

Introduction

Conference on Guarantee Fees charged by Fannie Mae and Freddie Mac

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On January 14, the *Wall Street Journal's* front page carried an article entitled "Hidden Fees in Most Mortgages Bring Scrutiny to Fannie, Freddie." The article, purportedly based on a previously undisclosed study by the Office of Federal Housing Enterprise Oversight—Fannie and Freddie's regulator—focused on the fees (known as G-fees) that Fannie and Freddie charge when they guarantee the payment of interest and principal on a pool of mortgages collateralizing an issuance of mortgage-backed securities.

If accurate, the article contained a number of facts that open an entirely new area of jeopardy for the two GSEs.

According to the article, OFHEO has concluded that Fannie and Freddie use their market power to keep their G-fees high, that these fees significantly increase the cost of a mortgage, although they are not disclosed, and that, in the words of the article, they yield "excessive profits at the expense of millions of homeowners." That charge throws into doubt Fannie and Freddie's claims that they are fulfilling a government mission by keeping mortgage rates low. It suggests, on the contrary, that they are using their government-granted monopoly position in the secondary mortgage market to overcharge homeowners. I think the less polite term is "rip off."

The article states that the G-fees that Fannie and Freddie charged in 2003 amounted to approximately 33 times the credit losses that they actually incurred in that year. For comparison, according to the OFHEO report cited in the article, G-fees were only 4.4 times losses in 1995. In addition, again as reported in the article, the G-fee for a \$250,000 mortgage is \$500, amounting to \$11,350 over the life of a 30 year mortgage.

Those of us who have followed the GSE issue over many years have been aware of the fact that Fannie and Freddie have tremendous market power to set G-fees. Discussions with mortgage lenders revealed that they were afraid to speak publicly about G-fee issue, or how fees were set, because Fannie and Freddie had the power to retaliate against them by raising the fees of any lender who publicly complained. The *Wall Street Journal* article suggests why this is such a worrisome matter for mortgage lenders: the fees charged by Fannie and Freddie differ from lender to lender, are heavily negotiated and are not disclosed. Lenders thus have no way of knowing whether their fees are higher or lower than those of their competitors, and a public complaint could bring an increase in a lender's G-fee, directly affecting its ability to compete and its profit level.

If OFHEO has finally begun to explore this dark corner of the mortgage market, it's about time. OFHEO's report, when completed and fully disclosed, is likely to contain

a lot of information that will not enhance the reputations of Fannie or Freddie, and may bring an antitrust investigation, or worse.

The presentation by Jay Brinkmann in today's conference will show that it is simplistic to compare G-fees solely with credit losses on guaranteed portfolios. Still, his calculations also show that if Fannie and Freddie targeted a return on equity that is roughly equivalent to that of commercial banks they could charge considerably lower G-fees. Stated another way, Fannie and Freddie are able to target much higher returns on equity than commercial banks, and that in turn requires considerably higher G-fees.

The fact that Fannie and Freddie can target a high return on equity, and achieve that return through their G-fee pricing, certainly suggests that they are not actually competing.

There is nothing illegal about this if they are not engaged in collusion, but in the difficult political position in which Fannie and Freddie find themselves today—with a regulator looking into their pricing and congressional committees in the House and Senate set to consider new and tougher regulatory legislation—the fact that they are charging unnecessarily high G-fees that directly increase mortgage rates will not increase the sympathy with which lawmakers hear their case for more lenient regulation.