Implications of Privatization of Sallie Mae," *Public Budgeting, Accounting & Financial Management*, Vol. 11, No. 1 (Spring 1999), pp. 56-80.

political power of the GSEs, and also because of fears among their competitors that Fannie Mae and Freddie Mac have acquired such a market presence that they would continue to be dominant in the mortgage market even if they did give up their government sponsorship.<sup>3</sup>[3]

This paper presents an alternative type of GSE reform to redress the balance between public costs and public benefits, while addressing concerns about the effects on the housing sector. Under the alternative approach, government would permit a federal regulator to charter numerous competing GSEs with legal powers identical to those of Fannie Mae and Freddie Mac. The regulator would have powers comparable to those of the Comptroller of the Currency, the federal agency that charters and supervises national banks.

By fostering competition, this alternative approach would (1) reduce the concentration of financial risk that today is present in the housing GSEs, (2) reduce the adverse consequences for innovation and competition that Fannie Mae and Freddie Mac cause through their market power, and (3) assure that a greater proportion of the federal subsidy would flow through the GSEs and into the housing market.<sup>4</sup>[4]

Fannie Mae and Freddie Mac have enjoyed returns on equity of between twenty and thirty-four percent over the past decade,<sup>5</sup>[5] far above the profitability of other financial institutions. By contrast to Fannie Mae and Freddie Mac today, national mortgage associations would obtain more competitive and less generous rates of return. They also would exert competitive pressure that would reduce the duopoly returns that the two largest GSEs currently enjoy. The resulting surplus could be used to lower mortgage rates and otherwise to improve the balance between public benefits and public costs of the housing GSEs.

This paper is organized as follows. Section I is the introduction and overview. Section II presents the proposal in institutional terms, including discussion of the attributes of the regulator and the GSEs that would be chartered under the proposal. The new GSEs might be called "National Mortgage Associations" in deference to a similar statutory system that the Roosevelt Administration helped to enact in Title III of the National Housing Act of 1934. <sup>6</sup>[6] Multiple "Nancy Maes" thus might join Fannie and Freddie in the housing finance playground. Section III considers some of the larger policy issues to be considered along with the proposal. These include the question whether creation of national mortgage associations could be a useful step in ending agency status for GSEs. Section IV concludes with an invitation to interested parties to comment on this idea.

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[3] Morgan Stanley Dean Witter, *Internet & Financial Services: Catching the Third Wave*, April 14, 2000, p. 18.

[4] On the last point, see, Robert S. Seiler, Jr., "Government Sponsored Enterprises as Public Utilities: the Case of Fannie Mae and Freddie Mac," paper presented at the Nineteenth Annual Research Conference, Association for Public Policy Analysis and Management, November 1997.

[5] Office of Federal Housing Enterprise Oversight, *1999 Report to Congress*, Tables 3 ("Fannie Mae Earnings") and 12 ("Freddie Mac Earnings"), pp. 86, 95.

[6] Ch. 847, 48 Stat. 1246, Enacted June 27, 1934.

## II. The Institutional Mechanics of Creating and Supervising new GSEs

At present, Fannie Mae and Freddie Mac benefit from unique charters that the Congress has enacted in legislation. No other incorporators, regardless of how well qualified may obtain a similar GSE charter except through another special statute. This is quite different from the legal framework for chartering national banks, federal savings and loan associations, or most other types of financial institution. A federal regulator, the Office of the Comptroller of the Currency (OCC) of the U.S. Treasury Department, for example, charters national banks. The Office of Thrift Supervision (OTS), also in the U.S. Treasury Department, charters federal savings and loan associations.

This paper proposes that the Congress should create a new federal regulator with authority comparable to that of the OCC or OTS. That regulator would have authority to charter and supervise new GSEs, here called “National Mortgage Associations.” Many “Nancy Maes” would be added to today’s list of GSEs. The new federal regulator might be called the “Office of National Mortgage Association Supervision,” (“ONMAS”) just as the OTS is named after the institutions that it supervises.

**The regulator:** The regulator would have authority to charter a large number of national mortgage associations. The new Office of National Mortgage Association Supervision would charter national mortgage associations that would compete against one another and against other types of financial institution, much as thousands of national banks compete in the financial markets today. The regulator would resemble the OCC in its authority to charter institutions, supervise them for safety and soundness, oversee the scope of their permitted business activities, apply requirements to serve public purposes that may not be as lucrative as other activities (for national banks, these are CRA requirements; for the housing GSEs, these might include contributions to an affordable housing fund), and appoint conservators or receivers in cases of serious financial difficulty. To assure the primacy of safety and soundness considerations, the new regulator would be an independent bureau within the Treasury Department.

**The new GSEs:** National mortgage associations would have the same statutory powers as Fannie Mae and Freddie Mac. Currently, for example, they would be authorized to “purchase, service, sell, lend on the security of, and otherwise deal in” conforming mortgages,<sup>7</sup>[7] and engage in all other activities that Fannie Mae or Freddie Mac may carry out under their charters. The law would link the statutory authority of National Mortgage Associations to that of Fannie Mae and Freddie Mac: whenever either Fannie Mae or Freddie Mac obtained an expansion of its statutory authority, this would automatically extend to the national mortgage associations chartered by the regulator. Conversely, any increase in statutory burdens on national mortgage associations, and especially capital requirements, would automatically extend to Fannie Mae and Freddie Mac.<sup>8</sup>[8]

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[7] Conforming mortgages are those that Fannie Mae and Freddie Mac may purchase under their charter authority, currently up to a size limit of \$ 252,700 for single-family mortgages. See 12 U.S.C. Secs. 1717(b)(2) and 1454(a)(2).

[8] This last point relates to historical precedent: the original statutory concept for national mortgage associations became flawed when competitors, then the savings and loan industry, managed to burden the

So long as the national mortgage association charter retains the basic benefits available to Fannie Mae and Freddie Mac, it is likely that various types of companies, possibly including Federal Home Loan Banks as well as completely private mortgage lenders, would find it financially attractive to establish and operate a mortgage business through the new charter. If the current GSEs drop their fees to try to drive out the new competition, the mortgage market will benefit from lower mortgage rates. Some large institutions may find it useful to create a national mortgage association as a way to put pressure on the GSEs to lower their fees; others may be able to develop scale fast enough to mount actual competition, much as the Federal Home Loan Bank of Chicago has used GSE status to create a growing market for itself.

**Open Issues:** Some issues will require special attention. Several of these relate primarily to the differences between GSEs and other financial institutions with federal backing: (1) supervisory powers of the new regulator; (2) capital requirements; and (3) affordable housing requirements for the new GSEs. Another issue relates (4) to the role of the Federal Home Loan Banks in the new system of housing finance institutions. Consider each of these in turn.

*Supervisory powers:* Ideally, all GSEs would be subject to supervision by a regulator that possesses the statutory powers of a federal bank regulator with respect to safety and soundness.<sup>9</sup>[9] By contrast to the Office of Federal Housing Enterprise Oversight (OFHEO), for example, the federal bank regulators have a full tool kit of enforcement powers, without much of the crippling language of the OFHEO statute, have discretion to set and change capital requirements on a case-by-case basis, and also have authority to close a failed institution. As was discussed at an earlier conference, OFHEO's powers are almost a parody of the powers of the federal bank regulators.<sup>10</sup>[10]

The GSEs have rejected the approach of providing comparable powers to their regulator.<sup>11</sup>[11] However, under this new proposal to create a potentially large number of national mortgage associations, the case for giving the regulator the supervisory powers of the federal bank regulators would become even more compelling.

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statute with such requirements and limitations that it was not profitable for firms to establish national mortgage associations. See, Milton P. Semer, Julian H. Zimmerman, Ashley Foard, and John M. Frantz, "Evolution of Federal Legislative Policy in Housing: Housing Credits," *Housing in the Seventies Working Papers*, Vol. 1, (Washington, DC: U.S. Department of Housing and Urban Development, 1976), at pp. 28-29.

[9] See, Thomas H. Stanton, "Federal Supervision of Safety and Soundness of Government-Sponsored Enterprises," *The Administrative Law Journal*, Vol. 5, No. 2, pp. 395-484 (Summer 1991).

[10] See, e.g., Thomas H. Stanton, "Devising an Effective Legal Framework for Supervising

the Public Benefits and Public Costs of Government Sponsored Enterprises," and Richard S. Carnell, "Federal Deposit Insurance Versus Federal Sponsorship of Fannie Mae and Freddie Mac: The Structure of Subsidy," papers presented September 8, 1999.

[11] See, e.g., Kenneth H. Bacon, "Privileged Position: Fannie Mae Expected to Escape an Attempt at Tighter Regulation," *Wall Street Journal*, June 19, 1992, p. A1.

*Capital:* The matter of capital is more difficult, for a number of reasons. First, the issue of risk-based capital for commercial banks is itself somewhat in disarray at the moment. Second, the GSEs have shown the ability to block any effort at increasing their capital requirements to levels comparable to those that apply to commercial banks. Yet, it is risky to allow any institutions, and especially to allow potentially numerous national mortgage associations, to operate on the basis of the thin capital requirements that apply today to Fannie Mae and Freddie Mac.<sup>12</sup>[12]

A compromise might be helpful here. For the first several years after enactment of the legislation, national mortgage associations would benefit from whatever low capital standards apply to Fannie Mae and Freddie Mac. The regulator of national mortgage associations would have statutory authority, comparable to that available to the federal bank regulators, to increase capital requirements on any GSEs that, in the judgment of the regulator, pose special problems of safety and soundness.<sup>13</sup>[13] Then four or five years after enactment, as the national mortgage associations begin to increase the scale of their activities, the government could phase in higher capital standards for all of the GSEs, to a level consistent with the evolving capital standards for commercial banks. One stock research report recently pointed out that Fannie Mae and Freddie Mac could raise "significant amounts of preferred capital...with little impact on EPS [earnings-per-share] growth."<sup>14</sup>[14]

*Affordable housing requirements:* Despite the best efforts of the Department of Housing and Urban Development, Fannie Mae and (especially) Freddie Mac continue to lag the primary mortgage market in serving minorities and others with special affordable housing needs.<sup>15</sup>[15] It may be time to concede that the present system of affordable housing goals has not worked well. Instead, the new legislation might require all national mortgage associations, plus Fannie Mae and Freddie Mac, to contribute to an Affordable Housing Fund on the same basis that the Federal Home Loan Banks currently contribute to such a fund.<sup>16</sup>[16]

The new regulator could administer that fund and assure that the money is properly allocated to affordable housing needs. While this is not an essential part of the proposal, the point remains that all GSEs – Fannie Mae, Freddie Mac, and the new national mortgage associations – can and should be required to make some genuine

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[12] Economists might argue, for example, that the shared monopoly of Fannie Mae and Freddie Mac results in the GSEs expecting that they will earn supernormal profits. This expectation of duopoly rents will be diminished as national mortgage associations begin to compete effectively. The reduction in franchise value could increase the incentive of some of the competing companies to increase returns by taking risks, compared with a more monopolistic market structure. The solution, of course, is to improve oversight of safety and soundness so that it resembles federal supervision of commercial banks, so that today's federally sponsored duopoly can be eliminated.

[13] See, 12 U.S.C. Secs. 1831o(g)(1) and 3907.

[14] Bernstein Research, *The GSEs: Hegemony in the Mortgage Market*, January 2000, p. 122.

[15] U.S. Department of Housing and Urban Development, Proposed Rule, 65 Fed. Reg. 12631, at p. 12678 (March 9, 2000). See also testimony of William Apgar, cited in footnote 1, above.

16[16] 12 U.S.C. Sec. 1430 (j)

contribution to affordable housing needs as partial compensation for the benefits that they receive from their federal charters.

*The Federal Home Loan Banks:* Given the substantial advantages of a GSE charter vis-à-vis banks and thrift institutions, it is likely that a number of banks and thrifts will seek to convert their mortgage operations to the new institutional form of a national mortgage association. If so, then the role of the Federal Home Loan Banks in providing agency-status advances will be even more diminished in policy significance than it is at present. (“Agency status” is a term that applies to the ability of GSEs to borrow in the federal agency credit market on the basis of the perception of an implied federal guarantee. This implied federal backing allows GSEs, despite their actual financial condition, to fund themselves at preferential rates close to those of federal Treasury borrowing.<sup>17</sup>[17])

Moreover, the competition from national mortgage associations could reduce conforming mortgage rates by some perceptible amount (perhaps 10-20 basis points?), compared to today. That would reduce the competitive advantage that the Mortgage Partnership Finance Program currently appears to enjoy vis-à-vis Fannie Mae and Freddie Mac.

One solution would be to permit the Federal Home Loan Banks to convert their charters to become national mortgage associations. <sup>18</sup>[18] The new charter must be flexible enough in its legislative design to permit cooperative ownership as well as investor ownership. This would permit the financial institutions that own Federal Home Loan Banks either to retain their cooperative control over a national mortgage association or, as they choose, to become investors in an investor-owned national mortgage association. The legal mechanics of such conversion will require careful attention. In particular, the converted institutions will need to possess sufficient perpetual stock to meet the statutory capital requirements applicable to national mortgage associations.

### **III. Larger Policy Issues to be Considered**

At least three larger policy issues remain for consideration. These are (1) the pervasive political influence of the GSEs and their potential ability to block legislative provisions that would strengthen the supervisory powers of the new regulator; (2) the need to address the problem of GSEs that may be considered "too-big-to-fail"; and (3) the possible role of national mortgage associations as a way to ease the transition to removal of agency status from the obligations and mortgage-backed securities of the housing GSEs.

#### **A. Strengthening the Supervisory Authority of the New Regulator**

It is undisputed that the GSEs exert considerable dominance over the political process. Political influence has been the hallmark of government-sponsored institutions

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[17] For a discussion of the so-called agency attributes of GSEs, and an example of the limited disclosures that GSEs make, see, Thomas H. Stanton, *A State of Risk* (New York: HarperCollins, 1991), pp. 40-44.

[18] See also, *Ibid.*, 1991), pp. 196-7.

since the days of the two Banks of the United States.<sup>19</sup>[19] A direct legislative effort to increase capital requirements for the housing GSEs, for example, would be met with allegations that this would cause higher mortgage rates.

The proposal to create national mortgage associations needs to be crafted with this issue in mind. The advent of increased competition in the conforming mortgage market can help to *lower* mortgage rates. The savings to consumers then would offset the costs of any slight increase in burden on the GSEs that could result from conferring increased bank-type supervisory powers on the new regulator.

As was discussed above, the statute might retain the existing inadequate capital standards, at least for the short run, but provide that the regulator would have discretion to require increased capital for any institution that the regulator believed posed special concerns relating to safety and soundness. The ability of the regulator to increase capital on such a selective basis would not increase the cost of funding mortgages through the other national mortgage associations.

Ultimately, the government needs to try to avoid the specter of Stanton's Law, that "Risk will migrate to the place where government is least equipped to deal with it." This means that the government will need to synchronize the capital standards and supervisory requirements applicable to other financial institutions with those that apply to national mortgage associations.<sup>20</sup>[20] This is important because of the capability of the financial markets to arbitrage across differential regulatory requirements. Firms will shift their mortgage portfolios, for example, so that the institutions with the lowest capital standards hold them, other things being equal.

## **B. GSEs That are Too-Big-to-Fail**

The housing GSEs are immense institutions that create an exceptional and growing concentration of risk for the financial system. At yearend 1999, Fannie Mae had total assets of \$ 575 billion plus net MBS outstanding of \$ 679 billion, for a total size of \$ 1.25 trillion. Freddie Mac had total assets of \$ 387 billion plus total MBSs outstanding of \$ 749 billion, for a total size of \$ 1.14 trillion.

Because of their size alone, these GSEs today are arguably "too big to fail." As Freddie Mac has stated:

"In light of long-standing public policy of preventing a crisis in the financial markets, it is not likely that Congress would fail to intervene to address a future crisis in the mortgage markets....Consequently, repealing Freddie Mac's and Fannie Mae's charters could result in eliminating the

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[19] Thomas H. Stanton, "Nonquantifiable Risks and Financial Institutions: The Mercantilist Legal Framework of Banks, Thrifts and Government-Sponsored Enterprises," in *Global Risk Based Capital Regulations*, edited by Professors Charles Stone and Anne Zissu, (Irwin Professional, 1994), pp. 57-97.

[20] Note that commercial banks may be diversified in their types of lending, as well as geographically. By contrast, while the GSEs may be diversified geographically, their lending is largely concentrated in a single type of loan, i.e., the conforming mortgage loan. Other things being equal, such differences among institutions argue for the application of higher capital requirements to the financially less diversified institutions.

benefits of the implied guarantee without eliminating the risk to the taxpayer."<sup>21</sup>[21]

The proposal to create national mortgage associations helps to address this problem by helping to disperse the funding of conforming mortgages among many different financial institutions. In addition, the legislation might include a provision that limits the total holdings of conforming mortgages by any single institution to a stated fraction, say 10 percent, of the entire conforming mortgage market for that year.<sup>22</sup>[22] A transition period would be required to allow Fannie Mae and Freddie Mac to reduce their mortgage portfolios, either by selling to other institutions or by funding the mortgages through securitization.

Finally, it would be useful to adopt some form of the too-big-to-fail provisions from the FDIC Improvements Act (FDICIA)<sup>23</sup>[23] to GSEs. The problem here, as Richard Carnell pointed out at a recent conference, is that the government finds it difficult to manage the implicit government guarantee, for fear of making the guarantee even more concrete than it is at present. Just as imaginative legal craftsmanship allowed government to create the implicit guarantee, so too a well drafted legal provision is needed to protect taxpayers from having their money used to bail out a failed GSE, except under conditions similar to those established by FDICIA for a bailout of a failed commercial bank through the FDIC.

### **C. Creation of National Mortgage Associations as a Step to Removal of Agency Status**

The creation of competing national mortgage associations, the limitations on concentration and the strengthening of supervisory powers, as described above, together can help to reduce the financial risk exposure of taxpayers to the potential costs of failure of any single GSE. In addition, the creation of national mortgage associations could provide an elegant transition to permit the government to remove agency status from the obligations and mortgage-backed securities of the housing GSEs. This is not an essential part of the proposal, but it is worth considering.

In other words, the government might take the following actions in legislation: (1) permit creation of national mortgage associations, (2) place a sunset provision, to take effect say five years after the date of enactment, in the legal provisions that together create the perception of agency status of GSE obligations and mortgage-backed securities, and (3) perhaps sunset the Federal Home Loan Bank Act in its entirety, again five years after date of enactment. In addition, some of the more questionable provisions

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[21] Freddie Mac, "Everything You Wanted to Know About Privatization But Had No Time To Ask," May 13, 1996, p. 20.

[22] The ten percent figure has precedent in provisions of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, which limit interstate mergers of depository institutions under that law to concentration limits of ten percent of outstanding insured deposits in the U.S.. See, 12 U.S.C. Secs. 1831u(b)(2) and 1842(d)(2).

[23] See, 12 U.S.C. Sec. 1823(c)(4)(G).

of the GSE charter acts will need to be updated, such as the exemptions from federal securities laws and from state and local income taxes.<sup>24</sup>[24]

Even without agency status, firms are likely to find the national mortgage association charter to be valuable. Fannie Mae and Freddie Mac have contended, in their proposals to displace private firms that offer credit life insurance and mortgage insurance, respectively, that the charter is broad enough to permit a combination of loan products and insurance products, for example. Also, the federal charters provide for a more uniform legal framework across the fifty states, and this too is of benefit to the mortgage market.

The creation of national mortgage associations can establish competitive conditions that ease the transition to a mortgage market without today's government sponsored enterprises. Competing firms will have the opportunity to build some scale in their mortgage operations before agency status is ended. Similarly, if the Federal Home Loan Banks were included in the legislation, they would have the chance to operate under an improved charter for some years before making the transition to non-agency status institutions.

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 took a similar approach to deregulation of geographic limits on commercial banks. By permitting regional banks to grow during a transition period, the legislation allowed strong institutions to emerge before the regulatory barriers to interstate banking disappeared completely. The proposal for national mortgage associations similarly could allow institutions to gain financial strength before they lost the protection of federal laws that impede more efficient competition.

Finally, the issue of affordable housing should not be lost in any proposal to create a more efficient mortgage market. As was discussed above, the creation of national mortgage associations would help to support affordable housing through creation of an Affordable Housing Fund that would receive a percentage of the annual net income of each housing GSE. The question then becomes what happens to this fund if the government removes agency status from the housing GSEs. There are a number of options for supporting such a fund, either from public or private sources, and the contours of that support will need to be fitted into the particular legislative package that policymakers decide to propose.

#### **IV. Conclusion: An Invitation for Comments**

It has been said that the essence of statecraft is to combine good policies with sound politics. The basic idea of national mortgage associations is to recognize the overwhelming political salience of the GSEs' battle cry that any change that they oppose, whether higher capital requirements or increased affordable housing or a more capable federal regulator, amounts to a tax on housing.

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[24] The recent proposal of the Treasury Department to reduce concentrated holdings of GSE obligations by banks and thrift institutions would be a useful precursor to such legislation.

The idea of national mortgage associations creates the possibility for *lower* mortgage rates, thanks to increased competition, along with a reduction in the concentration of financial risk in the three housing GSEs and other improvements in the balance between their public benefits and public costs. Needed now is healthy debate, both on the general idea, and on the particular elements that might be part of the package. The position of the housing GSEs on this issue can be anticipated. It would be valuable for other constituencies and analysts to make their views known as well.

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