

GSEs: *Where Should We Go from Here?*

The overall goal of the housing finance system is to help create and support a property-owning democracy. Different countries and times choose different ways to pursue this goal. The American housing finance system is unique in the world for the predominant role played by the housing government-sponsored enterprises (GSEs).

How did we get here?

Fannie Mae, Freddie Mac and the Federal Home Loan Banks (FHLBs) are all for-profit corporations owned by private shareholders, but each is chartered by a specific act of the U.S. Congress, dating respectively from 1938, 1970 and 1932. These acts grant special privileges and advantages to each of these entities. Estimates of the economic value of these advantages vary, but they are unquestionably worth billions of dollars a year.

Fannie and Freddie in particular are usually (and correctly) described as operating a government-created duopoly in the secondary mortgage market. All the GSEs are among the largest issuers of debt securities in the world. The three represent a very large financial sector: Their combined assets plus off-balance-sheet guarantees of mortgage-backed securities (MBS) total more than \$5 trillion.

The most fundamental choice in housing finance structure is whether the predominant funding source for mortgage loans will be deposits or bonds—in other words, depository institution balance sheets or the capital markets. The GSEs can best be understood as representing a historical “paradigm shift” in American housing finance from a deposit-based to a bond-based system.

The key transition was the insolvency and collapse of the savings and loans in the 1980s, which made possible the ascendancy of Fannie Mae and Freddie Mac. These two GSEs filled the competitive space formerly held by several thousand savings and loans. The new GSE-based system was a distinct improvement in the housing finance structure, because it

meant that long-term, fixed-rate mortgages could be financed with long-term, fixed-rate bonds and MBS. The GSEs thus represented a far better approach to the management of liquidity risk and also of interest-rate risk.

The interest-rate risk of a mortgage finance system cannot be made to disappear; it can only be moved to one economic party or another.

Variable-rate mortgage loans or fixed-rate loans with heavy prepayment fees put the interest-rate risk on the household borrowers—on average, the economic actors least-well-equipped to cope with it. Bond-based systems, including the use of MBS, move the interest-rate risk to capital market investors, who are much better able to address it.

It must also be noted that by setting up deposit insurance or GSEs, the government shifts interest-rate risk to itself. (This may be considered just, because it is the monetary behavior of the government in a purely paper currency system that creates the extremes of interest-rate risk.)

The GSE-based, capital market-funded housing finance structure that blossomed after 1980 never had any interest rate ceilings to contend with. It developed along with the globalization of capital markets, making GSE securities available to investors not only nationwide but worldwide. Mortgage finance no longer experienced periodic “credit crunches”; instead, it operated robustly. Throughout economic and financial cycles, long-term, fixed-rate mortgage credit was routinely and easily available to American households.

These were real achievements for the GSE-based system.

However, the achievements came at the price of creating what many economists believe is an implicitly colluding duopoly that concentrated both economic and political power.

What should the GSEs look like if we were drawing up new blueprints today? Here's one view that takes its cue from history.

BY ALEX J. POLLOCK

Fannie and Freddie amassed a dominating market and political role, reaped duopoly profits (economic rents) and created market distortions. The financing advantages derived from their government support allowed all three GSEs to grow huge in unintended ways.

All this was in notable contrast to their origins.

The origins of GSE charters

Each GSE was created in the particular circumstances of some historical moment, with the GSE seen as an answer—real or perceived—to the economic and political issues of a specific time.

The FHLBs were chartered under the sponsorship of Herbert Hoover in 1932. In the midst of the vast financial collapse of the Great Depression, mortgage loans had become illiquid, or “frozen,” in the terminology of the day.

The principal mortgage lenders—who were small, local, mutual savings-and-loan associations—often could not honor requests for savings withdrawals because they had no cash. So the savings accounts were frozen as well. In these circumstances, it was reasonable, at least as a temporary measure, to try using a GSE to re-liquify mortgages and the related savings.

Later in the 1930s, mortgage lending was still a problem, so the Roosevelt administration decided to have the government insure mortgages through the then-new Federal Housing Administration (FHA). The idea was that investors would be willing to buy mortgages based on the government’s credit insurance, but the results fell somewhat short of expectations. So Fannie Mae was chartered, originally as a subsidiary of the Reconstruction Finance Corporation, with the sole purpose of using government funds to buy FHA loans and hold them in portfolio. In terms of government policy, you could make a reasonable argument that—at least as a temporary measure—this was worth a try.

Fannie Mae’s charter was refashioned in 1968, during the Johnson administration, in order to move its borrowings off the federal budget and hold down the reported federal deficit. The motivation was clear, anyway.

Special circumstances surrounded Freddie Mac’s creation, too. In 1970, the government was still engaged in setting ceilings on the interest rates that could be paid on deposits, with the then-famous Regulation Q. Through this regulation, the government practiced nationwide price-fixing in the deposit market, so that financial institutions could not compete by offering interest rates that were “too high.”

When market interest rates went above the regulatory

ceilings, as they did with increasing frequency beginning in the mid-1960s—surprise!—savers withdrew deposits from savings-and-loan associations (then the predominant mortgage lenders). There were insufficient funds to meet mortgage demand, and mortgages were rationed. This was considered an emergency in housing finance, so to correct for one government intervention, a second one in the form of a GSE seemed necessary. A related idea—and not a bad one—was to introduce securitization of conforming mortgages.

In 1989, Freddie Mac, in a brilliant political maneuver, slipped a much more favorable charter into the thrift bailout legislation when all eyes were on the savings-and-loan industry collapse and related scandals. It thereby became, like Fannie Mae, a publicly traded corporation.

Every GSE got special benefits, privileges and economic advantages for its shareholders because it addressed problems that lawmakers were facing at a particular time. Every GSE represents a deal made with the government, which was willing to grant privileges and create contingent taxpayer liability in the context of specific historical circumstances.

It would be astonishing if these circumstances did not dramatically change in the course of several decades—as of course they have—making the original deal somewhat passé, if not completely irrelevant. Moreover, not only have circumstances fundamentally altered, but the GSEs themselves have developed in ways never intended or foreseen by their designers.

None of the circumstances that prompted the creation of America’s three GSEs still exists. The assumptions behind their deals with the government have changed beyond recognition. None of the problems to which GSEs were considered solutions was a permanent problem—and, although of course not everyone would agree, in my opinion none warrants continuation of the special privileges of their charters.

The GSE situation today

Needless to say, changes very surprising to most observers have occurred in the GSE system during the last three years. Fannie Mae and Freddie Mac have found themselves in a defensive posture that would have been considered unimaginable a few years ago.

Along with the fact that top management at both have been forced out, Fannie, especially, is burdened by onerous regulatory restrictions and ongoing government investigations. Both have spent hundreds of millions of dollars revising their accounting and restating financial reports.

Two key factors appear to have triggered these changes. One is that the executive branch became very critical—one

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might even say hostile—to Fannie and Freddie after they blocked the administration’s proposed GSE reform legislation in 2004. This attitude seems to have spread to the FHLB regulator, the Federal Housing Finance Board, which appears distinctly hostile to any attempt by the FHLBs to make themselves relevant to the securitized mortgage world.

The other factor is that an unexpected source of vulnerability for all GSEs was created by the introduction of a convoluted accounting rule, FAS 133, and this vulnerability has been exceptionally costly for them.

Consider this situation: a U.S. president who is popular in the South and West, while much resented on the East Coast, particularly in “elite” circles, leading his administration against a large, elite, government-sponsored financial power. This could be Andrew Jackson in the 1830s rejecting the rechartering of the Second Bank of the United States—the GSE of its day. Or it could be George W. Bush and the humbling of Fannie Mae and Freddie Mac. It strikes me there’s an intriguing parallel there.

Jackson wrote, as he vetoed the rechartering bill in 1832: “Admit that the bank ought to be perpetual, and as a consequence the present stockholders will be established a privileged order, clothed both with great political power and enjoying immense pecuniary advantages from their connection with the government. It is easy to conceive that great evils to our country and its institutions might flow from such a concentration of power.”

Jackson’s thoughts apply to the problems posed by GSEs in 2006. We have the same problems of government-sponsored profits for shareholders, concentration of power and special grants of privileges, as Jackson opposed.

Where should we go from here?

Considering the structural issues caused by the GSEs, mortgage market leaders and policymakers need to be asking: Where should we go from here? What is required, in my mind, is a fundamental, not a tactical, reconsideration, for which the currently pending House and Senate bills are a good beginning.

The required recalibration of the GSEs’ status makes good sense for the taxpayers, who are on the hook, and for the government, which is one party to the GSE deal. Having observed how much circumstances have changed, the question “What should the GSE deal be *now*?” should be posed and answered.

I suggest the answer has four structural elements:

1. Limited-life charters for all GSEs

In the first place, as a minimum requirement, no GSE should continue to have a perpetual charter.

The clear lesson of financial history is that GSEs should be given only limited-life charters: With GSE reform legislation now being considered by Congress, it is not too late to apply this lesson. The existing perpetual charters of all three should be revoked, and Congress should switch Fannie Mae, Freddie Mac and the FHLBs to limited-life charters. Twenty years is the American tradition for such charters, beginning with Alexander Hamilton and the First Bank of the United States in 1791. This would set the charter expirations for Fannie, Freddie and the FHLBs in 2026.

2. Enhanced competition

Everyone agrees with the provisions of the current House and Senate bills that would abolish the Federal Housing Finance Board (the FHLB regulator) and the Office of Federal Housing Enterprise Oversight (OFHEO—the Fannie and Freddie regulator), and replace them with a new combined GSE regulator. Both the Finance Board and OFHEO have regulatory domains too narrow to make sense—they are equally unable to see the whole picture of the GSE sector and its huge global issuance of government-sponsored debt. Creating an overall view of the entire \$5 trillion housing GSE sector is a distinctly good idea.

However, creating stronger regulation in and of itself may have an ironic, unintended consequence: actually increasing confidence in the government’s commitment to the GSEs, strengthening even further the bond market’s unshakeable belief in the implied government guaranty.

In other words, the unintended result of strengthened regulation by itself could be to enhance the government-supported duopoly power of Fannie and Freddie, and indeed to support a rebound in their political clout.

To address this problem, I believe GSE reform legislation needs to become clearly pro-competitive, consistent with the fundamental principles of market economies. The deregulatory experience since the 1970s shows that greater productivity and consumer benefits have been created in many industries by forcing competition on hitherto comfortable oligopolies. A notable contrast to this trend has been the secondary mortgage market.

In order to achieve a competitive outcome, GSE reform legislation, in my view, should include the following.

□ It should clearly state that the intent of Congress, in addition to safety and soundness, is also to enhance competition. No one can disagree with this as a fundamental principle.

□ It should instruct the new combined GSE regulator that the development of its regulations must include the goal of promoting competition in the GSE sector.

□ It should add mortgage securitization to the explicit legal powers of the FHLBs. This provision would directly attack the duopoly power and economically excessive guaranty fees of Fannie and Freddie, give mortgage lenders more competitive pricing, and add choice to the secondary mortgage market.

□ It should give the new regulator the authority to issue as many new Fannie Mae and Freddie Mac-type charters as there are qualified and willing applicants, so that these charters are administered like those for national banks or federal savings and loans. This will ensure that the economic rents created by the charters are competed away to the benefit of the mortgage lenders and consumers. One or more of the FHLBs might spin off part of its operations into such a new charter.

3. Joint-venture logic

Former congressman J.J. Pickle, who had a lively interest in GSE issues, observed that for Fannie and Freddie, the risk is 99 percent public and the profit is 100 percent private. From the government’s point of view, what kind of a deal is that?

As has been discussed, every GSE is a deal between the government and the GSE’s shareholders, appropriately thought of as a joint venture. As with every joint venture, the

question must be asked: How are we going to divide the net profits? Certainly not zero–100. If the FHLBs’ 10 percent of profits affordable-housing contribution can be thought of as the government’s share of the profits, that would suggest 10–90. In the current House bill, the corresponding 5 percent affordable-housing contribution for Fannie Mae and Freddie Mac would suggest 5–95. But I suggest the government should be asking, “Why not 50–50?”

The right split should reflect what each partner brings to the profitability of the joint venture. How much of the net profit of Fannie, Freddie and the FHLBs is due to the credit support and special privileges granted by the government? That should define the joint-venture profit split.

4. The road to privatization

As part of its now-implemented privatization proposal, Sallie Mae put forward the concept of a “life cycle for GSEs.” The idea is that GSEs are formed to address some specific problem of the market of a given time (as has been discussed at length earlier). If they are successful, they lead the market to address the problem. Then they should cease to exist as GSEs and move on to a new life as a competitive private company without any special government-granted advantages. This is a very sensible approach. I think it should be applied to the housing GSEs.

In other words, GSEs should be, by nature, temporary institutions. We may recall the Roman hero Cincinnatus, who left the plow to become dictator and save the state, but when the crisis was over, went back to his farm. At a crucial time in the American founding, Cincinnatus was the heroic model for George Washington. So for GSEs: When they have addressed the problems of the time and helped the market develop new capabilities, they should cease to be GSEs and become private companies. We may think of this as either the “life cycle” or the “Cincinnatian” doctrine.

Thus, although it is unlikely in the near term, privatization of the GSEs is an idea whose time should ultimately arrive. The triggering event will probably be that, like Sallie Mae, one or more of the GSEs will decide that the economic advantages of their special charters are no longer worth the regulatory restrictions and burdens they entail. Or they may find that there are greater economic opportunities from competing freely in the private market, or both. If the government demanded a greater share of the joint-venture profits, the ideas of the GSEs would probably move in this direction. **NB**



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