

Summary of Comments on Jay Brinkmann's "Discussion of the Economics of G-Fees"

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1. This is a very informative presentation of how "g-fees" work and how they produce extremely high sustained returns on equity for Fannie and Freddie.
2. The single most important question (on p. 4) answers itself if properly rewritten to change one word and add one phrase:

"Absent competition, are the fee levels set competitively with only two principal providers of this type of insurance, with their government charters protecting them from other entrants?"

The obvious answer is: of course not.

3. Similarly, a key point (on p.19) needs some changes to make it fit what hundreds of mortgage lenders believe to be the case:

The g-fee "reported average is a little over 20 basis points, with a range on either side that is not related at all to the risk of the loans delivered by smaller lenders."

This is why the Federal Home Loan Bank mortgage programs, which were conceived (by me) to address this non-competitive pricing, now have over one thousand participating lenders.

4. Credit losses have recently been very low. The return on equity calculations should also consider the long run average credit loss ratio. Based on OFHEO data, the 34 year average for Fannie, from 1971 to 2004, is 4 basis points. The g-fees are still very high relative to the average loss—and losses of small community lenders on their residential mortgage portfolios tend to be even lower.

Putting into the return on equity formula the long run average losses would lower the return on equity somewhat, but this would be largely offset if we used average short term rates to calculate the value of the float, which also is currently low, reflecting the 2% fed funds rate in Jay's model.

A final long run effect we should consider is that operating costs fall with scale and improving technology over time; they "remain constant" only in the short run.

5. I believe one correction is required in the return on equity calculations. In all financial companies, we must add to the ROE the income earned by investing the capital in financial assets. This is not reflected in Jay's basis point analysis. As a quick estimate, if that equity yields 5% on average, which is about 3% after tax, which can be added to the estimated returns on equity.

This would bring Jay's 26% estimate to 29%, which is very close to an analysis I have seen of ROE based on Fannie's official business segment reporting. That analysis resulted in a three-year (2001 to 2003) average ROE of 30% for the credit guaranty segment.

In any case, these are very attractive returns, which are not at all affected by the messy issues of accounting for derivatives.

The segment analysis also suggests that the rate of return for the guaranty business is substantially higher than for the portfolio business, the latter of course being subject to accounting disputes.

6. A key point (on p. 20):

“Many lenders [are] reluctant to speak up on issues where they might differ with the GSEs.”

This is a measure of duopoly or market power.

7. What to do:

- As Jay says (on p. 21), “more competition”! More competition, one way or another, is in fact the only good answer. Privatization is one way of ensuring more competition. Bert Ely's “mortgage holding subsidiary” proposal is another idea. FHLBs are immediately available competitors, being GSEs themselves.
- Jay also suggests, “innovative fee structures to allow greater credit risk sharing”: this is the fundamental idea of the FHLBs' Mortgage Partnership Finance program, the “partnership” reflecting credit risk structures.
- An excellent pro-competitive action would be for the Congress to enact the proposed amendment to the Federal Home Loan Bank Act suggested by the Mortgage Bankers Association and the National Association of Home Builders. This would make explicit the power of FHLBs to securitize mortgages in competition with Fannie and Freddie. There is little doubt that in this case lenders and home buyers would rapidly benefit from competitively priced g-fees, which would more closely reflect the actual risks.

8. As the Congress considers GSE reform, I believe an essential principle is that all regulatory reforms should be designed to be pro-competitive. Paul London, in [The Competitive Solution](#), details the impressive consumer benefits, productivity and economic energy created in many industries since the 1970s by fostering competition in formerly comfortable oligopolies and monopolies, and argues that these policies “are the most important forces behind America’s prosperity.”

Notably absent from his list of successes, however, is the secondary mortgage market, with its notably duopolistic g-fee pricing. We need to apply the success of “the competitive solution” to the GSEs at some point. A good time would be now.