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## The Case for Privatizing Fannie Mae and Freddie Mac Grows Stronger

By Peter J. Wallison

*In the past few months, Fannie Mae and Freddie Mac seem to have lost control of the one risk they really must control—their political risk. As a consequence, their once impregnable position with investors has weakened substantially; now they are confronted with ugly choices that—only a few years ago—it did not seem likely they would ever have to make. A hard look at these choices suggests that privatization for these two government-sponsored enterprises (GSEs) has become an attractive option.*

In late March, the Senate Banking Committee adopted tough new regulatory legislation despite Fannie and Freddie's tenacious opposition. To prevent the legislation from being tougher still, the two companies appeared to have called in all their Democratic markers, producing a rare partisan split in the committee. Under these circumstances, the enactment of new regulatory legislation this year is doubtful, but that is far from the end of the problems for these two government-sponsored enterprises.

### No Longer a Political Juggernaut

Since last fall, Fannie and Freddie have been buffeted by an almost continuous barrage of bad news from government sources that once were afraid to stir up the GSEs' powerful network of support groups and lobbyists:

- The Treasury Department showed its determination to gain tougher regulation for Fannie and Freddie by opposing and ultimately dismembering a House Banking Committee bill that the Treasury considered too weak. This was the first sign that Fannie and Freddie, despite their massive network of lobbyists, would not have their usual way with the legislative process.

- The Office of Management and Budget, in an analysis that accompanied the president's 2005 budget, declared that Fannie and Freddie were undercapitalized, in need of serious new regulation, and failing to perform an important part of their mission: to provide affordable housing, especially for the minority community.
- At the request of the Office of Federal Housing Enterprises Oversight (OFHEO), the GSEs' regulator, Congress approved \$7.5 million that would enable OFHEO to do a forensic audit of Fannie's accounting.
- With that audit underway, OFHEO suggested that it had already turned up accounting problems, warning the market that Fannie might have to restate its financial reports for previous years. When Fannie's spokesman denied that the company knew anything about this, OFHEO's director issued a statement calling Fannie's denial inaccurate and misleading.
- OFHEO proposed new corporate governance regulations that, among other things, would require Fannie and Freddie to split the offices of chairman and CEO and limit the terms of their directors.
- The White House let it be known that the president would no longer appoint the five

Peter J. Wallison (pwallison@aei.org) is a resident fellow at AEI.

directors of Fannie and Freddie that he is authorized to appoint, a clear effort to eliminate one of the links to the federal government that underpin Fannie and Freddie's status as "government sponsored."

- The Department of Housing and Urban Development (HUD), the GSEs' mission regulator, requested authority to levy \$6.5 million in fees on the GSEs so it could better enforce its affordable and low-income housing regulations.
- HUD is now receiving public comments on significantly tougher regulations it has proposed in those areas, which if ultimately adopted will force Fannie and Freddie to devote more resources to the less profitable and riskier underserved market.
- The Federal Reserve Board announced that it would no longer permit Fannie and Freddie to borrow short-term from the Fed by incurring overdrafts in the course of making payments on their securities, a benefit some have calculated to be worth about \$10 million per year.
- A Fed economic study concluded that the value of Fannie and Freddie's government subsidy was between \$119 billion and \$164 billion, far higher than earlier estimates by the Congressional Budget Office (CBO); that between 42 percent and 81 percent of the companies' market value is attributable to their government subsidy; and that the benefit homebuyers derived from this subsidy was only 7 basis points—less than a third of previous estimates.
- CBO announced that it had updated its 2001 study of Fannie and Freddie's subsidy and, using the same methodology, concluded that the subsidy had grown from \$11 billion in 2000 to almost \$20 billion in 2003. Of this amount, CBO estimated that Fannie and Freddie retained about one-third and passed the balance through to homebuyers. CBO also noted that its conclusions, although using a different methodology, were consistent with the Fed study.
- Gregory Mankiw, the chairman of the President's Council of Economic Advisers, declared in a speech that Fannie and Freddie posed risks to the economy and had to be reined in by stronger capital regulation and other restrictions. Speeches and testimony by Treasury officials also emphasized these concerns, and one

Treasury official declared that if Congress wanted to eliminate the GSEs' \$2.25 billion "line of credit" at the Treasury—another of the links that confer GSE status—the department would be willing to discuss doing so.

- The Organization for Economic Cooperation and Development (OECD), in a report on the U.S. economy, recommended that limits be placed on the growth of Fannie and Freddie.
- Last, but far from least, in testimony before the Senate Banking Committee, Fed chairman Alan Greenspan declared Fannie and Freddie a systemic danger to the economy and called for their privatization.

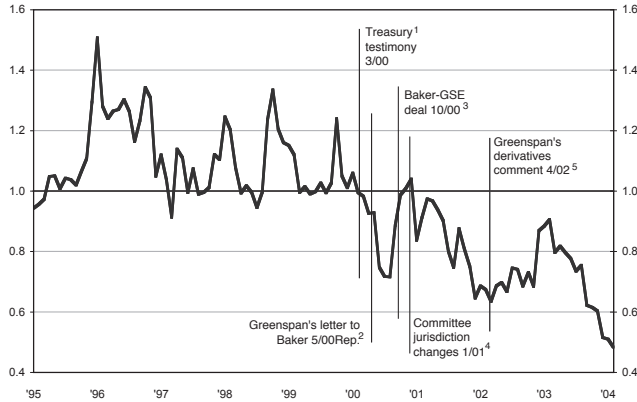
## Declining Investor Support

Perhaps the most ominous signs of long-term trouble for Fannie and Freddie were not government actions at all, but changes in the way they are viewed in the private sector. Several examples suggest that their control over events is beginning to weaken. Wells Fargo, one of the nation's largest banks and a major player in the mortgage market, publicly challenged Fannie and Freddie's commitment to affordable and low-income housing. Only a few years ago, a public complaint about the GSEs by a participant in the housing markets would have been unthinkable.

Major media outlets began to assign reporters to the Fannie and Freddie "beat." The *Wall Street Journal*, *Washington Post*, *Financial Times*, Dow Jones Newswire, and Bloomberg News all designated specific reporters to follow events at or involving Fannie and Freddie. To call this a deathwatch would be an exaggeration, but it indicated that Fannie and Freddie had been recognized as a potential source of important developments in the future, virtually guaranteeing a flow of unfavorable publicity for two companies that had successfully flown under the media radar for many years.

Finally, and perhaps most important, investors and analysts began to draw attention to the severe decline in Fannie's price-earnings ratio (Freddie's is not available because it has not been able to publish audited financial statements for 2002 or 2003). Listed on the New York Stock Exchange, Fannie Mae has been consistently one of the most profitable public companies in the United States. The company boasts that it is one of only four or five companies in the S&P 500 that have had double-digit increases in profitability for fifteen straight years. Indeed, the company's profit has been doubling every five years

Figure 1: Fannie Mae P/E Relative to S&P Financials (since January 1995)



**Notes**

1. Under Secretary of the Treasury Gary Gensler testifies that the Clinton administration will support elimination of the Treasury "line of credit" to the GSEs.
2. Federal Reserve chairman Greenspan notes in a letter to Rep. Richard Baker (R-La.), chairman of the subcommittee with jurisdiction over the GSEs, that the GSEs distort allocation of funds within the financial markets and create risks.
3. Fannie and Freddie agree to issue subordinated debt and to hold ninety days' worth of liquidity.
4. House Financial Services Committee is established, with Rep. Michael Oxley (R-Ohio) as chair.
5. Chairman Greenspan comments that the GSEs create risk in the market through the use of derivatives.

since the beginning of the 1990s, and its return on equity has been consistently in the range of 23 to 26 percent.

With a success record like this, Fannie should have a price-earnings ratio well up into the 20s, but by mid-April 2004 its P-E was about 9.5. For comparison, the composite P-E ratio of the S&P 500 financials was twice as high (see the accompanying chart). What this has meant for Fannie's shareholders is that the price of the stock has not participated at all in the recovery of the securities market since 2002. Although the Dow Jones Industrial Average has climbed almost 2000 points since September 2002, Fannie's stock price is today almost exactly where it was when the market began its upward move. Moreover, as this *Outlook* goes to press, the price is lower than it was on January 4, 1999, the day that Franklin Raines became chairman and CEO of Fannie Mae.

The significance of this fact should not be underestimated. What it means is that investors have built into Fannie's stock price an enormous risk premium, perhaps anticipating that there will be some event—probably government action—that will seriously diminish the company's value. From the perspective of investors, the many events listed above constitute what analysts call "headline risk"—the downward pressure on a stock price that follows upon the disclosure of bad news.

If the Fannie Mae board is like other boards, this is their greatest concern. Fannie is not of course a takeover target, but since the takeover period of the 1980s corporate managements and boards have looked to a company's stock price as an indication of how investors view the quality of their stewardship. When a company's stock price is not increasing, at least when stock prices in general are rising, it is a vote of no confidence. On golf courses, around lunch and dinner tables, and in discussions with analysts, the company's directors and manage-

ment are almost certainly being asked how the company plans to change this adverse trend.

Unfortunately for Fannie, this is a very difficult question. Quite apart from the headline risk created by the drumbeat of bad news coming from the administration and other government agencies, the legislation adopted by the Senate Banking Committee establishes a significant baseline for what Congress could do if a major event in the future stimulates a demand for new regulatory legislation. As long as this legislation is looming, it will be difficult for Fannie's stock price to recover. On the other hand, as the description of the legislation below might suggest, acceding to the bill and allowing it to become law would also be unpalatable to Fannie's management and investors. There are rumors in Washington that Franklin Raines, Fannie's chairman, told his board that agreeing to this bill would be tantamount to giving up Fannie's franchise. While this may be a bit of an exaggeration, the bill clearly has troubling elements for Fannie and Freddie.

**The Senate Bill**

Ever since it opposed a House bill that it characterized as too weak, the Treasury Department had been insisting that the administration had three bottom-line, nonnegotiable demands for any regulator of Fannie Mae and Freddie Mac: (1) the power to adjust the GSEs' capital requirements, including the imposition of a leverage ratio in addition to a minimum level of risk-based capital; (2) the authority to control the GSEs' mission—that is, to approve or disapprove of new activities; and (3) the ability to act as a receiver in the event of a GSE's insolvency, with the usual receiver's power to marshal assets and impose losses on classes of investors and creditors.

Although unusual in Washington, the administration's position does not appear to have been part of a bargaining process. When the legislation came before the Senate committee, the administration insisted on its minimum demands, and when the bill came out of committee with a weaker receivership provision than it wanted, the Treasury publicly opposed the bill. Fannie was not willing to compromise either. Despite statements by Franklin Raines that Fannie wanted a strong regulator—most recently at an AEI luncheon address in February 2004<sup>1</sup>—the company implacably opposed almost every major provision of the Senate bill. Many observers saw Fannie's position as a product of the close presidential election: because of Fannie's close ties to the Democratic Party, a Kerry victory in November would likely end the threat of tougher regulation for the foreseeable future.

But in the absence of a Kerry victory, the Senate bill will hang over Fannie and Freddie like a dark cloud, until the extent of the new regulator's authority is determined. Not only was the new regulator given the power to increase minimum and risk-based capital, but under the Senate bill the same regulator would have the power to disapprove new activities if they were not deemed to be in "the public interest." This language would significantly impair the GSEs' ability to enter new activities by pointing to very broad language in their charters. The new regulator would also have receivership powers, but they would be subject to a forty-five-day period during which Congress could overturn the regulator's appointment of a receiver. The weakening of this provision caused the chairman of the committee, Senator Richard Shelby (R-Ala.), and the administration, to disavow the bill in the form that the committee has passed.

But the bill contains more unwelcome news for Fannie and Freddie. Among other things, it requires them to set aside 5 percent of their pretax earnings in an affordable housing fund, tightens the definition of low-income housing so that it applies to incomes that are 60 percent of median income (instead of 80 percent), and requires the GSEs to lead the market in extending credit to subprime borrowers and the manufactured housing market. All of these mandates will increase risks and reduce profitability. It is again important to note that demands of this kind, which were advanced by the Democrats on the committee and supported by the Republicans, would probably not have been politically possible as recently as last year and were most likely the price the Democrats extracted for their virtually unanimous support of the GSEs' position in opposition to the bill.

## The Privatization Option

With all these wolves circling just outside their camp, it is no longer possible to dismiss the idea that Fannie and Freddie will opt for privatization. Indeed, in comparison with the other courses available to them—accepting the Senate bill or continuing to oppose it—privatization is beginning to look attractive. If President Bush is reelected, the legislation adopted by the Senate Banking Committee this year will come back again in the next Congress, and probably in a stronger form. The regulatory portions will be difficult enough to accept, but it is almost impossible to imagine that the new affordable and low-income housing provisions—which will have significant adverse effects on the GSEs' profitability—can be eliminated from any new bill that passes Congress.

If Congress acts, the new law will increase the likelihood of regulatory action to raise the GSEs' capital levels, reduce their ability to expand their activities into new areas of the economy, and require costly support of affordable and low-income housing. If the bill is not passed, its potential impact will continue to depress their stock prices. When the board of directors asks Franklin Raines for the plan that will move the company's stock price out of the doldrums, it is hard to see any strategy that will work. Moreover, if things proceed as they have over the past three months, Fannie and Freddie will continue to look like the Bad News Bears, as government agencies, members of Congress, members of the mortgage industry, affordable and low-income housing groups, a range of independent analysts, their free market critics, and the press pummel them with complaints and charges. Investors, under these circumstances, will continue to build a risk premium into their stock prices that will drive their price-earnings ratios even lower.

Over against this is the example of the Student Loan Marketing Association, known as Sallie Mae, a GSE that privatized in the mid-1990s. Sallie's P-E is about 14, and it does not have to contend with regulation (the market sets its capitalization), restrictions on its activities (it can enter any business it wants), or meeting affordable and low-income housing goals. When Fannie and Freddie were free of criticism and threatening legislation, when they had convinced the markets that they had complete control of their political risk, it made a great deal of sense to remain as GSEs. In the circumstances they face today, the answer is no longer so clear.

If Fannie and Freddie's managements were to consider privatization, the most important question would be

whether they would be able to obtain the highly favorable privatization framework Congress granted to Sallie Mae. In that case, Congress allowed Sallie to establish a private-sector holding company for the GSE, free of any controls or regulation and free to enter any business, and also permitted the original government-sponsored unit to continue functioning for an additional ten years, providing the parent company with a strong cash flow. If Fannie and Freddie could obtain similar treatment, they would be in a position to dominate the housing market while extending their activities into other areas of the financial economy. Because of their size and domination of a vital sector of the U.S. economy, the two companies as privatized entities might even be considered too big to fail and thus might continue to obtain the favorable financing they currently enjoy. For this reason, many have feared the possibility that the GSEs would seek privatization and obtain it in the form Congress granted to Sallie Mae.

This, however, is not the only way that privatization could occur, and a Congress worried about dropping two huge new unregulated financial companies into the competitive U.S. financial market has a number of alternatives. To demonstrate what possibilities are available, AEI recently sponsored the development by lawyer and consultant Thomas H. Stanton of a privatization plan for Fannie and Freddie that avoids the dangers implicit in the Sallie Mae framework. The current version of the plan, along with a new system for financing housing, developed by Bert Ely, is posted in its entirety on the AEI website.<sup>2</sup>

The plan contains the following principal elements:

- Upon enactment, Fannie and Freddie must cease purchasing mortgages and mortgage-backed securities (MBSs) for their portfolios; existing mortgages and MBSs in their portfolios would be sold off and reduced to zero five years after the date of enactment.
- Fannie and Freddie could continue to securitize mortgages for a six-month period after enactment but at the end of that period would have to begin winding down that aspect of their operations; securitization activities would have to cease three years after enactment. As securitization by the GSE wound down it would gradually have to be transferred to a subsidiary of a private-sector holding company that Fannie and Freddie would be permitted to establish as described below.
- As in the case of Sallie Mae, Fannie and Freddie would be able to form holding companies that could

engage in any business, but only if the GSEs maintained a capitalization equivalent to that required for a stand-alone AA rating (this will limit their ability to distribute cash from their GSE operations to the holding company as dividends), and only if they spin off to independent corporations their housing and mortgage databases and their automated underwriting systems. They would be able to continue to use both, but so could any other company that acquired a license from the spun-off company.

- At the end of five years, the GSE charters would be terminated, and any outstanding GSE obligations (including both debt and the guarantees of any remaining MBS) would be defeased (backed by U.S. Treasuries).

By requiring that they eliminate their portfolios of mortgages and MBSs over five years and their securitization activities over three, this plan would reduce the size of the companies that would succeed to the remaining business of Fannie and Freddie. They would no longer have size and data advantages over other mortgage market participants. In this way, the plan avoids the highly favorable framework adopted by Congress in the Sallie Mae privatization and should allay concern in the private sector that the privatization of Fannie and Freddie will free two gigantic financial companies—both of which could be considered too big to fail—to compete in any market they choose.

Nevertheless, while it must still be considered unlikely that Fannie and Freddie will seek privatization in the near future, it is no longer the wild long shot it once was. Although no one in Congress has joined Alan Greenspan's call for privatization, that is not the relevant test of likelihood. If there is to be a privatization initiative, it will come from Fannie or Freddie, or both, and if they are unable to increase their stock price significantly in any other way, privatization may be the best solution available.

At the pace that events are moving against Fannie and Freddie, it is entirely possible that within the next two years we will be discussing alternative privatization plans instead of new regulation.

## Notes

1. A summary, a transcript, and a video recording of the event are available online at [www.aei.org/event742](http://www.aei.org/event742).

2. Go to [www.aei.org/event743](http://www.aei.org/event743).