

August 2004

The Housing GSEs: Through Competition to Privatization

By Alex J. Pollock

The three government-sponsored enterprises concerned with housing, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, constitute a \$4.8 trillion financial sector. As is increasingly well known, Fannie Mae and Freddie Mac in particular dominate the secondary mortgage market and parlay their privileged position into extraordinary profits. By considering the three GSEs together, we can see how developing a common regulatory framework for them could be the basis for developing a competitive market. That in turn would lead to the ultimate goal of complete privatization of all three GSEs at the same time.

The residential mortgage market, a key factor in creating a property-owning citizenry for a free society, ought to be as economically efficient and competitively robust as possible. The American residential mortgage market, however, besides being the largest credit market in the world, is uniquely characterized by the predominance of government-sponsored enterprises (GSEs).

The controversial structure of the GSEs combines huge size, political influence, and special privileges that implicitly subsidize profits, as well as political risk. The three housing GSEs—Fannie Mae, Freddie Mac, and the Federal Home Loan Banks (FHLBs)—have combined assets and off-balance-sheet securities guarantees of \$4.8 trillion. This remarkable amount is divided among the GSEs, as shown in the accompanying table.

As Peter Wallison has made clear, the future role of these GSEs is an essential issue in U.S. financial policy¹: in particular, the question is how to put all three on the path to successful privatization.

Alex J. Pollock is a resident fellow at AEI. He previously served twelve years as president and chief executive officer of the Federal Home Loan Bank of Chicago.

COMPARATIVE AND AGGREGATE SIZE OF THE
HOUSING GSEs
(\$ billion)

	Total Assets	Off-Balance- Sheet Guarantees	Total
Fannie Mae*	\$989	\$1,360	\$2,349
Freddie Mac**	\$803	\$752	\$1,555
Combined FHLBs*	\$901	—	\$901
Total GSEs	\$2,693	\$2,112	\$4,805

*as of 6/30/04

**as of 12/31/03

Note that in terms of asset size, the combined Federal Home Loan Banks are in between Fannie and Freddie.

The answer proposed in this paper is that the most efficient path to privatization of the housing GSEs lies first through creating a truly competitive secondary mortgage sector, which would significantly reduce or eliminate the large duopoly profits now generated by Fannie and Freddie.

To do this, all three housing GSEs, including the Federal Home Loan Banks, must be considered and addressed together by guiding policy principles and resulting legislation. The goal should be maximum competition and minimum privileged profitability. The GSE structure should insure that Fannie and Freddie experience a

“level playing field” of competition from all twelve FHLBs, and through them, from thousands of private financial institutions that participate in FHLB mortgage-financing programs. As the ability of GSE charters to generate duopoly profits is reduced, so will be the motivation to resist privatization. In other words, the costs and constraints of GSE status will become a worse trade-off versus the economic rewards to Fannie and Freddie’s shareholders.

The three housing GSEs are now central to the American home finance system, although their prominence dates only from the late 1980s—less than twenty years ago. All three GSEs enjoy congressionally granted special privileges that generate large economic benefits. Fannie and Freddie, in particular, display duopolistic traits and extraordinary levels of profitability that have been maintained over more than fifteen years.

The Federal Home Loan Banks

Of the three housing GSEs, the Federal Home Loan Banks are the least known by the general public and have received less focus and discussion in public policy debates. Yet, as the table shows, their size (measured in total assets) is in between Fannie and Freddie, and they are equally active in the issuance of government-sponsored debt.

The Federal Home Loan Banks were created in the depths of the Great Depression (at the initiative of Herbert Hoover) and reflect the ideas of the Progressive Era. Although each is a separate corporation, the twelve FHLBs were structured as a geographic cartel, with centralized issuance of joint debt. Thus today’s \$821 billion in outstanding bonds and notes is the joint liability of all FHLBs.

In financing power, FHLB debt is fully competitive with that of Fannie and Freddie as to rate and price, terms, structure, volume, and acceptance in the global fixed-income markets. This is the principal reason the FHLBs can be serious competitors to Fannie and Freddie in the secondary market financing of residential mortgages.

The stock of the Federal Home Loan Banks is entirely owned by their members, principally commercial banks and thrifts, and it benefits from a required return on equity much lower than that expected from Fannie and Freddie by the public stock market, specifically about 7 percent versus 25 percent after tax return on equity, respectively. FHLBs compete indirectly with Fannie and Freddie by lending to member banks and thrifts against the pledge of residential mortgages. More to the point,

since 1997, they have introduced mortgage-financing programs in direct competition with Fannie and Freddie. It is these programs that offer the possibility of developing a genuinely competitive secondary mortgage market.

The current GSE regulatory structure involves two different regulators—both relatively new and, in general, little known—one for Fannie and Freddie, and one for the Federal Home Loan Banks. This regulatory structure is redundant and inefficient and leads to large disparities in regulations, capital requirements, and regulatory burden. There are also major disparities in tax treatment. This is in spite of the fact that all three housing GSEs have the same purpose: to promote homeownership and housing finance through linking residential mortgages to capital market financing.

Because the three housing GSEs have the same purpose, operate in the same sector, have the same capital market funding imperatives, and manage very similar risks, policy consistency and efficiency would be gained by applying to all three:

1. a common regulator
2. common regulatory principles
3. common capital requirements, and
4. a common transition to fully private status.

The Ultimate Goal: Privatization

The three housing GSEs were all formed to meet perceived needs of stressful economic times: 1932, 1938, and 1970 (for the Federal Home Loan Banks, Fannie, and Freddie, respectively). Along with their special federal charters, all were given special privileges, tax status, government ties, and government support, leading to the well-known implied government guaranty of their debt, which the GSE debates notwithstanding, continues to be inferred by the capital markets.

The particular economic problems of the GSEs’ creation are long gone. All three GSEs have evolved into large and strong financial enterprises, and in the case of Fannie and Freddie, into dominant companies with market power. There is no longer any need for special privileges.

The three housing GSEs should be phased out of their politically favored status until they ultimately compete as fully private companies in the private sector. GSE reform legislation continues to be a possibility—under a second Bush administration, most observers believe it would be a

high probability. Any GSE legislation should reflect the ultimate goal of privatization by means of a sunset on the GSE's government-sponsored status after a ten-year transition period. This is more than enough time to allow the reorganization of structures and resources, as the very successful privatization of Sallie Mae has shown. Indeed, as Tom Stanton has suggested in papers presented at the American Enterprise Institute, the Sallie Mae transition structure provides a good model for the privatization of the housing GSEs, as well.²

The Transition: A Competitive Secondary Market

As an essential part of preparing for privatization, the transition period should be targeted for the development of increasing competition and the resulting greater economic efficiency of the secondary mortgage market. This is made possible only by considering the three housing GSEs together and in particular by using the FHLBs to break up the duopoly power that the government created by chartering Fannie and Freddie.

As noted above, the Federal Home Loan Banks have an ability to finance long-term mortgages equal to that of Fannie and Freddie. All twelve FHLBs offer secondary mortgage market programs in combination with their member institutions that compete directly with Fannie and Freddie. These programs offer alternatives and choices that have already resulted in greater price competition. Moreover, they have grown in outstanding assets to over \$100 billion since 1997 and have the potential for continued growth.

The point of their growth, from a public policy point of view, should be to reduce the privileged profits reaped by the GSE sector and move the secondary mortgage market ever closer to an economically efficient—that is, truly competitive—structure. Impeding progress toward this goal are the regulatory disparities between Fannie and Freddie, on one hand, and the FHLBs, on the other. Removing these disparities through a common regulatory framework and a “level playing field” constitutes a key step toward the ultimate goal.

Common Regulatory and Tax Treatment

Capital Requirements. A fundamental principle of sound capital requirements is that equivalent risks should require equivalent capital. Today the capital requirements of housing GSEs are disparate: those of

the Federal Home Loan Banks, on one hand, and Fannie and Freddie, on the other, bear no relationship to each other. To increase competition on a “level playing field” basis, to reduce privileged profits, and to prepare for privatization, all of the housing GSEs should have the same capital standards, with equivalent risks requiring equivalent capital in each case. This should apply to both leverage and risk-based capital requirements.

Other Regulatory Principles. Not only capital requirements, but all regulatory principles should be applied in common and equally to all three housing GSEs. This includes, as long as operations exist under GSE charters, strict, narrow mission limitations on those operations to the promotion of home ownership and housing finance.

At the same time, the housing GSEs will continue to operate in a world of financial innovation, advancing technology, demographic change, and globalization of markets. All three should have the equal ability to create new housing finance products, consistent with their housing finance mission, to meet the needs of the mortgage markets. As all three housing GSEs add competitive pressure through innovation, reduction of profits due to charter privileges should continue and preparation for the privatized future be enhanced.

At the end of the transition period, any remaining government-sponsored assets and liabilities should be put on a liquidating basis, as Stanton recommends. Of course, for the new privatized companies, all special limits on mission activities and powers, as well as all government support, explicit or implied, will have been eliminated.

A Common Regulator. Today the regulatory structure for housing GSEs is redundant and inefficient. Most observers, as well as the Senate Banking Committee in its GSE bill of earlier this year, have concluded that regulatory oversight of the three housing GSEs should be consolidated into one regulator. An additional, essential policy goal is that this regulator be charged with equitable and pro-competitive treatment of all three GSEs, to insure a maximally competitive secondary mortgage sector as it transitions to privatization.

The common regulator implies the merger of the Federal Housing Finance Board into the Office of Federal Housing Enterprise Oversight or their combination in a new regulatory body, as the Senate Banking Committee bill provided. In either case, the management of

the agency should be vested in a director, not in a board, which in the fourteen-year history of the Federal Housing Finance Board has proven cumbersome and divisive. In either case, the common regulator must be responsible for applying common regulatory principles to Fannie, Freddie, and the FHLBs.

The ten-year period for transition to privatization should also apply to the housing GSE regulator. Upon successful completion of privatization, there will no longer be special privileges or government support, explicit or implied, for Fannie, Freddie, or the FHLBs. With no more housing GSEs to regulate, the housing GSE regulator should cease to exist ninety days later.

Tax Status. An additional desirable goal is a common tax status for all housing GSEs. Currently, Fannie and Freddie are subject to federal income taxes, but the Federal Home Loan Banks are not. However, the FHLBs do make large payments for the Resolution Funding Corporation (REFCORP), a historical leftover of the 1989 thrift bailout, and also are required by statute to make Affordable Housing Program grants. Together these represent significant de facto rates of taxation.

To put all housing GSEs in a common tax status, the Federal Home Loan Banks should be made subject to the federal corporate income tax, while the anachronistic REFCORP payment should be eliminated. Statutorily mandated affordable housing grants should then become tax credits.

These changes would eliminate any competitive disparity between Fannie, Freddie, and the FHLBs caused by tax treatment. Of course, upon completion of privatization, all former GSEs would be taxed as normal business corporations.

Boards of Directors. As structured by their charter statutes, the boards of directors of Fannie and Freddie each have eighteen members, of which thirteen are elected by the shareholders and five appointed by the President of the United States. This year President Bush has declined to make appointments to either board.

Each of the twelve Federal Home Loan Banks has its own board of directors, which includes both elected and appointed directors. In total, there are 193 directors, of which 79 are appointed, not by the president, but in a highly unusual manner, by the regulator—the Federal Housing Finance Board. The General Accounting Office has pointedly criticized this situation as an

undesirable conflict. In any case, a common GSE regulator could not appoint directors to one of the three GSEs. Appointed directors of the FHLBs should be put on the same basis as those of Fannie and Freddie, if indeed government-appointed directors were to be retained for housing GSEs through the transition period.

Upon completion of privatization, all government appointment of directors should cease, if not before.

The Path: Through Competition to Privatization

The path for all housing GSEs—Fannie, Freddie, and all the Federal Home Loan Banks—should first lead to a more competitive, “level playing field” secondary mortgage sector, in which the current generation of privileged profits is greatly reduced or eliminated. If the GSE status yields no excess profits, then from a shareholder point of view, privatization becomes the preferred alternative.

A ten-year transition period, with the sunset of both GSE status and GSE regulation at the end, will be the beginning of a more economically efficient, fairer, more robust home financing sector.

Upon privatization, it appears possible that the Mortgage Holding Subsidiaries of banks and thrifts, proposed by Bert Ely in papers presented originally at the American Enterprise Institute, could be successful and multiply.³ They, along with the privatized former GSEs, would allow a bond-based, soundly financed mortgage system, which would simultaneously be truly competitive. In such a system, extraordinary profits would appear only temporarily to reward the latest innovation—in short, we would have a well-functioning market.

Notes

1. See, for example, Peter J. Wallison’s *May Financial Services Outlook*, “The Case for Privatizing Fannie Mae and Freddie Mac Grows Stronger,” (available at www.aei.org/publication20395).

2. In September, the AEI Press will publish *Privatizing Fannie Mae, Freddie Mac, and the Federal Home Loan Banks: Why and How*, which Tom Stanton has written with Bert Ely and Peter Wallison.

3. See Ely’s “Section-by-Section Summary: The Mortgage Holding Subsidiary Act” in Wallison, Stanton, and Ely’s forthcoming volume (see note 2 above).