

Conference Paper

**Thinking About the Future of Fannie Mae and Freddie Mac**

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**Setting GSE Policy through Charters, Laws, and Regulations**

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**I. Introduction**

This paper is probably best written by a combination of a lawyer and a lexicographer. It discusses whether and how public policy can control the housing GSEs through their charters and regulations: how to write charters that effectively limit them to appropriate activities. In a day when clever lawyers can argue about the meaning of “is,” that may seem a pointless exercise. Nonetheless, it is my assignment.

It is useful to start by putting the subject in the context of the conference agenda. The conference announcement refers to the GSEs as “running out of things to buy.” One option is to buy new things - or sell new things. That’s not listed in the announcement as one of the four general approaches for future GSE policy, but there is at least historical reason to think it’s what the GSEs themselves have in mind. Certainly there is a track record of new program activity going back a good 30 years, to the creation of the GSEs in their present form.

My paper thus concerns whether public policy can limit GSE activity to what they “should” buy. To be clear, I am not trying to describe how to rewrite the charter or the regulations. I am asking a logically prior question: Given the political will on the part of Congress and the Administration, are the charters, the laws, and the regulations effective instruments of control? Assume that policymakers do want to limit the GSEs, can they enforce their policy decisions?

In practice, the answer to this question may seem self-evident. If Congress and the Administration have the political will, then charter violations or charter stretching can be addressed, politically or administratively. If Congress doesn’t have the political will, then even an independent regulator will be limited, at least in the long run and perhaps much sooner. But, even assuming the political will, which I assume for most of this paper, there are still issues as to whether, and how, that political will can be made effective.

When issues arise, someone has to be able to act, even given the political will to limit GSE activities. Congress may not be in a position to act, purely as a matter of time. Congress is busy - even the relevant committees are often busy. They have their own schedules and agendas, within a two-year legislative cycle. Some entity has to interpret the charter and the laws, in between Congressional directives. So, of course, Congress has delegated regulatory responsibility to executive branch agencies: to HUD since 1968, to OFHEO since 1992. Thus, in the first instance, effective policy concerns the charters

and the laws, but it leads into questions of how effective regulation can be.

Although the focus of the paper is on the program activities of the GSEs and the question of new program approval, there are relevant examples from other GSE policy issues that shed some light on how - and how not - to set policy effectively. These are (1) capital standards; and (2) housing goals - requirements to purchase mortgages on low- and moderate-income housing, and other categories of special concern to Congress. After this discussion, the paper will consider new program approval and related issues.

## **II. The Interaction Between Legislation and Regulation**

The 1992 GSE regulatory legislation - the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Title XIII of the Housing and Community Development Act of 1992 - includes extensive language on both capital standards and housing goals. But Congress took rather different approaches - nearly opposite ones - to these two issues. It tried to write a very specific capital standard into law, specifying the economic scenarios which the GSEs should be able to survive. In the case of housing goals, it listed its categorical objectives, but with one exception left it to HUD as regulator to establish both qualitative and quantitative standards for meeting those objectives.

The regulatory processes put in motion have been quite different, with perhaps the opposite outcomes to those that might be expected.. OFHEO took six years to formulate capital standards as proposed regulations. HUD promulgated final regulations on housing goals within three years, after establishing interim goals within a year.

There are certainly other factors contributing to the different schedules besides the specificity of the 1992 legislation. OFHEO was a new agency, trying to set up shop in a new administration. And it is inherently harder to establish capital standards than housing goals. But the 1992 legislation contributed significantly as well.

### **A. Capital Standards**

The capital standard is a stress test. Each GSE is supposed to have enough capital to withstand specified adverse economic conditions. The legislation is quite explicit about those economic circumstances. It addresses both interest rate risk and credit risk. The specified interest rate change is a 600 basis point increase, or decrease, in the Treasury 10-year rate, occurring within a year; the rate then remains unchanged for nine more years. The specified credit risk scenario is a rate of mortgage default loss and severity equal to the worst historical regional experience in the United States over a two year period; the region must include at least five percent of the population. These changes are assumed to occur simultaneously.

This legislation raises a variety of problems. The combinations of interest rate changes and credit losses may not be at all consistent, in terms of economic analysis. A given credit risk situation is in reality accompanied by some pattern of interest rate fluctuations. It would have been more reasonable to choose an actual historical experience and require the GSEs to withstand the interest rate and credit conditions that occurred at the time, rather than choosing separate standards and combining them. In addition, the credit risk scenario had to be defined in terms of the GSEs' experience.

Their relevant data extends back only to 1978. Thus the regional experience would have occurred in the early 1980s. That was certainly the expectation of policymakers as the legislation was being drafted and debated. In the early 1980s, also, interest rates rose sharply, putting Fannie Mae in a negative net worth position for several years. My own sense at the time was that Congress was overly concerned with interest rate risk because it was fighting the “last war,” which for the GSES was the early 1980s.

The outcome, in the capital standard proposed by OFHEO last year, seems to be a scenario with house price declines, mortgage default rates and losses that are lower than those in the stress tests of the private rating agencies. One reason is that OFHEO is constrained to use a regional experience, while the rating agencies based their stress tests on individual metropolitan areas.

The 1992 legislation limited OFHEO’s discretion in other ways. It specified a 30 percent add-on to the stress test capital requirement, to cover management and operations risk. It also specified the mortgage product classifications to be used in determining credit risk.

The legislation required OFHEO to propose a capital standard within 18 months of its own establishment, which would have meant by December 1994. When 1997 came around and no capital standard had been proposed, Congress directed GAO to assess OFHEO’s capacity to fulfill its mission. GAO reported that one reason for delay was “the complexity of the development process as specified in the act” (GAO, 1997, p. 7), making particular reference to the stress test, both the individual credit and interest rate components and their combination, and also to the classification system of mortgage products. GAO did not say that the complexity of the legislated stress test was the only factor in the delay, by any means; it noted the problems of starting a new agency. In some respects, GAO suggested that Congress left too much discretion to OFHEO, for example in identifying the region for the credit risk component of the stress test. (The benchmark region turned out to be Oklahoma, Louisiana, Arkansas and Mississippi in 1983-1984; when the legislation was written, the general expectation was that it would be Texas, probably in 1982-1983.) But GAO concluded that the complexity of the legislation was partly responsible for the delay.

In this respect, it is worth noting that the Republican members of the House Banking Committee objected to the stress test in the House version of the legislation, on the grounds that it was too specific, to a degree “not desirable or workable in a law” (Wylie et al, 1991, p. 109). This is not the same capital standard included in the legislation as passed, but the House version was if anything less prescriptive.

What this episode tells us is that you can’t write an econometric model into legislation very well. It seems clear that Congress should have been thinking more broadly about what kind of economic situation it wanted the GSEs to be able to withstand. Then it needed to give the researchers at the regulatory agency enough leeway to specify the details in a coherent way, instead of hardwiring the stress test.

## **B. Housing Goals**

The 1992 legislation established three types of housing goals: for low- and moderate-income families; for “underserved” areas, defined as central cities and rural

areas; and a special affordable housing goal for low-income housing in low income areas, and for very low-income families. The special affordable housing goal is required to be at least one percent of mortgage purchases. The HUD Secretary is required to establish specific goals in these categories. The legislation also established two-year transition goals of 30% for each of the first two categories, and dollar amounts of \$2 billion & \$1.5 billion for Fannie Mae and Freddie Mac, respectively (on the basis of 1990 or 1991 activity, this amounted to less than 0.5 percent for each GSE).

Some of these terms have precise meanings in housing legislation. The Cranston-Gonzalez National Affordable Housing Act of 1990 defined “low-income” as being below 80 percent of the area median income (either metropolitan area or nonmetropolitan county), and “very low income” as below 50 percent of area median income. To put these concepts in perhaps a more familiar context, the poverty line is about 30 to 35 percent of the national median income, so “low-income” is about 250 percent of the poverty line and “very low income” is about 150 percent of it. This however is necessarily imprecise, because poverty is determined nationally rather than locally. “Moderate-income” does not have a precise meaning; prior to the 1990 act, the term “low- and moderate-income” was defined for FHA mortgage insurance, in terms of the mortgage amount rather than family income.

Two of these goals are not specific in stating what the GSEs have to do. They do not specify exactly who the GSEs should serve, but establish income and geographic categories that are of special public policy concern. Nor do they specify a numerical goal.

Thus within the legislative framework, HUD has been able to develop more detailed goals by regulation. It has defined “low- and moderate-income” as income below the area median income. It has decided to define underserved areas *within* cities rather than as comprising cities as a whole, by Census tract on the basis of income and minority population (so that, for example, Chevy Chase within the District of Columbia doesn't qualify). Underserved areas have Census tract median income of no more than 90 percent of area median income, or minority population of at least 30 percent and tract median income no more than 120 percent of area median income. A similar definition is used for rural areas (nonmetropolitan counties). The county median income must be no more than 95 percent of the state or national nonmetropolitan median, or minorities must comprise at least 30 percent of the population and the county median income be no more than 120 percent of the state nonmetropolitan median income.

HUD has set numerical goals for these categories as a percentage of GSE mortgage purchases or securitizations, based on analyses of their importance in the conventional conforming mortgage market. For 1995-1997, HUD calculated the low- and moderate-income share at 57 percent, the underserved area share at 33 percent, and the special affordable housing share at 29 percent. These are all higher than the transition goals established in the 1992 legislation. They are also higher than HUD's estimates in 1995 when it first established numerical goals after the expiration of the transition goals. HUD is proposing to raise the goals; its March 2000 proposed regulation for the years 2001-2003 sets them at 50 percent, 31 percent, and 20 percent, respectively (U.S. Department of Housing and Urban Development, 2000).

These goals have not been established without controversy, including objections

from the GSEs in their comments on the proposed rule in 1995. But the regulator had the authority to establish understandable goals within the legislative framework, and to modify them as market conditions changed.

Thus from these two experiences, it seems reasonable to conclude that the GSEs can be constrained to serve public policy purposes, given the political will to do so. But it is not easy; there are perhaps unexpected pitfalls in the process.

However, there are other aspects of the housing goals issue that are relevant to the subject of this paper. Despite HUD's efforts, the GSEs are not particularly active in serving these target populations, as I noted in my paper for the first AEI conference. Their market share is about 20 percent to 25 percent of the mortgages in these various categories, and the loans they buy are not particularly low down payment mortgages, which suggests that they are not particularly increasing homeownership in America, because they are not particularly serving families that are on the margin of homeownership (Weicher, 1999, pp. 17-18).

It is also important to note the time dimension of the policy issue. The 1992 legislation and the 1995 HUD regulation were a long time coming. They are the outcome - at least, the current outcome - of a policy debate that started in the late 1970s.

In 1978 HUD Secretary Patricia Roberts Harris was concerned that Fannie Mae was not doing enough to promote national housing policy goals. HUD issued proposed regulations mandating Fannie Mae to direct 30 percent of its purchases to low- and moderate-income housing, and 30 percent to properties in central cities. HUD cited Section 309(h) of the FNMA Charter Act as authority for its actions: "The Secretary may require that a reasonable portion of the corporation's mortgage purchases be related to the national goal of providing adequate housing for low and moderate income families, but with reasonable economic return to the corporation."<sup>1</sup> HUD also cited Section 302(b), requiring the approval of the Secretary to deal in conventional mortgages. In the ensuing political brouhaha (including 1,217 negative comments on the proposed regulations and 16 positive comments), Secretary Harris retreated; HUD established goals and insisted on its right to regulate, but the goals did not have any real force (U.S. Department of Housing and Urban Development, 1987, pp. 162-166).

The issue was essentially dormant until 1989. A GAO report in 1985 concluded that HUD was not monitoring Fannie Mae's low- and moderate-income housing performance (U.S. General Accounting Office, 1985, ch. 6), but there was no immediate political action in consequence. The next development came when FIRREA changed the Charter Act to add a public purpose concerning low- and moderate-income housing. Before 1989 the Charter Act authorized Fannie Mae to "provide special assistance...for the financing of (1) selected types of home mortgages (pending the establishment of their

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<sup>[1]</sup>Quotations and citations from the Federal National Mortgage Association Charter Act and the Federal Home Loan Mortgage Corporation Act are taken from the 1984, 1994 and 1998 compendia of Basic Laws on Housing and Community Development prepared by the Office of Legislative Counsel of the U.S. House of Representatives.

marketability) originated under special housing programs designed to provide housing of acceptable standards...for segments of the national population which are unable to obtain adequate housing under established home financing programs....” This meant subsidized housing, produced under several programs between 1961 and 1974. FIRREA eliminated this purpose and substituted “provide ongoing assistance to the secondary market for home mortgages (including mortgages securing housing for low- and moderate-income families involving a reasonable economic return....” FIRREA also changed the Federal Home Loan Mortgage Corporation Act so that this language applied to Freddie Mac as well.

The issue attracted substantial attention in the policy discussions leading up to the 1992 legislation. Secretary Harris had established the low- and moderate-income goal in terms of the purchase price of the house, not the income of the buyer. Price and mortgage data were more readily available, and HUD assumed that price and income were fairly highly correlated, although even in 1978 data from the American Housing Survey (AHS) could have been used for a serious analysis of the relationship. As the legislative discussions focused on affordable housing goals, HUD’s analysis of AHS data showed that fewer than half the buyers of homes that met the 1978 regulatory price standard actually had low or moderate incomes (incomes below the area median). About half of the homes in the conventional conforming market met the 1978 standard; only about 30 percent met the income criterion; only about 20 percent met both. This contributed to the legislative decision to set goals based on income, and to leave their implementation to the regulator.

The 1992 legislation also modified the language concerning public purpose. It changed “home” to “residential” and rewrote the parenthetical language as “(including activities related to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities)”. It also added a new purpose, to “promote access to mortgage credit throughout the National (including central cities, rural areas, and underserved areas)...” These changes in the charter acts appear to be reinforcing the housing goals legislation, telling the GSEs to reach farther down in the income distribution.

This chronology covers about 15 years. It suggests a further qualification to the conclusion that the GSEs can be constrained to serve public policy purposes, given the political will to do so. It is not easy - and it takes a long time.

### **III. New Program Activities**

Approval of new programs is the opposite situation from the housing goals. The policy question is typically whether the GSEs should be *prevented* from doing something, rather than whether they should be *required* to do something. The reason of course is the competitive advantage that the GSEs derive from the privileges given to them in their charters.

This issue also has a long history. When Fannie Mae was reconstituted in 1968 as a private corporation, it was limited to government-guaranteed mortgages, as it had been since its creation in 1938. Two years later, when the Emergency Housing Finance Act of 1970 created Freddie Mac with the authority to buy conventional mortgages, Section 302 (b)(2) was added to the FNMA Charter Act, giving Fannie Mae authority to “purchase,

service, sell, lend on the security of, or otherwise deal in” conventional mortgages - subject to the approval of the Secretary of HUD. Parallel language covering home improvement loans and manufactured housing loans was added to the Charter Act in 1978 and 1980, respectively, as Sections 302(b)(3) and 302 (b)(4). These sections are in addition to the general regulatory authority of the HUD Secretary contained in Section 309(h). In 1984 the Secretary was required to approve or disallow a new program request within 45 days (60 days if the Secretary requests additional information from Fannie Mae).

These provisions of the Charter Act were retained when FIRREA was enacted in 1989, and similar language was inserted in the Corporation Act. Freddie Mac’s previous programs to deal in conventional mortgages were grandfathered.

The 1992 legislation modified the language in the acts. The approval requirements in the three Charter Act sections were deleted and replaced with a new Section 302(b)(6) stating that the Fannie Mae could not implement any new program before obtaining the approval of the HUD Secretary. The legislation further specified that the HUD Secretary should approve new programs proposed by either Fannie Mae or Freddie Mac, unless he or she determined that the programs were not authorized by the Charter or Corporation Acts, or were not in the public interest.

#### **A. Congress as New Program Regulator?**

Marvin Phaup of CBO has argued that Congress is the effective regulator of program activity (Phaup, 2000, pp. 457-458). He points out that every proposed new program since 1992 has been approved by the HUD Secretary. Fannie Mae’s Mortgage Protection Plan was effectively disallowed by Congress, rather than by HUD. Fannie Mae would have provided cash-value life insurance and short-term disability and unemployment insurance to first-time homebuyers whose mortgages it purchased. Congress changed the law in 1997 to reduce the tax advantages of investing in cash-value life insurance, partly because of Fannie Mae’s plan. Fannie Mae then dropped the idea (Seiler, pp. 136-137).

Phaup also points out that Congress forced Freddie Mac to abandon its investment in Philip Morris bonds. In addition, there is a more recent example that could be cited in support of this hypothesis. Freddie Mac received statutory authority to go into the private mortgage insurance business late in 1998, as an amendment to the Corporation Act contained in legislation dealing with other issues; the amendment was not the subject of any Congressional hearings. The authority was quickly repealed when Congress realized what it had done. This was purely a legislative issue; the HUD Secretary as regulator had no role in it. The Clinton Administration, however, did not favor the additional authority (McKinley, 1999, p. 12).

Although Phaup suggests that his generalization may only apply since 1982, earlier examples could be cited as well. One concerns second mortgages. In 1981 HUD Secretary Samuel Pierce allowed Fannie Mae to buy second mortgages, on a temporary basis; with the juxtaposition of a serious recession and very high mortgage rates at that time, homebuyers were finding second mortgages necessary in order to complete the purchase. When Fannie Mae requested a second extension of the authority in 1984, Secretary Pierce asked for public comments before making a decision. Congress

overrode him by extending the authority for three years by statute, and then made it permanent in 1988 (U.S. Department of Housing and Urban Development, 1987, pp. 47-49, 171-173; Weicher, 2000, pp. 435-436).

REMICs provide another instance. The Tax Reform Act of 1986 gave the GSEs authority to issue REMICs, subject to regulatory approval. After receiving approval from Treasury Secretary James Baker (who had the right to approve securities issuances but not new programs), Fannie Mae announced its intention to issue REMICs backed by conventional mortgages. Secretary Pierce claimed authority to determine whether Fannie Mae could issue such REMICs, which Fannie Mae first rejected and then accepted. Secretary Pierce gave conditional approval in 1987, and then gave permanent approval in 1988 - under strong pressure from Congress, according to HUD staff who were involved in the issue at the time (U.S. Department of Housing and Urban Development, 1987, pp. 175-176).

If Phaup is correct, then public policy can control the GSEs - not so much through their charters as through Congressional acts. Further, what Congress appears to be saying is that the GSEs can extend their activities quite broadly in the mortgage market, but perhaps not outside that market. In return, "Congress wants assurances that it is not going to have to face the budgetary cost of a financial rescue of a GSE" (Phaup, 2000, p. 458). This is not something Congress can monitor on a continuing basis, and Congress knows that, at least after the S&L debacle. Thus Congress leaves that determination to a regulator.

But there are counter-examples. The clearest is HUD's 1990 refusal to allow Fannie Mae to purchase debt obligations secured by conventional mortgages. HUD concluded that the requested authority was quite broad and would let Fannie Mae "engage in complex transactions significantly different from the examples given by F.N.M.A. in the documents submitted to HUD and from those engaged in previously" (U.S. Department of Housing and Urban Development, 1991, p. 57). This would have allowed Fannie Mae to make advances against conventional mortgages, a type of activity limited to the Federal Home Loan Banks. After denying the request, HUD did not hear any particular objections from Congress. It might be argued that this was a special case, because of its timing: right after FIRREA, with the collapse of the S&Ls still front page news and Congress unwilling to run apparent risks of further problems in the housing finance system. (HUD was also concerned that the program could significantly increase Fannie Mae's financial risks.) Also, it might be argued that there was precedent from an earlier HUD ruling, in 1985, that Fannie Mae was not authorized by the Charter Act to buy mortgage backed obligations issued by financing subsidiaries of financial institutions. For whatever reason, the program approval decision by the regulator was not overridden by Congress (U.S. Department of Housing and Urban Development, 1991, pp. 56-57; Weicher, 2000, pp. 435-437).

More recent evidence comes from one of the episodes cited by Phaup: Freddie Mac's purchase of Philip Morris corporate bonds. Congress did indeed object, but Congress acted in a way that suggests it saw a separate and important role for HUD. Representative James A. Leach, Chairman of the House Committee on Banking and Financial Services, asked GAO to investigate federal regulatory oversight of nonmortgage investments. GAO responded that HUD's general regulatory authority allowed it to limit nonmortgage investments by the GSEs: "HUD has general regulatory

authority over the housing enterprises....HUD also has authority to approve new mortgage programs that could contain nonmortgage investment components” (U.S. General Accounting Office, 1998a, p. 7). Subsequently, GAO responded to a further request from Representative Richard H. Baker, Chairman of the Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, to review HUD’s implementation of its general regulatory and new program approval authorities (U.S. General Accounting Office, 1998b, p. 7). It is clear that key Congressional committee chairmen (both members of the Banking Committee when the 1992 legislation was enacted) did not think that Congress had reserved new program approval authority to itself, de facto. Nor did GAO think so. (The substance of the issue was the ability of the GSEs to generate arbitrage profits by investing in corporate securities, benefitting from their agency status. There was particular concern over their investments in long-term securities (defined as over five years), which were dubiously related to their need for short-term liquidity. Making nonmortgage investments is certainly one way for the GSEs to continue their rapid growth.)

Other episodes indicate the difficulty of Congressional regulation. Activities can get under the Congressional radar screen. Congress and the Clinton Administration made clear in 1998-1999 that they didn’t want the GSEs in the PMI business. But while Freddie Mac’s authority was being repealed, Fannie Mae was putting in place something that looks quite a bit like mortgage insurance, reducing the required insurance coverage if mortgages go through their automated underwriting system, and if the homebuyer pays a fee. Freddie Mac put a similar program in place a couple of months later (McKinley, 1999, pp. 13-14). Congress has not raised the same concerns over this activity.

## **B. Ancillary Services**

It is also possible for the GSEs to work their way around the program limitations in the charter acts. In 1994, the GSEs started to lease their proprietary automated underwriting systems to lenders. As Vern McKinley pointed out in his paper at the first AEI conference on GSEs a year ago, the charter acts prohibit them from originating mortgages. “The question of whether the provision of the charter limiting origination has been violated depends on what the definition of ‘originate’ is” (McKinley, 1999, p. 11). Origination could be narrowly defined as simply the funding of a loan; it could be broadly defined as including the underwriting process. Clearly the GSEs have opted for the narrow limitation. Robin Seiler has pointed out that the GSEs are also supplying “credit reports, property valuations, title insurance and other origination-related services to lenders; providing funds to lenders immediately after loan papers are signed; and brokering the sale of the rights to service conforming mortgages” (Seiler, 1998, p. 139). This is a good start on a comprehensive list of origination and settlement services. As McKinley observes, the GSEs “can draw much of the profitability” from the origination process, broadly defined.

How do these activities comport with the charter acts? Seiler says that “Automated underwriting and other financial services provided to lenders are not new lines of business for Fannie Mae and Freddie Mac” as of 1998. The first stage in the process of moving into ancillary services was apparently Fannie Mae’s purchase of an underwriting software firm in 1985. Fannie Mae did not seek regulatory approval, but justified its action under Section 309(a) of the Charter Act, authorizing it to “do all things as are necessary or incidental to the proper management of its affairs and the proper

conduct of its business.” Fannie Mae’s chairman, David Maxwell, also justified the purchase as “part of a larger role that Fannie Mae has always been expected to play in carrying out our Charter Act mandate” (U.S. Department of Housing and Urban Development, 1987, pp. 46-47). The fact that there was apparently a long development stage before Fannie Mae was able to offer automated underwriting seems to have blunted criticism of its actions, but it is certainly doubtful that Congress intended, in 1985 or later, for the GSEs to move into the origination and settlement services markets.

### **C. Incremental Program Growth**

The GSEs have often created a new program in a series of small steps. There are several examples of temporary or pilot programs turning into full-scale ones. Second mortgages, already alluded to, is one such. The special circumstances which led Secretary Pierce to approve a temporary program no longer applied in 1984, when he sought public comment on Fannie Mae’s request for a second extension, but the program was established enough for Congress to make it permanent anyway. In a similar situation in 1991, Secretary Kemp gave approval for a Fannie Mae pilot program to buy construction loans. FIRREA limited the ability of the S&Ls to make these loans, and builders were looking for alternative sources of funds. Secretary Kemp then allowed a broader program in 1992. The move into ancillary services is another instance, although in this case there was no external event creating unusual, severe problems for participants in the housing or mortgage markets.

The most striking and most far-reaching example is the “Romney letter.” As mentioned above, the 1970 legislation that allowed Fannie Mae to buy conventional mortgages also made that authority subject to the approval of the HUD Secretary. In 1971 Secretary George Romney gave Fannie Mae approval for a limited program of purchasing conventional first mortgages, on a trial or demonstration basis. Fannie Mae has since argued that the letter gave it permanent authorization it to purchase any kind of conventional first mortgage. It has claimed that the Romney letter extended to conventional mortgage instruments that were of minimal importance in the mortgage market in 1971, such as balloon mortgages, or even undreamed of at the time, and regardless of the financial risks that might be posed by the alternative instruments. Indeed, Fannie Mae claimed in 1978 that the Romney letter exhausted HUD’s regulatory authority over conventional mortgage programs, in support of its assertion that Secretary Harris could not establish housing goals (U.S. Department of Housing and Urban Development, 1987, p. 165).

The Romney letter is a kind of special case of a GSE creating a new program in small steps. In this instance, it took a small step and then argued, some years afterward, that the small step was really a giant step

### **D. Parsing the Charter and Corporation Acts**

“Originate” is not the only word with varying interpretations in the context of public policy toward the GSEs. They have had terminological arguments with their regulators on various occasions. The most noteworthy have concerned the language about the public purposes of the GSEs: what they are allowed to do and what they are expected to do.

From its reconstitution in 1968 until FIRREA, Fannie Mae had two statutory public purposes: to provide supplementary assistance to the secondary market for home mortgages; and to provide special assistance for selected mortgages (meaning mortgages on privately-owned, federally-subsidized lower-income housing), or during a housing or national recession. FIRREA replaced these with three new purposes: to provide stability in the secondary market for home mortgages; to respond appropriately to the private capital market; and (as already discussed in Section II of this paper) to provide ongoing assistance to the secondary market for home mortgages by increasing the liquidity of mortgage investments, including mortgages for housing for low- and moderate-income families. FIRREA also amended the Corporation Act to assign the same purposes to Freddie Mac.

Controversy over the first of these purposes - both what it means and whether the GSEs have fulfilled it - has occurred at intervals over at least the last 20 years. Both the pre-FIRREA and post-FIRREA first purpose statements have commonly been interpreted by housing market analysts and policymakers to refer to countercyclical mortgage market activity; indeed, that was part of the reason for its creation, and the countercyclical purpose was restated in the 1954 Charter Act as well as later. As discussed in my paper for the first AEI conference, the research evidence is mixed: Fannie Mae may have acted countercyclically to a modest extent through the late 1970s, but not during the double recessions of 1980 and 1981-1982, while Freddie Mac did not behave particularly countercyclically during its first two decades. Freddie Mac had no specific public purpose to do so in its Corporation Act until FIRREA, but it was certainly expected by its owners, the S&Ls, to help them during recessions. During the 1990-1991 recession both GSEs were certainly active mortgage buyers, although since this period coincided with the post-FIRREA structural changes in the mortgage market, it is not clear how much of the GSE growth was countercyclical and how much was secular. As we know, their share of the market has continued to grow during the current long economic expansion.

The fact that there have been only two recessionary period in the last quarter century - only one in the last 17 years - may indicate that this public purpose is becoming less important. But it is extremely relevant to the capital requirements of the GSEs. How much capital they need to withstand an economic downturn depends not only on the severity of the downturn but on how they react to it. The timing of their reaction is especially important.

As part of its regulatory activities between 1989 and 1992, HUD performed stress tests to estimate the amount of capital needed by the GSEs to withstand an economic downturn. These analyses became part of the policy debate over the appropriate capital standard in the 1992 legislation. HUD used a Depression scenario, modeled on a scenario developed and used by Moody's to analyze the capital adequacy of private mortgage insurance companies. The analysis concluded that both GSEs could survive 10 years of the Depression scenario if they stopped doing business immediately at the beginning of the downturn, but neither could survive as long as seven years if they continued to do business for as long as two years after the downturn began (U.S. Department of Housing and Urban Development, 1991(b), Ch. II; U.S. Department of Housing and Urban Development, 1992(a), Ch. III; U.S. Department of Housing and Urban Development, 1992(b), Ch. III). The significance of these time periods is that 10 years qualifies a company for an Aaa rating, and seven years for an Aa rating. The GSEs argued that they would stop doing business as soon as downturn started, in which

circumstance they would be able to survive 10 years of the Depression scenario, and therefore did not need additional capital. Even if they were somehow able to identify the onset of the depression and immediately stop buying mortgages, such behavior would be inconsistent with their charter acts. They would hardly be providing stability in the secondary market for residential mortgages.

In other respects, the language of the charter acts raises broad questions about GSE activities. The second public purpose is “to respond appropriately to the private capital market.” One might question whether an appropriate response is to dominate the mortgage market, to the extent of absorbing 90 percent of the conventional conforming market by 2003 (Wallison and Ely, 2000). In addition, one might question how any of the legislated public purposes are served by expansion into ancillary services such as origination and settlement, or whether providing these services is necessary to the proper conduct of the GSEs’ business.

The charter acts also state that, within the conventional mortgage market, the GSEs are expected to restrict themselves to “mortgages which are deemed by the corporation to be of such quality, type, and class as to meet, generally, the purchase standards improved by private institutional mortgage investors.” About three years ago both GSEs began to buy and securitize subprime mortgages - loans to borrowers with impaired credit. The subprime market has grown dramatically since FIRREA, with most of the growth coming in refinancing or making new first mortgages for current homeowners. These loans have markedly higher delinquency and default rates than prime mortgages, and perhaps one-third to two-thirds are for the purpose of debt consolidation, because the rates for even the riskiest category of subprime mortgages are lower than the rates on credit card balances. By going into the subprime market, the GSEs take greater risks than they have previously, and in effect become consumer lenders (Weicher, 1997; Seiler, 1998, pp. 140-141; McKinley, 1999, pp. 8-10).

The GSEs frequently describe their powers in terms that bear no close relationship to the charter acts. They tend to refer to their “mission” - a not particularly clearly defined concept - rather than their “purposes.” The statement of Congressional findings in the 1992 legislation (Section 1302) reflects this GSE position, saying that they “have important public missions that are reflected in the statutes and charter Acts establishing the [Federal Home Loan] Banks and the enterprises.” But it does not specify what those missions are, and I do not believe the term is defined elsewhere in the relevant laws. A vague “mission” is much easier to use as justification for GSE activities than more specific “purposes,” but the interpretation of the purposes can be stretched if need be, with sufficient ingenuity.

## **Conclusion**

Clearly, it is hard to constrain the GSEs on paper - by charter, law, and regulation. There are some examples where they have been limited by regulators following the procedures specified in law. By and large, however, enforcing public policy decisions is a story of frequent skirmishes and tortured legal and lexicographical arguments. (The process isn’t helped by the peculiar bifurcated regulatory structure, but that is a subject for a different paper.)

It is possible to make a case that Congress has chosen itself to regulate the GSEs’

program activities. The corollary of that proposition is that the charters and laws have been effective means of setting policy for the GSEs. My judgment is that both arguments are overstated. First, Congress is quite likely to make the basic decisions about the role of GSEs, as it did with respect to REMICs and second mortgages. But many new program activity issues are on a much smaller scale, and many are fairly arcane, as the private mortgage insurance issue illustrates. Also, the mortgage market like many markets is changing under the impact of new information technology, and the legislative process is a slow and awkward way to regulate the GSEs as these changes occur.

Second, Congress is always concerned about the availability of “enough” mortgage credit for housing. This is the concern that kept it from addressing the S&L problems from the mid-1970s on, until those problems became too obvious to overlook and demanded urgent attention. Congress may therefore be chary of limiting the GSEs’ ability to provide mortgage money. That probably does not mean that Congress would favor a monopoly or duopoly structure in the mortgage market, or GSE dominance of mortgage originations, if it were confronted with those issues in so many words.

Congress typically is not confronted with them in those terms, however. In my paper for the first AEI conference a year ago, I remarked that both Fannie Mae and Freddie Mac “were privatized almost by happenstance,” in response to immediate political exigencies that are now irrelevant and long forgotten (Weicher, 1999, p. 18). The same can be said about some of their expansions into new program areas. There was a recession, or a spike in interest rates, and policymakers reacted. The constant in all these situations has been the GSEs’ financial interest (both their managers’ and their stockholders’ interest) in extending their exploitation of their government guarantees. That abiding interest confronts any public policy approach that attempts to constrain the GSEs to a particular set of activities, and limits its effectiveness.

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