

## Cato Institute Policy Analysis No. 293: The Mounting Case for Privatizing Fannie Mae and Freddie Mac

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### Executive Summary

Two of the largest government-sponsored enterprises (GSEs), the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), receive government subsidies estimated to be worth \$6 billion. Of that total, an estimated \$2 billion goes directly as income to shareholders and employees of Fannie Mae and Freddie Mac. By design, the remainder of the subsidy largely diverts investment into the middle- and upper-income housing sector and away from capital sectors of the economy.

Fannie Mae and Freddie Mac preserve their privileged status through a multi-million-dollar lobbying effort that includes massive "soft money" campaign contributions and the payment of exorbitant salaries to politically connected executives and lobbyists. The GSEs also protect their government-sponsored empire through millions of dollars of charitable donations to Washington advocacy groups.

Because of their quasi-governmental status, there is a market perception that Fannie Mae and Freddie Mac mortgage-backed securities and debt carry an implicit federal guarantee against default. Hence, the GSEs expose the federal taxpayer to an ever-increasing potential contingent liability that could ultimately cost tens of billions of dollars to rectify.

To remedy the situation, those GSEs should be stripped of the privileges of government sponsorship and be converted to fully private enterprises. The only remaining questions for analysis are when and how privatization should occur.

### *The Mission of Fannie Mae and Freddie Mac*

Two of the largest government sponsored enterprises (GSEs), the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), exist primarily for the purpose of creating a secondary market for mortgages.<sup>[1]</sup> A secondary market allows mortgage lenders to sell their loans, instead of requiring them to hold them on their books until maturity or full payment. For the mortgage lender there are two primary advantages to selling the mortgage after it has been made. First, selling the loan allows the institution to avoid the risk of mismatching the cost of money borrowed short term, primarily in the form of deposits or short-term debt, with the income earned long term on the loan--the so-called interest rate risk. Second, once the institution sells the loan, it no longer bears the risk of default--the so-called credit risk.

In turn, the mortgage GSEs pioneered a financial vehicle called securitization that allows them to bundle mortgages

into securities that are sold to investors. The securities are backed by the payment stream of the underlying mortgages. Through securitization, the GSEs have the option of avoiding interest- rate risk and credit risk by passing them on to the holders of the securities. However, the credit risk is generally retained by the GSEs by offering a guarantee to the securities holder against the mortgages going into default, a contract for which the GSEs receive a fee. The entire process becomes a cycle that feeds on itself:

1. Consumers obtain home mortgages from lenders.
2. Lenders sell mortgages to the GSEs or swap them for securities backed by the lenders' mortgages.
3. The GSEs generally bundle mortgages into mortgage- backed securities (MBS) and sell them to investors.[\[2\]](#)
4. With funds from the sale of the securities, GSEs buy more home mortgages from lenders.
5. With proceeds received from the GSEs for their mortgages or from the sale of the GSEs' MBS, the lenders make new loans to home buyers (i.e., cycle back to step 1).

Why did Congress first create Fannie Mae in the 1930s and later maintain government sponsorship for it after spinning it off from full government control in the 1960s? Members of Congress believed that private markets alone were incapable of supporting such financial institutions, and only through continued government sponsorship could such entities survive. The general notion of the ineffectiveness of private markets is referred to as market failure. In the case of the secondary market for mortgages, such market failures include the existence of nationwide credit shortages and market instability, regional credit imbalances and differences in interest rates, a thin and illiquid market, difficulties in assessing the credit quality of mortgages and the foregone positive externalities created by expanding homeownership opportunities.[\[3\]](#) Whether the arguments of market failure were true 30 or 60 years ago, they are much more suspect today. Given the spectacular pace of innovation in the financial markets, the GSEs now actually may impede innovation and competition rather than foster it.

To overcome the alleged market failures in the mortgage market, Congress has conferred valuable benefits upon the GSEs, which treat the agencies nearly as favorably as a government agency. Explicit benefits to Fannie Mae and Freddie Mac include

1. designation of GSE securities as "government securities" for purposes of the Securities Exchange Act of 1934[\[4\]](#) and the Federal Reserve Act,[\[5\]](#)
2. exemption from registration and reporting requirements of the Securities and Exchange Commission (SEC),[\[6\]](#)
3. exemption from state and local income taxation,
4. assignment under a low-risk category for bank and thrift risk-based capital and investment diversification standards,[\[7\]](#) and
5. availability of a \$2.25 billion line of credit from the Treasury Department.[\[8\]](#)

Fannie Mae and Freddie Mac also enjoy an implicit benefit that derives directly from their quasi-government status. This implicit benefit arises because the many legislative benefits give the GSEs the aura of a fully guaranteed government entity. The financial markets perceive that the debt and securities issued by those agencies carry a federal guarantee of payment if one of the GSEs were to default.[\[9\]](#) A good market-based indicator of the existence of that implicit benefit is contained in a recent study by Standard and Poor's to assess the rating that the GSEs would receive without such an implicit benefit. Without the benefit, the study concluded that Fannie Mae would be rated A- and Freddie Mac A+, but with government sponsorship providing an extra tier of protection against default, the GSEs' actual rating was AAA in the market.[\[10\]](#) That translates into a roughly 70 basis point advantage on debt and 40 basis point advantage on mortgage-backed securities.

Clearly, in bestowing such benefits on the mortgage GSEs, Congress is providing an economic subsidy to the institutions. As Aida Alvarez put it when she was director of the Office of Federal Housing Enterprise Oversight (OFHEO), the GSEs' primary regulator, "The phrase 'economic subsidy' is appropriate...even though the government writes no checks to either enterprise, because private investors would be willing to pay money for the same benefits. When the government provides economic benefits free of charge, it incurs an opportunity cost equal to the value of the benefits."[\[11\]](#) Those economic benefits make it unprofitable for other private, non-government-sponsored enterprises to compete with Fannie Mae and Freddie Mac and enable the GSEs to exist essentially in a duopoly market structure.[\[12\]](#) Thus, private nonsponsored companies are limited to competing in the "jumbo" market of mortgages that

exceed the ceiling placed on GSE mortgages or in the market for loans that do not conform to the GSEs' specifications.

As in most instances where government benefits are bestowed, certain conditions also are attached to GSE status, such as the imposition of a number of affordable housing program requirements; the imposition of a federal regulatory structure, including the payment of the expenses of the agency that maintains that regulatory structure;[\[13\]](#) the requirement that five board members be appointed by the president; the placement of a ceiling upon the size of mortgages that can be purchased in the secondary market, which currently stands at \$214,600 for a one-unit property;[\[14\]](#) and the requirement that any loan with a loan-to-value ratio exceeding 80 percent have either private mortgage insurance, a 10 percent seller-financed second mortgage, or available recourse to the primary lender in event of default.

Fannie Mae[\[15\]](#) is currently the largest financial institution in the United States at \$351 billion of assets, besting the largest of bank holding companies, Chase Manhattan at \$336 billion (as of year end 1996).[\[16\]](#) The majority of those assets were held in mortgages and mortgage-backed security holdings of \$286 billion. A major reason for Fannie Mae's large size is that it chooses to hold a large proportion of its mortgages in portfolio. Of the \$834 billion in total outstanding Fannie Mae mortgages (both in portfolio and in mortgage-backed securities), roughly 34 percent are retained in portfolio. The percentage has grown steadily over the past five years. The trend points to an increased level of interest-rate risk assumed by Fannie Mae.

As of December 31, 1996, Freddie Mac[\[17\]](#) held total assets of \$174 billion,[\[18\]](#) seemingly a great deal smaller than Fannie Mae. However, Freddie Mac chooses to hold a smaller percentage of its total outstanding mortgages of \$611 billion, with 23 percent held in portfolio, but has recently accelerated its efforts in this area to reach parity with Fannie Mae.

### ***The Privatization Reports***

Recent legislation required several government agencies and departments to publish studies on the potential effects of privatization of Fannie Mae and Freddie Mac.[\[19\]](#) These included reports by the Comptroller General of the United States (GAO Report), the Secretary of Housing and Urban Development (HUD Report), the Secretary of the Treasury (Treasury Report), and the Congressional Budget Office (CBO Report) (collectively, Privatization Reports).[\[20\]](#) The legislation defined the term privatization as the "desirability and feasibility of repealing the Federal charters of [Fannie Mae] and [Freddie Mac], eliminating any Federal sponsorship of the enterprises, and allowing the enterprises to continue to operate as fully private entities."

#### ***The HUD Report***

Of the four reports, the HUD Report, in tandem with supporting testimony given July 24, 1996, by Nicolas P. Retsinas, federal housing commissioner and assistant secretary for housing, gives the most forceful argument for maintaining the current structure of the GSEs. The HUD Report voices skepticism about the benefits of removing government sponsorship and emphasizes the benefits derived from maintaining Fannie Mae and Freddie Mac's special status. The report's broad conclusion is "that there is no compelling reason to fully privatize Fannie Mae and Freddie Mac at this time. Specifically, the benefits achieved from full privatization would not offset the financial uncertainties and likely increases in borrowing costs that would be associated with full privatization."[\[21\]](#) However, unlike the other legislatively mandated reports, the HUD Report does not provide independent or quantified estimates of the balancing of costs and benefits of GSE status.

#### ***The Treasury Report***

The Treasury Report, in tandem with supporting testimony given July 24, 1996, by Lawrence Summers,[\[22\]](#) deputy treasury secretary, takes a middle ground position. It does not explicitly support maintaining the status quo as the HUD Report does, but it also does not present a strong case for privatization. The Report concludes that "the secondary market for conforming, conventional mortgages could operate efficiently and effectively even if Fannie Mae's and Freddie Mac's government sponsorship were altered,"[\[23\]](#) and "firm conclusions regarding the desirability of ending or modifying government sponsorship of Fannie Mae and Freddie Mac are premature."[\[24\]](#)

The Treasury Report calculates that the pretax benefits of government sponsorship conferred upon the GSEs total almost \$6 billion a year. But only roughly \$4 billion of that benefit is passed on to home buyers in the form of lower mortgage rates.<sup>[25]</sup> Thus, approximately \$2 billion a year in pretax income accrues to the benefit of the government-sponsored enterprises, an arrangement that allows them to earn above-normal profits considering the degree of risk assumed (see Table 1). Such estimates do not include the added value provided by the GSEs through affordable housing activities.<sup>[26]</sup> The figures suggest that the GSEs are a highly inefficient method of subsidizing homeownership.

**Table 1**  
**After-Tax Return on Equity in the Financial Services Industry (percentage)**

	1995	1994	1993	1992	1991	1990
Fannie Mae	23.1	24.3	25.3	26.5	27.7	33.9
Freddie Mac	21.9	23.2	22.2	21.2	23.6	20.4
FDIC-Insured Comm. Banks	14.7	14.6	15.3	13.0	7.9	7.5
FDIC-Insured Savings Institutions	9.4	8.3	9.2	9.5	1.3	-6.7
S&P 500	NA	19.3	14.6	12.6	10.3	14.2
S&P Financial	NA	NA	13.5	10.5	9.4	9.2

Source: Treasury Report, pp. 40-41.

Note: NA = not available.

An early draft of the Treasury Report that showed more support for privatization was reportedly revised because of a heavy lobbying effort by the GSEs themselves. The pressure was applied at meetings on May 4 and 11, immediately before a scheduled May 15, 1996, release date of the Treasury Report, at which Fannie Mae executive vice president Robert Zoellick and other executives of Fannie Mae and Freddie Mac heavily lobbied Deputy Treasury Secretary Summers. Ultimately, the report was altered and submitted after the May 15 deadline.<sup>[27]</sup> Rep. Richard H. Baker (R-La.), chairman of the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises of the House Committee on Banking and Financial Services, complained when the study was released, "I am convinced that, for whatever reason, this report has been rewritten, reaches no conclusions, ignores the changes in the marketplace that have occurred, and gives little direction to this subcommittee for a prompt response to the circumstances we face."<sup>[28]</sup>

### ***The GAO Report***

The GAO Report, with supporting testimony given on June 12, 1996, by James L. Bothwell, director of financial institutions and markets issues, makes a number of conclusions regarding the removal of government sponsorship. The report does not make any specific recommendation that privatization would be preferable to the status quo, but does present it as a viable policy option.

The GAO Report concludes that if the various benefits bestowed upon the enterprises are removed it would increase the enterprises' costs and affect their activities. Nearly all of these benefits (80 to 95 percent) result from lower funding costs for enterprise debt and mortgage-backed securities due to the perceived implicit guarantee.<sup>[29]</sup>

The increase in the GSEs' costs would cause mortgage interest rates to increase by roughly 15 to 35 basis points because the enterprises would pass the previously noted higher costs on to home buyers. That would translate into increased costs for a typical mortgage holder of a \$100,000 mortgage of \$10 to \$25 per month. But the elimination of the cost advantage enjoyed by the enterprises, which to this point had been a barrier to entry for new entrants, would also prompt new entrants into the market.<sup>[30]</sup>

The GAO Report also concludes that removing government sponsorship would remove one method of federal policy to channel mortgages to targeted borrowers such as low- and moderate-income borrowers.<sup>[31]</sup>

## *The Congressional Budget Office Report*

The CBO Report and supporting testimony by Director June O'Neill on June 12, 1996, not only recognize the costs of granting GSE status, but also reveal skepticism of any benefits in the form of lower interest rates to homeowners. The Report notes that the GSEs "are not the source of that benefit. Rather, the housing GSEs are a vehicle for conveying a subsidy to intended beneficiaries."[\[32\]](#) The CBO Report also questions GSE claims that if government sponsorship is removed, mortgage markets would not be as stable as they currently are and notes that the affordable housing initiatives undertaken by the GSEs could be accomplished by fully private firms, or by other government programs after repeal of government sponsorship.[\[33\]](#)

The CBO Report estimates that the various subsidies to Fannie Mae and Freddie Mac are worth approximately \$6.5 billion a year, of which about \$4.4 billion is passed through to home buyers in the form of lower mortgage rates. The remaining \$2.1 billion difference is retained, accruing to the benefit of the GSEs, a phenomenon that prompts the CBO to label Fannie Mae and Freddie Mac as "spongy conduits" (see Table 2).[\[34\]](#) In other words, the GSEs are an expensive method of assisting home buyers. Ultimately, the report concludes that "scant evidence exists of public benefits from the GSEs that would justify a retained taxpayer subsidy that is more than \$2 billion annually."[\[35\]](#)

The report also emphasizes the limitations of the GSEs' federal regulator, OFHEO, in regulating the enterprises, and thus protecting the interests of taxpayers.[\[36\]](#) Finally, the report notes that because of dramatic innovations that have occurred in the mortgage market since the GSEs were created, the case for Fannie Mae and Freddie Mac's GSE status is weaker today than 30 years ago and policymakers should weigh the desirability of continuing to provide the current subsidy.[\[37\]](#)

**Table 2**  
**CBO Analysis of the Subsidy to Fannie Mae and Freddie Mac (dollars in billions)**

	Fannie Mae	Freddie Mac	Total
Subsidy-debt	1.9	0.7	2.6
Subsidy-MBS	2.0	1.8	3.8
Total Subsidy	3.9	2.6	6.5
Passed through to Home Buyers	2.5	1.9	4.4
Retained Subsidy	1.4	0.7	2.1
Subsidy (percentage of net income)	41.1%	44.9%	42.3%

Source: CBO Report, p. 19.

Note: Net income, before taxes and gifts.

## *The Empire Strikes Back*

The GSEs' response to the four reports varied depending upon whether or not the authoring agency or department was seen as endorsing the status quo of the GSE structure. For example, Fannie Mae's response to the HUD and Treasury reports was that "HUD has affirmed the valuable support for housing and homeownership provided by Fannie Mae, and the Treasury recognized the many uncertainties associated with the analysis [of privatization issues] and the great risks of tinkering with a system that works well."[\[38\]](#) In contrast, the response to the CBO Report by David Jeffers, vice president for corporate relations at Fannie Mae, noted: "This is the work of economic pencil brains who wouldn't recognize something that works for ordinary home buyers if it bit them in their erasers."[\[39\]](#)

Robert Zoellick, the executive vice president of Fannie Mae, echoed that harsh assessment of the CBO Report with testimony on July 31, 1996.[\[40\]](#) As a summary critique of the report, he noted that "accounting, by its double entry nature, assumes a zero sum logic: if one party benefits, the other must lose. In fact, Fannie Mae, like the rest of the business world, is an example that the whole can be greater than the sum of its parts. In the lexicon of business, the corporation 'adds value' beyond the mere sum of its inputs (or advantages). Once one acknowledges this dynamic

analysis--instead of the static, accounting-type straightjacket most typified by CBO's report--it is apparent that the benefits Fannie Mae provides to the public and its shareholders exceed the alleged numbers assigned to its charter advantages." [41] Zoellick later referred to the CBO Report as "a polemic . . . [that] appears to reflect a bias against housing that is found among some economists, who believe that, as a nation, we have invested too much in the housing sector." [42]

Amazingly, Zoellick also pretended that Fannie Mae and Freddie Mac are not subsidized institutions, noting that the GSEs "do not receive any federal subsidies,...[and their] debt is not guaranteed by the federal government." He also noted that "the companies do not receive one cent from the taxpayer," "there are no dollar outlays or specific guarantees that can be priced" and "[t]hat is why [HUD, Treasury, CBO, and GAO] came up with such inconsistent and divergent estimates." [43]

Thus, Fannie Mae contends that it "is impossible to accurately measure the value of a subsidy that does not explicitly exist. However, it is possible to identify the many tangible benefits Fannie Mae provides to American home buyers. Taken together, these benefits create a whole that is substantially greater than the sum of its parts." [44]

Fannie Mae also notes that the GAO, Treasury, and HUD reports all point out the inherent riskiness to housing finance and the capital markets of repealing the federal charters of the GSEs. This riskiness results from the size of the GSEs and their unique role in the housing market. [45] If the market lacked competition, then there might be a justification for taking on such risk. But Fannie Mae notes that there is no evidence that the enterprises exercise market power. [46]

Finally, Fannie Mae takes issue with the contention that it, along with Freddie Mac, constitutes a duopoly structure. It argues that looking at the market for conventional, conforming mortgages securitized (of which Fannie Mae and Freddie Mac essentially constitute the entire market) is improper, and that a more accurate picture of market structure is seen by adding in the market for nonsecuritized mortgages. [47] Finally, Fannie Mae touts the fact that "[e]very year since 1985, *Forbes* magazine has rated Fannie Mae as the nation's most productive financial services company" [48] as evidence that its market is vigorous and competitive.

### ***The Economic Case against the Mortgage GSEs***

In today's mortgage marketplace, Fannie Mae and Freddie Mac's case for a never-ending stream of federal subsidies is unpersuasive. Preserving the GSEs' protected governmental status can no longer be justified on either equity or efficiency grounds.

#### ***How the GSEs Reduce Economic Efficiency***

When Congress creates income redistribution programs, it levies taxes on or borrows from one group to redistribute to another. Similarly, when Congress subsidizes a particular type of lending, it redistributes credit from higher return investments to relatively lower return investments. In the case of the GSEs, Congress, through Fannie Mae and Freddie Mac, intentionally encourages homeownership by lowering interest rates for housing, but it raises interest rates on all other types of credit.

Contrary to the GSEs' claims, such intervention does not come without costs. The Treasury Report states these costs succinctly: "While the benefits of GSE status provide an important subsidy that promotes homeownership, such a subsidy has economic costs. To the extent that the GSEs pass through the benefits of government sponsorship, they reduce the price of, and increase the demand for, mortgage credit relative to other types of credit. The economic effect of the subsidy to mortgage credit--absent increases in the savings pool or attracting capital from abroad--is to raise the price or reduce the amount of credit for other uses, such as small businesses, exporters, rural communities, and other business and consumer borrowers." [49] Thus, eliminating the GSE status of Fannie Mae and Freddie Mac would actually be a net gain for those who do not have either the resources or the desire to become home buyers, but borrow for other purposes, because nonhousing rates will be lower. The GSEs argue that lower mortgage rates are the ultimate free lunch, but the GSE structure encourages investment in the housing sector only at the expense of investment in other sectors. [50]

As a further example of this zero-sum process, assume that Congress comes to the conclusion that the Internet is such

a superior and efficient form of technology that it wants to encourage investors to direct more funds into the technology to perfect it--i.e., no more problems connecting to a service provider, no more difficulty pulling up web pages, more efficient search engines. Congress could do so by either explicitly or, as in the case of the GSE structure, implicitly guaranteeing the debts of any company that engaged in such technology. Either of those choices would cause capital to flow to Internet-related companies, thereby reducing interest rates for such companies, and presumably they would pass along some of the benefits to their customers. But, because there has been no increase in the available supply of credit, credit for non-Internet-related activities would shrink and interest rates in those sectors would increase.

Hence, the CBO and others who critique the GSE structure do not, as Fannie Mae charges, express a bias against housing. Rather, it is the GSEs that want to perpetuate a bias in favor of investment in the housing sector.

Nor is it true that without the GSEs the secondary market for home mortgages would not function properly. Today, without the prodding or intervention of Congress, a robust secondary market for automobile loans has developed on its own, in the private sector, with securitized automobile loans outstanding growing from roughly \$18 billion in 1989 to \$44 billion in 1995.<sup>[51]</sup> Fannie Mae states that the GSE structure adds value beyond the sum of its individual parts. But if the GSEs lost their government sponsorship, any private sector elements and efficiencies inherent in Fannie Mae or Freddie Mac's structure would survive through to a fully privatized entity.

### ***Fannie Mae and Freddie Mac as Duopolists***

In the market for securitizing conventional conforming mortgages, Fannie Mae and Freddie Mac clearly constitute a duopoly--an industry dominated by only two competitors. The standard tool used in analyzing the degree of market power is the Herfindahl-Hirschman Index.<sup>[52]</sup> It reveals the relative degree of concentration in an industry, with pure monopoly markets having an index reading of 10,000 and relatively competitive markets having a reading under 1,800. In a study commissioned by the agencies responsible for the Privatization Reports, the authors (Hermalin & Jaffee) calculate that the Herfindahl index for the market for securitizing conventional conforming mortgages stands at roughly 5,000.<sup>[53]</sup>

As a basis of comparison, if a merger is contemplated that results in an index of 1,800 or more it will generally raise the interest of the Justice Department's antitrust division. The jumbo market, made up of companies performing the same activities as Fannie Mae and Freddie Mac, but for loans over their \$214,600 limit, does not have the barriers to entry present in the market for conforming mortgages, and thus has a Herfindahl index reading of roughly 1,200. Hermalin and Jaffee conclude that Fannie Mae and Freddie Mac are best described as tacitly colluding duopolists, while the jumbo segment of the market is competitive.<sup>[54]</sup>

The market concentration commanded by Fannie Mae and Freddie Mac would not be a problem if it were the result of its ability to outperform its rivals in the free and open marketplace. But that is not the explanation for the duopoly status of Fannie Mae and Freddie Mac. Rather, other participants in the financial services industry cannot compete with the GSEs because of the benefits of their quasi-government status. The special advantages conferred upon the GSEs effectively lock out all other private firms from the narrow band of activities of purchasing mortgages under \$214,600 in the secondary market and securitizing them. The only way to have a truly competitive market is to eradicate those barriers so the conforming market can emulate the competitiveness of the jumbo market.

A related danger of the duopoly regime of Fannie Mae and Freddie Mac is that their huge size and market concentration would cause a severe disruption to the housing market if one of them were to fail. As a result those entities, as they are currently constituted, are perceived to be "too big to fail."<sup>[55]</sup> That means that in the event of a financial collapse of either or both of the GSEs, Congress could be persuaded to ill-advisedly "bail them out," as in the case of Chrysler, requiring loan guarantees or costing federal taxpayers billions in outlays. Fragmenting the market by introducing competition would reduce the likelihood of such a bailout by ensuring that no one company's failure would be viewed as disastrous.

### ***The GSEs Help the Relatively Affluent, Not the Poor***

The \$4 billion of benefits passed along to home buyers, like the tax deduction for home mortgage interest, goes largely

to benefit middle- and upper-income households. Nearly 90 percent of the \$51 billion of benefits of the home mortgage interest deduction in the tax code benefits households with over \$50,000 of income, a sector comprising only 25 percent of households.[\[56\]](#) Similarly, an analysis of Fannie Mae and Freddie Mac's relative percentages of loan purchases from lower income groups shows levels far below other government secondary market participants, commercial banks, and savings and loans (see Table 3).[\[57\]](#) Only about 13 percent of homeowners benefitting from the GSE structure have incomes below 80 percent of the median family income and thus meet the general definition of lower income, compared with 24 percent for commercial banks and 23 percent for life insurance companies. The same analysis concluded that of the GSEs' total purchases of mortgages less than 3 percent are from black borrowers and less than 4 percent are from Hispanic borrowers, again percentages well below those of other market participants. Thus, an analysis of the benefits passed along to home buyers reveals a classic case of white, middle- and upper-class welfare.[\[58\]](#)

**Table 3**  
**Secondary Market Participants' Loan Purchases from Borrower Groups (1991-94)**

	Lower Income	Black	Hispanic
Ginnie Mae	33.5	8.8	7.7
Farmers Home Administration	31.9	4.2	4.9
Commercial Banks	23.9	6.4	4.6
Other Purchasers	22.6	6.0	5.3
Life Insurance Companies	23.1	8.1	5.0
Savings and Loan Companies	19.1	4.0	3.3
Fannie Mae	13.4	2.7	3.8
Affiliate Institutions	16.4	4.1	2.9
Freddie Mac	13.1	2.1	3.9

Source: Treasury Report, p. 59. This material was drawn primarily from various Federal Reserve studies undertaken by Glenn B. Canner, Wayne Passmore, and Dolores Smith.

Note: Lower income denotes less than 80 percent of the median income. Table does not reflect data after 1994 that may show the continued effects of a variety of affordable housing goals imposed on the GSEs.

### *The GSEs as Corporate Welfare*

The process of estimating the benefits bestowed upon the GSEs undertaken in the CBO, GAO, and Treasury reports was difficult.[\[59\]](#) The estimates do vary. But the GSEs' regulator, OFHEO, an agency that would be considered a neutral party in the debate, reviewed the estimates and noted that the methodologies used were reasonable.[\[60\]](#)

Both the CBO and Treasury reports agree that the GSE structure benefits Fannie Mae and Freddie Mac to the extent of \$6 billion, of which roughly \$2 billion is retained--meaning that this portion of the subsidy benefits Fannie Mae and Freddie Mac shareholders, executives, and employees, not homeowners. That is why government subsidies to the GSEs are one of the most expensive forms of corporate welfare in Washington today.[\[61\]](#)

### *The GSEs as Financial Time Bombs*

The GSEs typically dismiss their critics by noting their evident sound financial health. Fannie Mae's Robert Zoellick testified before Congress that the GSEs "do not receive one cent from the taxpayer." That statement ignores the fact that Fannie Mae and Freddie Mac are taking on risks that, under pressure of the implicit guarantee, expose taxpayers to a large contingent liability.[\[62\]](#) In that case, the contingent event is the failure of one of the GSEs. The creation of the contingent liability or taxpayer exposure because of the existence of an implicit guarantee is noted in the HUD, CBO, GAO, and Treasury Reports.[\[63\]](#) Yet, the GSE structure is a popular mechanism for Congress to deliver public benefits



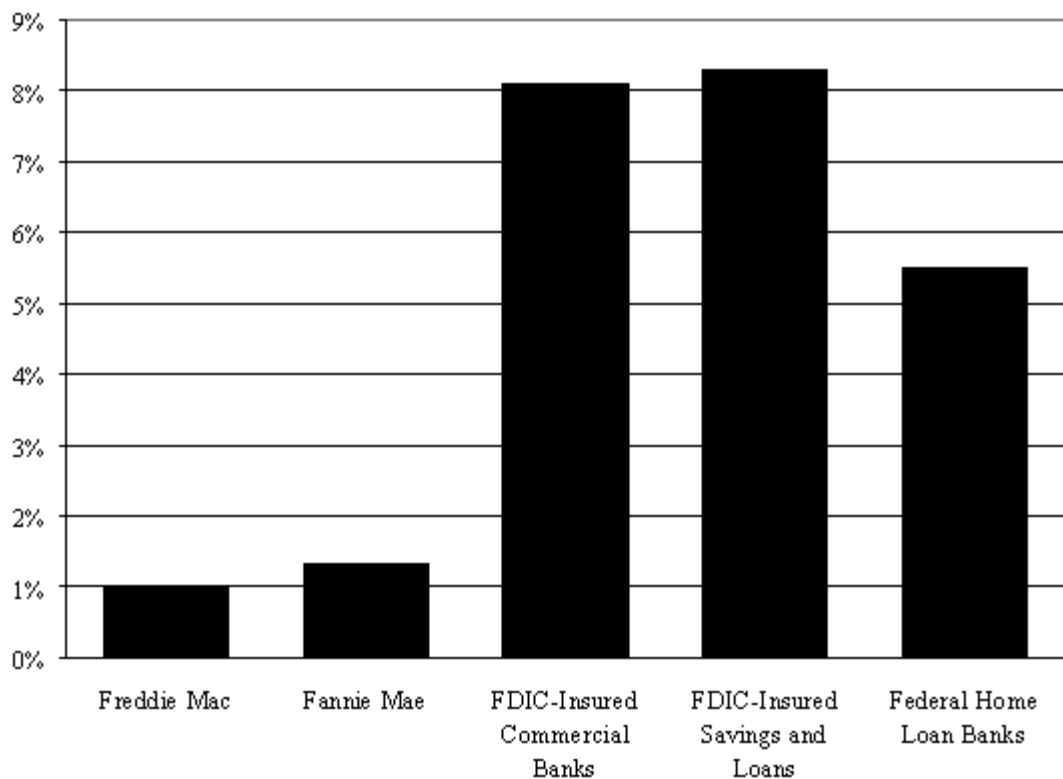
precisely because the costs are hidden "off-budget." This has been called the "subterfuge" reasoning for creating such GSEs.[\[64\]](#) In fact, the entire structure of the GSEs, whereby Congress offers special status in return for the government as a whole taking on a hidden, contingent liability as a quid pro quo for various housing programs that never hit the budget, acts as a back-door method to increase spending on housing without having to go through the appropriations process.

So the real issue is whether there is any likelihood of one of the GSEs failing. As federal taxpayers have discovered time and again, the government's contingent liabilities often do require expensive bailouts. There are precedents for the failure of a government-sponsored enterprise. The insolvency of Fannie Mae in the late 1970s and early 1980s, combined with the bailout of one of the farm-related GSEs, the Farm Credit System, in the late 1980s, highlight the possibility of a failure. Both of those periods of financial difficulty occurred during times of systemic problems in the sector served by the GSEs. It is estimated that Fannie Mae was insolvent by approximately \$11 billion in 1981, a time of volatile mortgage rates.[\[65\]](#) The farm-related GSE known as the Farm Credit System experienced financial difficulties during the 1980s, a time of systemic difficulties for the agricultural industry. The problems of the Farm Credit System required a "bailout" of approximately \$5 billion.[\[66\]](#) Clearly, the possibility of the failure of a GSE is more than a theoretical notion.

If Fannie Mae or Freddie Mac required a bailout, the impact would clearly be analogous, from a federal budget standpoint, to the recent difficulties of the Federal Savings and Loan Insurance Company: a steady stream of positive receipts shown on the federal budget for a period of time and then tens of billions of dollars of outlays during a time of systemic difficulties.[\[67\]](#)

The highly leveraged nature of the GSEs adds to the solvency concerns. Fannie Mae and Freddie Mac are comparatively more leveraged than their financial counterparts (see Figure 1). In defense of the GSEs, the comparison overstates the risk-based difference in leverage between the GSEs and other financial institutions, because their activities are less risky than those of other financial institutions.[\[68\]](#) For example, mortgage-backed securities require a relatively small amount of capital to insure against risk, given their low risk compared to other types of assets.

**Figure 1**  
**Capital-to-Asset Ratios as of December 31, 1995**



Source: HUD Report, p. 170. The calculations for Freddie Mae include sold portfolio and for Fannie Mae, mortgage-backed securities outstanding.

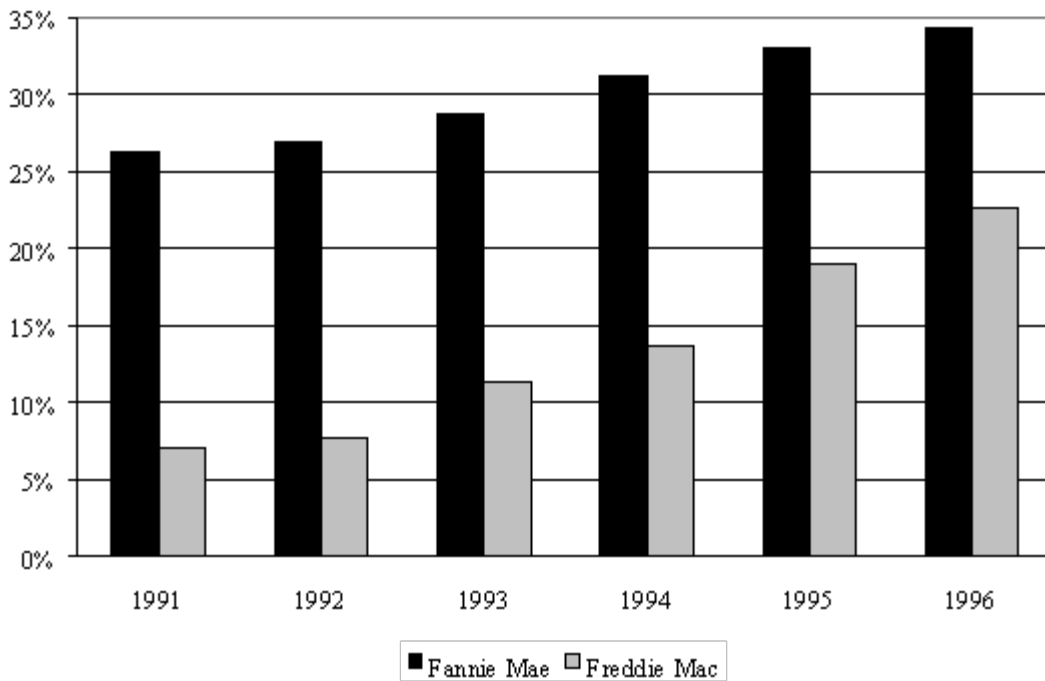
During 1996, OFHEO, the GSEs' regulator, released a proposal for risk-based capital requirements for Fannie Mae and Freddie Mac.<sup>[69]</sup> The final capital regulations must balance sharply divergent pressures. On one hand, the GSEs must be sufficiently capitalized to endure a period of volatile interest rate fluctuations, thus assuring that taxpayers will not be required to extend financial assistance. Alternatively, under pressure from the GSEs, they must not make the capital requirements so high that they cause Fannie Mae and Freddie Mac to reduce their leverage and thus drastically reduce their currently lofty returns on equity.

### ***Recent Trends in Risk Assumption***

During the 1990s, the GSEs have taken on greater risks that may ultimately threaten their viability in light of their comparatively more leveraged capital position. One example is the practice of holding an increasingly higher proportion of their assets in portfolio (see Figure 2). Fannie Mae currently holds roughly 34 percent of its \$834 billion in total outstanding mortgages in portfolio, as opposed to selling them through securitization. This percentage is up from 26 percent in 1991.

The percentage of loans held in portfolio at Freddie Mac has risen from 7 percent in 1991 to nearly 23 percent at the end of 1996. Financing mortgages with debt is generally more profitable than securitizing the loans.<sup>[70]</sup> But holding assets in portfolio causes the GSEs to be exposed to both interest rate risk and credit risk; securitization combined with a guarantee exposes them only to credit risk. Certain hedging techniques, such as entering into derivatives contracts, do reduce interest rate risk, but they of course do not completely eliminate it.<sup>[71]</sup> Furthermore, as noted in a recent summary by the Office of Management and Budget, derivatives "increase [the GSEs'] exposure to counterparty, currency, and other risks and make managing the risks in their portfolio more complex."<sup>[72]</sup>

**Figure 2**  
**Percentage of Loans Held in Portfolio**



Source: Fannie Mae, p. 66, and Freddie Mac, pp. 2-3--Annual Reports, 1996.

Another area where the GSEs are increasing their risk is the purchase of loans with high loan-to-value ratios. Over the past few years there has been an increasing trend of loans purchased with high loan-to-value ratios at the time of origination, and a decreasing trend of loans purchased with low loan-to-value ratios.<sup>[73]</sup> The higher the loan-to-value ratio, the less capital the borrower has at risk, and the higher the credit risk for the holder. A high loan-to-value ratio is a strong predictor of future default on a loan. This increasing trend has been to a large degree due to a reduction in the number of refinancings the last few years, loans that tend to have lower loan-to-value ratios. But it also may be due to pressure applied to the GSEs to extend affordable housing credits, which have higher delinquency rates.<sup>[74]</sup>

Freddie Mac also is pushing headlong into the subprime mortgage market, which involves lending to riskier applicants who have been late on paying monthly credit cards or other debt. Freddie Mac plans to buy up to \$2.5 billion of such loans in the coming year and ultimately take a 50 percent market share in the subprime market.<sup>[75]</sup>

The key question is not whether the GSEs, as privately owned corporations, should be engaging in risk-taking activities such as holding a higher share of loans in portfolio, taking on mortgages with high loan-to-value ratios, or purchasing mortgages extended to borrowers with shaky credit histories. The proper question is whether the federal government should assume the downside risk of the failure of one of the GSEs. Only by fully removing government sponsorship can this risk be eliminated.

### *The GSEs' Expanding Empire*

It is clear that many of the activities that the GSEs are getting involved in are increasing their risk exposure. But some activities are also getting the GSEs increasingly far afield from what has been the core of their existence--to sustain a liquid secondary market by buying high-quality mortgages in an effort to facilitate home purchases. Some of the new ventures can be described as an abuse of charter privileges, often testing the outer limits of the GSEs' statutory directive. For those institutions already serving such markets, competing with giants like the GSEs, with their preferential borrowing rates and tax exemptions, becomes difficult.

Freddie Mac's foray into the subprime market, just discussed, is a departure from limiting GSE activities to high-quality purchases. More specifically, the charters of Fannie Mae and Freddie Mac limit mortgage purchases to loans "of such quality, type, and class to meet, generally, the purchase standards imposed by private institutional mortgage investors."<sup>[76]</sup> A major justification for this limitation is to reward those home purchasers who have maintained a

strong credit standing. Furthermore, limiting purchases to high-quality mortgages also reduces potential taxpayer exposure if one of the GSEs fails.

Another example of an activity distant from the secondary market function is the practice of taking on debt to purchase corporate bonds in an effort to capture the spread or rate differential between the preferential GSE borrowing rate and the rates paid on the bonds. For example, Freddie Mac recently borrowed \$125 million at 6.99 percent and then purchased \$125 million of identical maturity corporate bonds at 7.68 percent. [77] It also recently purchased \$340 million of Philip Morris debt, part of a \$10 billion proposed inventory of non-housing-related long-term investment instruments. The bonds were quickly sold when Chairman Jim Leach criticized the move as "a government-sponsored hedge-fund and arbitrage operation," but Freddie Mac plans to continue the program with more "politically correct" investments. [78]

In response to Representative Leach's criticisms, Freddie Mac CEO Leland Brendsel noted that "[r]aising funds at one rate and investing those funds in a higher rate is not arbitrage--it's the fundamental way all financial institutions operate." That may be the case, but clearly such a move is an abuse of the privileges of GSE status. Such actions are reminiscent of abuses of the government student loan program whereby well-off families, fully capable of paying education costs, drew student loans specifically to invest the proceeds at a higher rate, to capture the resulting differential.

Additionally, Fannie Mae now offers and stands ready to buy reverse mortgages. [79] The product, primarily marketed to elderly homeowners, is the opposite of a normal mortgage, in that the value of the home can be drawn out by receipt of regular monthly payments. Such a product has no connection to the goal of assisting home ownership; instead it targets those who already own their own home. The same criticism can be leveled at the entrance of the GSEs into the home equity market. [80]

Finally, Fannie Mae recently attempted to enter the insurance business through what it called the Mortgage Protection Plan. [81] The program would have offered first-time homebuyers a purportedly "free" package of insurance services, including credit life insurance which would pay off a mortgage if the borrower dies, as well as disability and unemployment insurance. After criticism by Representative Leach that the program would allow Fannie Mae to lend money raised at agency rates to the insurance industry under the guise of life insurance, the program was modified to a much smaller, targeted affordable housing product. Representative Leach noted that Fannie Mae "sought unilaterally to expand their authority" with the move. [82]

### *The GSEs' Expansive Political Empire*

The GSEs argue that all the benefits of their quasi-government status are passed on to home buyers in the form of lower interest rates. But a clear indicator of how much the agencies actually benefit from government sponsorship is noted in the degree of effort they expend to maintain it. In fulfilling their fiduciary capacity to shareholders, management of the companies vigilantly guards against assaults on its protected status. The CBO has noted: "Not only do the managements of Fannie Mae and Freddie Mac have a fiduciary responsibility to defend shareholder interests, but their own financial interests and compensation are closely linked to the continued flow of federal subsidies to the enterprises. Thus, the greatest risk facing the management and shareholders of the housing GSEs is that Congress might act to reduce those subsidies or the GSEs' ability to retain them." [83]

In the past year during which various reports and testimonies have surfaced regarding their potential privatization, the GSEs have written editorials, [84] given testimony, [85] and lobbied heavily with their executives, including their dozen employees who are registered lobbyists under the Lobbying Disclosure Act of 1995 and numerous political consultants under contract. [86] As the CBO Report notes, the lobbying activity "seem[s] aimed at ensuring the flow of federal benefits to the enterprises in perpetuity." [87]

The issue of lobbying to maintain their current status highlights the desire of the GSEs to enjoy the best of both worlds, in a gray area of a quasi-private and quasi-public institution. The GSEs claim to be private companies when they engage in extensive lobbying activities, which a government agency would be heavily criticized for. [88] Yet their lobbying is a clear instance of using benefits that accrue from government sponsorship to fund activities designed to maintain the continued flow of government largesse. This is an activity Rep. David McIntosh (R-Ind.) refers to as

"funding welfare for lobbyists." Fannie Mae alone spent \$1.9 million in the first six months of 1996 on the explicit costs of lobbying.[\[89\]](#)

One example of Fannie Mae and Freddie Mac's lobbying muscle was its apparent success in persuading the Treasury Department to modify its report on the GSEs and tone down the pro-privatization language in the original draft.[\[90\]](#)

**Table 4**  
**Key Alumni of Fannie Mae**

Name	Position	Former Position
Franklin Raines	Director of the Office of Management and Budget	Vice chairman of Fannie Mae from 1991 to 1996
William Daley	Secretary of Commerce	Presidentially appointed director of Fannie Mae
Ellen Seidman	Special assistant to President Clinton for economic policy, who reportedly took part in the review of the Treasury and HUD reports; currently the director of the Office of Thrift Supervision	Fannie Mae senior vice president from 1987 to 1993
John Buckley	Communications director for former Sen. Bob Dole's presidential bid; press secretary for Rep. Jack Kemp	Senior vice president of communications with Fannie Mae; recently returned to his position at Fannie Mae

Source: "The Fannie Mae Government-in-Waiting," *Institutional Investor*, September 1996, p. 51 [hereinafter, Government-in-Waiting]; "Wall Streeters in Washington," *Institutional Investor*, September 1996, p. 54.

Another example of such lobbying came in early 1996 to block efforts to promote a flat tax that would eliminate the home mortgage interest deduction. Fannie Mae and Freddie Mac, along with the National Association of Realtors and the National Association of Home Builders, under the pseudonym of the Coalition to Preserve Home Ownership, sponsored \$270,000 of advertisements in Iowa and New Hampshire during the Republican primary season on behalf of the mortgage interest tax deduction.[\[91\]](#) The home-mortgage interest deduction directs more investment dollars toward housing expenditures, which benefits the GSEs. The idea that a government-subsidized organization would use its funding to try to influence election outcomes certainly violates the spirit of a democratic society, if not the letter of campaign finance laws.

The GSEs' lobbying resources were also evident in a recent battle over charging the GSEs a fee in exchange for their status. There is a clear argument that charging the GSEs a fee for their status is justifiable and feasible.[\[92\]](#) The GSEs have put up a heavy lobbying effort, claiming that such a fee is a "tax on homeownership."[\[93\]](#) Similar lobbying efforts were evident in the defeat of Rep. Jim Leach's proposal to require the GSEs to contribute to the efforts to restructure the bank and thrift insurance funds, although the link to Fannie Mae and Freddie Mac in such a contribution is not as clear as in the case of charging a fee for their status.[\[94\]](#)

To carry out their lobbying efforts, Fannie Mae, in particular, wields an inordinate level of political clout on both sides

of the aisle, as evidenced both by alumni of the agency and by those who currently work there. The alumni list reads like a who's who in Washington, as shown in Table 4.

One might easily conclude that some senior executives at Fannie Mae were chosen as much on the basis of their political clout as their financial prowess. The most recent example of this is the hiring of Jamie Gorelick, former deputy attorney general, to fill Franklin Raines' former position as vice chairman at Fannie Mae. An article in a financial trade publication noted that Gorelick is "well-versed in the ways of Washington" and thus will be able to "fight for Fannie Mae on Capitol Hill." [95] What the article neglected to note was Gorelick's lack of experience in finance or the mortgage markets. [96] Those currently working for Fannie Mae who formerly held weighty political positions are listed in Table 5.

**Table 5**  
**Political As Well As Financial Talents**

Name	Current Position	Former Position
James Johnson	Chairman and CEO of Fannie Mae	Campaign manager of the Mondale for President campaign; executive assistant to Vice President Mondale
Jamie Gorelick	Vice chairman of Fannie Mae	Deputy attorney general; general counsel, Defense Department
Robert Zoellick	Executive vice president and general counsel of Fannie Mae	Deputy White House chief of staff under President Bush; State Department counselor, undersecretary of state and counselor to the secretary under Secretary Baker; and deputy assistant secretary at the Treasury Department under Secretary Baker
Ann McLaughlin	Fannie Mae non-Presidentially appointed Board member	Labor Secretary under President Reagan
Mary Cannon	Vice president of Fannie Mae	Assistant secretary of HUD for public affairs; assistant to secretary of HUD for policy and communications and Legislative Director, all under Jack Kemp
Duane Duncan	Vice president and director of government affairs at Fannie Mae	Staff director for Rep. Richard Baker (R-La.), chairman of the subcommittee with jurisdiction over the GSEs
David Dworkin	Director of policy communications at Fannie Mae	Acting deputy assistant secretary of State under President Clinton
Wendy Sherman	President of the Fannie Mae Foundation	Assistant secretary of state for legislative affairs under President Clinton

Source: "Clinton Names Chair and Members of Advisory Committee on Critical Infrastructure Protection," *U.S. Newswire*, June 6, 1997; Fannie Mae, "Notice of Annual Meeting of Stockholders--May 16, 1996," March 25, 1996, p. 8; Government-in-Waiting, p. 51; Jackie Calmes, "A Challenged Fannie Mae Can Rely on Its Clout--Reports Will Raise Idea, Again to Privatize or Charge Fees," *San Diego Union Tribune*, May 26, 1996, p. H1; Michael Carroll,

"Masters of Beltway Capitalism," *Institutional Investor*, July 1995, p. 60.

Fannie Mae also has an impressive array of high-priced, politically well-connected lobbyists on its payroll to influence the Executive Branch and Congress. The lobbyists include former Republican senator Steve Symms, former Republican representative Vin Weber, Reagan White House chief of staff Kenneth Duberstein, assistant to President Reagan for domestic affairs Dan Crippen, President Bush's legislative liaison chief, Nicholas Calio, and former senator Bob Dole aide Alfred Lehn.[\[97\]](#) As the lists suggest, Fannie Mae covers all its bases by hiring high-priced politicos in both parties.

What is more troubling than the ability of the GSEs to lobby against any changes in the current structure is what that lobbying strength would mean if one of the GSEs failed before removal of government sponsorship. Such a lobbying machine would surely exert enormous pressure to transform what is now an implicit guarantee into an explicit one.

### *Money and Political Influence at Fannie Mae and Freddie Mac*

Efforts by the GSEs to command influence do not stop with lobbying. Fannie Mae once had a political action committee (PAC), but criticism of it as the only PAC maintained by a federal agency helped lead to its demise. The GSEs have, however, used other methods to contribute to legislators, including the "soft money" or campaign committee route, with more than \$750,000 contributed through this mechanism during the last election cycle.[\[98\]](#) The contributions were almost exactly evenly split between Democratic and Republican committees. Freddie Mac contributed \$557,500 to such committees, including \$140,000 to the National Republican Senatorial Committee chaired by Banking Committee chairman Alfonse D'Amato and \$210,000 to the Democratic National Committee. Fannie Mae contributed \$198,150 in total to such committees, with \$75,000 going to D'Amato's Senatorial Committee. During 1996, Fannie Mae and Freddie Mac also contributed \$40,000 and \$50,000, respectively, to a single Republican House and Senate Dinner Committee gathering held on June 10, 1996.

Those campaign contributions are unusually large given the GSEs' narrow legislative interest, which is limited to maintaining their current preferred status. Comparatively, financial giant Citicorp, which has far broader legislative interests ranging from the expansion of bank investment powers to fair lending and Community Reinvestment mandates, gave only \$163,150 through the soft money route during the 1996 election cycle.[\[99\]](#)

For the current 1997-98 election cycle, the GSEs are well on their way to meet or exceed the levels of the previous cycle, with soft money contributions of nearly \$400,000 for just the first six months of 1997. The officers at the GSEs are also big contributors to politicians--particularly members of the Banking Committee. For example, Fannie Mae chairman James Johnson was active in this area, making campaign contributions to members on both sides of the aisle to the tune of \$21,500 during the most recent election cycle.[\[100\]](#)

But the money trail does not end with political contributions. In many ways, the actions of the GSEs are similar to the little rich kid that buys the neighborhood kids candy so they will like him. Fannie Mae has contributed roughly \$3 million annually to community groups in the District of Columbia, helping to assure that any attempts to remove the current local income tax loophole (which costs D.C. \$300 million annually) are squelched.[\[101\]](#) Lloyd Smith, executive director of the Marshall Heights Community Development Organization in D.C., is one of the local community leaders who urged members of the city council to allow Fannie Mae to maintain its tax break. Shortly thereafter, his group's funding level was boosted to \$650,000, during a high-profile ceremony with Franklin Raines presenting a check. This tax exemption is especially significant because of the extensive financial problems the city has experienced recently. As a D.C. City Councilman bluntly put it, "I believe Fannie Mae ought to pay local taxes. There is no public policy reason to exempt them. It is not fair."[\[102\]](#)

The academic community also benefits mightily from the GSEs. For example, Susan Wachter, who helped write a study commissioned by the agencies responsible for the Privatization Reports,[\[103\]](#) has received more than \$100,000 of Fannie Mae research funds. In fact, the study she worked on had five authors, all five of whom had at that time, or in the past, received research funding from Fannie Mae. The study concluded that privatization of the GSEs would adversely affect housing markets; Fannie Mae agreed with the bulk of its conclusions.[\[104\]](#) Wachter notes all too truthfully that anyone would be hard-pressed to find "a single researcher in the country who hasn't been paid to do work [on housing finance issues] by" Fannie Mae.[\[105\]](#)

That financial carpet-bombing has also included the contribution of funds to many liberal or left-wing, activist organizations in Washington that might otherwise be critical of the billions of dollars of corporate welfare diverted to Fannie Mae and Freddie Mac. A recent analysis by the Capital Research Center of corporations' charitable giving patterns listed Fannie Mae and Freddie Mac in its "bottom ten," and gave both a failing grade of "F" for their support for organizations hostile to the free market. Fannie Mae gave approximately \$3 million over a two-year period (1992-93) to such organizations as the Association of Community Organizations for Reform Now (ACORN)--\$120,000; Center for Community Change--\$200,000; Children's Defense Fund-- \$170,000; Enterprise Foundation--\$725,000; and the National Center for Lead-Safe Housing--\$800,000. Those organizations support extensive, interventionist, government solutions to housing issues. The largest two recipients of Freddie Mac's half a million dollars during this same period were the Children's Defense Fund (\$154,800) and the housing-activist Enterprise Foundation (\$200,000).[\[106\]](#)

Wall Street is also a GSE beneficiary, drawing over \$100 million of fees each year.[\[107\]](#) If the GSEs were privatized, other firms would compete in the current market occupied by the GSEs, and the Wall Street firms likely would draw fees from them. But until then, few firms are willing to question the current GSE structure and risk jeopardizing any current relationships.

***The Best Political Talent Money Can Buy***

Due to their peculiar quasi-governmental status, the GSEs are not subject to normal federal civil service salary restrictions. In fact, Fannie Mae and Freddie Mac's executives receive compensation packages that are extraordinarily generous. For example, Fannie Mae chairman James Johnson collected over \$5 million in 1995. Other officers at the GSEs also drew hefty compensation packages (see Table 6).

Compensation packages such as those are not rare for private entities of a similar size, and purely private companies without government sponsorship should be free to pay any salaries they wish to get the talent they need. What is objectionable in the case of Fannie Mae and Freddie Mac is that public funds are in part underwriting such high salaries. CBO raised the objection this way: "The problem with executive compensation at Fannie Mae and Freddie Mac is not necessarily that it is too high, but that such a large share of it is paid by taxpayers and is awarded on the basis of management's success in securing ever-larger transfers from the government to the enterprises and their shareholders."[\[108\]](#) One of the potential benefits of removing government sponsorship would be that it would allow the GSEs to pay whatever salaries they want without scrutiny of taxpayers.

**Table 6  
Top Compensation Packages at Fannie Mae and Freddie Mac**

Name, Title	Compensation 1995
James A. Johnson, Chairman--Fannie Mae	\$5.1 million
Lawrence M. Small, President--Fannie Mae	\$3.7 million
Franklin D. Raines, Vice Chairman--Fannie Mae	\$3.0 million
Leland C. Brendsel, Chairman--Freddie Mac	\$2.2 million
Robert J. Levin, EVP of Marketing--Fannie Mae	\$1.9 million
J. Timothy Howard, EVP & CFO--Fannie Mae	\$1.7 million
David W. Glenn, President--Freddie Mac	\$1.4 million

Source: Fannie Mae, Notice of Annual Meeting of Stockholders, March 25, 1996, p. 13.  
Freddie Mac, To the Stockholders of Freddie Mac, April 12, 1996, p. 12.

Note: Compensation includes salary, bonus, restricted stock awards, long-term payouts, and miscellaneous compensation.



In addition to the secondary mortgage market that Fannie Mae and Freddie Mac sustain, which cycles from borrower to lender to GSE and back, another cycle has developed. Particularly in the case of Fannie Mae, the current evolution of the GSE structure is such that the shareholders elect a board that hires and pays extraordinary salaries to officers, many of whom are former high-powered political officials, who act as lobbyists in helping to maintain a legislatively granted status, the benefits of which redound to the GSE shareholders.

### *How Beneficial Are the GSEs?*

Fannie Mae cites a litany of "public benefits" provided by the GSEs that are used to justify the present GSE structure. They include claims of "providing tens of billions of dollars each year to finance homeownership and affordable housing for low-, moderate-, and middle-income families and communities," "substantial service to minority borrowers," "investing in technologies to reduce the cost of getting a mortgage for every home buyer," and "acting as a constant source of innovation and outreach for the entire housing finance industry."

To the extent that those benefits exist, they do not undermine the case for privatization. Undoubtedly, the benefits could be provided explicitly by government housing agencies, such as the Federal Housing Administration, through an on-budget mechanism. Alternatively, a fully privatized Fannie Mae or Freddie Mac could be compensated, again through an on-budget mechanism or subsidy, for undertaking them.

The GSEs also argue that they lower interest rates for home buyers. Fannie Mae estimates this savings at 25 to 50 basis points and Freddie Mac estimates a total of \$10 billion per year. In Freddie Mac's analysis, the mere existence of a differential between interest rates in the jumbo market and the conforming market is entirely attributed to the efforts of the GSEs.<sup>[109]</sup> But the interest savings is almost entirely caused by the implicit guarantee. As noted in the CBO Report, the GSEs "are not the source of that benefit. Rather, the housing GSEs are a vehicle for conveying a subsidy to intended beneficiaries."<sup>[110]</sup>

The GSEs also claim responsibility for "making housing finance available in all markets, under all economic conditions, providing stability to the mortgage market by preventing credit crunches." Yet many of the credit crunch problems, cited as so-called "market failures" in the HUD Report, were problems created by government failure, not market failure. State and federal statutory limitations on nationwide banking have prevented banks from interstate branching and intrastate branching, thus preventing such a nationwide financial presence from developing. Furthermore, regional interest rate differences can be justified. If a geographic area is experiencing a housing-related recession or depression, causing a local "credit crunch" of tight credit, then those are normal market processes signaling that credit should be tightened in that area, and interest rates should increase to reflect an increase in risk or decrease in available supply. Ironically, many of the federal government's housing finance policies through the GSEs and FHA encourage home purchases in precisely the markets where they should not take place. The market signals sent by differential interest rates from one region of the country to another should not be squelched through cross-subsidies, but should be encouraged as valuable market signals as to where home building and buying should take place.

### *Can the GSEs Be "Reformed"?*

A number of the Privatization Reports suggested various reforms of the GSEs that fall short of full removal of government sponsorship.<sup>[111]</sup> Some of those recommendations would simply continue the current market distortions of the present GSE structure. For example, one proposal involves authorizing one or more additional housing GSEs as a way to create more competition. Another would grant an explicit government guarantee on all mortgage-backed securities under the current loan limit. Either proposal would at best have the effect of simply reallocating a duopoly structure among more firms in the secondary market, while marginally increasing the contingent liability. Those options also might create an even larger constituency for continued government subsidies.

There are, on the other hand, a series of modest intermediate reforms that move in the right direction by limiting the GSEs' market power and reducing the competitive advantage in the marketplace. Congress could do the following:

1. *Raise the affordable-housing goals (roughly \$8 billion as of 1995) to reduce the net benefits to the GSEs.* Raising the affordable-housing goals would attempt to increase the social cost of doing business for

the GSEs by requiring more in return for their special status. Unfortunately, it would also increase the budgetary subterfuge that occurs with the current structure.

2. *Increase the equity requirements of the GSEs.* That would provide an extra layer of taxpayer protection from potential losses suffered by the GSEs and bring the GSEs more in line with the capital standards of genuinely private financial institutions.

3. *Lower the ceiling on conforming mortgages from its current level of \$214,600.* That would force the GSEs to target their activities toward mortgage markets that serve low- and moderate-income borrowers and would increase competition by expanding the segment of the market that is fully competitive, what is now the "jumbo market." The argument, properly extended, would lead to the conclusion that government sponsorship should be removed entirely so that the entire market is truly competitive.

4. *Cap the GSE mortgage portfolios by limiting the amount of GSE mortgages held in portfolio.* That would limit potential GSE risk going forward.

5. *Impose a cost of capitalization fee to recover some of the benefit retained by the GSEs.*[\[112\]](#) CBO suggests a fee of 20 basis points which would generate roughly \$800 million of revenue per year.[\[113\]](#) This would reduce the competitive advantage that the GSEs now enjoy in the mortgage market.

6. *End one or more of the legislative benefits of government sponsorship.* Any movements to strip Fannie Mae and Freddie Mac of their exemption from SEC registration and reporting, exemption from state and local taxes, or line of credit with the Treasury would reduce the artificial competitive advantage of the GSEs and reduce the market perception of an implicit government guarantee.

Each measure should be regarded as a temporary, transitional reform. Together the measures would refocus the GSEs' activities to the markets serving low- and moderate-income home buyers and reduce the growth of the agencies' portfolios. Such restrictions would allow greater innovation and private entry into the mortgage finance marketplace. However, they are all second-best solutions to the optimal reform: full privatization.

### ***How to Fully Privatize Fannie Mae and Freddie Mac***

How should government sponsorship of the GSEs be removed? Clearly, all explicit legislative benefits bestowed upon them should be eliminated immediately. Those benefits were granted because of the market-failure argument that the private markets could not sustain an entity that would be profitable and still provide the necessary degree of liquidity and stability in the mortgage markets, including low- and moderate-income housing. That rationale is not valid, given the innovation in the secondary markets epitomized by the automobile securitization sector. Fannie Mae and Freddie Mac would still be profitable even without the benefit of such handouts. The quid pro quo for ending the GSEs' explicit benefits would be that all mandates imposed upon them would be lifted.

Fannie Mae and Freddie Mac's implicit benefit--the market perception that the government is the ultimate guarantor for the GSEs' debt and securities--arises because of the many explicit benefits that give the aura of a government entity. The exemption from payment of state and local income taxes is similar to exempting other government entities from such tax payments. The SEC exemption gives the impression that an investor does not need such information because the securities are riskless. The special risk category underlying bank capital regulations also is a signal that such securities are nearly riskless, as is the ability of the Federal Reserve to use such securities in the course of open-market operations. If such explicit guarantees are removed, then it would logically follow that the implicit guarantee also would wither away.

But if this turns out not to be the case, how can Congress convey explicitly to the investment community that no such federal guarantee exists? And how should current holders of debt and securities be treated?

A number of options are available that would send a strong signal to the markets that Fannie Mae and Freddie Mac no longer have the benefit of an implicit guarantee. The most dramatic option would be to liquidate the two firms by selling off their assets, paying off their liabilities, and winding down the remaining securitizations in a timely manner.

Any residual would be divided up among current GSE shareholders. If an institution wanted to fill the same role as the GSEs it could either buy up assets from the liquidation of the GSEs or simply begin to purchase assets in the newly formed secondary market. However, seizing private assets in such a manner would run afoul of the "Takings Clause" of the Fifth Amendment. Given the track record of government liquidation entities, economic damages would likely be attributable to the discount generally associated with such government disposition activities.

An alternative option would disperse Fannie Mae and Freddie Mac into a half dozen new secondary market competitors, similar to the breakup of American Telephone and Telegraph. A study commissioned by the agencies responsible for the Privatization Reports (Stanton Study) suggests that such a breakup plan is one way to pursue a restructuring.[\[114\]](#) However, a breakup plan would require a value judgment regarding the "appropriate" number of competitors for the resulting industry.

A more desirable alternative would simply allow market processes to dictate the appropriate number of competitors. If the two-entrant structure is an appropriate form for the resulting industry after removal of government sponsorship, then it is best left to the secondary mortgage market to determine. Thus, the resulting industry structure after removal of government sponsorship should not be dictated in detail by transition legislation. Large players in the jumbo and nonconforming markets that include subsidiaries of GE Capital, General Motors Corporation and Norwest Corporation are just a few examples of potential competitors to Fannie Mae and Freddie Mac.[\[115\]](#) Such competition would be the best of all worlds. Alternatively, a transition period whereby the GSEs are allowed to enter new industries while still holding on to many of the benefits of GSE status, thus crowding out non-government-sponsored competitors, would be undesirable.

The Student Loan Marketing Association (Sallie Mae), which is currently going through a privatization process, could potentially be used as a model for a transition period to a fully private secondary market.[\[116\]](#) Similar to Sallie Mae, a Fannie Mae/Freddie Mac privatization plan could involve a transition period over a number of years, with the benefits of sponsorship eradicated by the end of the period.[\[117\]](#) A number of the previously mentioned "reforms" could be instituted during such a transition. All debt obligations and mortgage-backed securities that benefited from agency status at the beginning of the process would retain the status until retired.[\[118\]](#)

If the benefits of government sponsorship were taken from the GSEs, Fannie Mae and Freddie Mac shareholders would still likely claim that this would constitute a taking or breach of contract.[\[119\]](#) Results of shareholder litigation are difficult to predict but, as the Stanton Study notes, the enabling legislation creating Fannie Mae noted that the corporation would continue until dissolved by Congress.[\[120\]](#) That language would be damaging to potential shareholder arguments that they relied on the assumption that Congress would never dissolve the corporation or take the lesser action of removing government sponsorship from the corporation.

### *Conclusion*

It is time to remove the special government privileges bestowed upon the GSEs. The GSEs have used those privileges to earn above-average profits well in excess of the risk they assume in the marketplace. They have, in turn, used the profits to entrench themselves in the current political system. The benefits that Congress has conferred upon the GSEs enrich their shareholders and executives, who are fighting to maintain the status quo. The ultimate cost of the GSEs is that they divert resources from potentially more productive investments and they place the taxpayer at risk if either of the entities should fail. Yet there is little, if any, remaining benefit to the public from the GSEs, given the innovations that have occurred in the financial marketplace.

Therefore, Congress should immediately provide for the orderly privatization of the GSEs. Admittedly, stripping the GSEs of their exalted status will not be easy politically, given their massive lobbying operation. The GSE structure is a classic case of a narrowly provided legislative subsidy that the beneficiaries will fight vigorously to maintain. But the unhealthy and disproportionate political influence wielded by the GSEs only underscores the need for privatization.

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### *Notes*

1. The terms mortgage GSEs, GSEs, enterprises, and the collective Fannie Mae and Freddie Mac will be used

interchangeably throughout the course of this analysis. Congress has chosen to create GSEs in a number of areas, primarily to encourage lending in the areas of housing and the provision of mortgage credit (beyond the two discussed in this analysis, the Federal Home Loan Banks), agriculture and the provision of farm credit (the Farm Credit Banks, the Banks for Cooperatives, and the Federal Agricultural Mortgage Corporation), and education and the provision of student loans (Sallie Mae).

2. It is important to highlight the option the mortgage GSEs have to either hold the mortgage purchased in portfolio or bundle the mortgages into a security through the securitization process. If the mortgage is held in portfolio the GSEs must fund the purchase, by taking on debt, for as long as the mortgage is held. The process is analogous to an individual who chooses to buy a house and funds it by taking out a mortgage for the duration of the time the house is owned or until the mortgage is paid off. If the purchased mortgages are instead packaged into a security by the GSEs, the funding is not necessary. Also, many financial institutions purchase mortgage-backed securities outside the context of swapping them for their mortgages.

3. U.S. Department of Housing and Urban Development, "Privatization of Fannie Mae and Freddie Mac: Desirability and Feasibility," Office of Policy Development and Research, July 1996, pp. 160-64 [hereinafter, HUD Report].

4. 15 U.S.C. 78c(a)(42)(c) defines such securities as "government securities" and such government securities are "exempted securities" under 15 U.S.C. 78c(a)(12)(A)(i).

5. 12 U.S.C. 347, 355; 12 C.F.R. 201.108(b). Such preferred status allows them to be purchased in Federal Reserve open-market operations and pledged as collateral on advances from the Federal Reserve.

6. Citations for all provisions regarding Freddie Mac are contained in 12 U.S.C. 1451, et seq.; and Fannie Mae 12 U.S.C. 1716 et seq.

7. 12 C.F.R. 3-Appendix A(3)(a)(2)(vi) (Office of the Comptroller national bank regulations). Such securities are given a 20 percent risk weight, which is not as favorable as the 0 percent risk weight of U.S. government securities, but is more favorable than the 50 percent risk weight generally placed on privately issued mortgage-backed securities. The Office of Thrift Supervision's regulation, 12 C.F.R. 567.6(a)(1)(ii)(H), has slightly different standards than the banking agencies, allowing certain "high quality mortgage-related securities" other than GSE securities to be accorded a 20 percent risk weight. 12 U.S.C. 24(7) details diversification standards for national banks.

8. For a list of lesser benefits see HUD Report, pp. 28-29.

9. In fact, specific legislative provisions stipulate that the securities of the enterprises are not backed by the full faith and credit of the United States (12 U.S.C. 4501(4), 4503), but the market has taken the actions of Congress, in their entirety, as an indicator of a federal guarantee.

10. HUD Report, p. 29 n 35. This study was recently updated and a differential still exists but has narrowed. According to the study, the two GSEs have AA- ratings. Snigdha Prakash, "S&P: Fannie, Freddie Have Reduced Risk, Earning Better Debt Rating," *American Banker*, March 27, 1997, p. 12.

11. Aida Alvarez, director, Office of Federal Housing Enterprise Oversight, Testimony before the Capital Markets, Securities and Government Sponsored Enterprises Subcommittee, July 31, 1996, p. 7 [hereinafter, OFHEO Testimony].

12. At least the duopoly status exists in the secondary market securitization of those loans under the agency's \$214,600 mortgage ceiling.

13. Citations for all provisions regarding the creation and powers of the Office of Federal Housing Enterprise Oversight are contained in 12 U.S.C. 4501, et seq.

14. The mortgage-purchase ceiling recently was raised to \$214,600 from \$207,000. Jennifer Corbett, "Fannie Mae, Freddie Mac Boost Ceiling on Mortgage Purchases to \$214,600," *Wall Street Journal*, November 29, 1996, p. A3B.

15. Fannie Mae was created in 1938 as an agency of the U.S. government and at that time was limited in its purchases of mortgages to those insured by the Federal Housing Administration (FHA) or guaranteed by the Veterans Administration (VA). In 1968, the agency was split into Fannie Mae, a privately owned entity possessing certain statutory benefits and requirements, and the Government National Mortgage Association (Ginnie Mae), a government entity within the Department of Housing and Urban Development that was limited to financing FHA and VA loans. Shortly thereafter, in 1970, Fannie Mae was authorized to purchase conventional mortgages. Carrie Stradley Lavargna, "Government Sponsored Enterprises Are 'Too Big to Fail': Balancing Public and Private Interests," *Hastings Law Journal* 44 (1993): 1001-2 [hereinafter, "Too Big to Fail"]; Federal National Mortgage Association, "Background and History--1970," pp. 1-7.
16. Fannie Mae, *1996 Annual Report* (Washington: 1997), p. 40 [hereinafter, Fannie Annual Report]. Chase Manhattan reached \$336 billion of assets as of year-end 1996. "1996 Performance of Top U.S. Banking Companies," *American Banker*, March 26, 1997, p. 15.
17. Freddie Mac was created in 1970 as a part of the Federal Home Loan Bank System, focusing primarily on purchasing loans from the thrift industry. Freddie Mac has always been privately owned, originally by the Federal Home Loan Banks and the thrift industry. Freddie Mac's shares were made freely transferable in the late 1980s. "Too Big to Fail," pp. 1002-3.
18. Freddie Mac, *1996 Annual Report* (McLean, Va.: 1997) p. 39 [hereinafter, Freddie Annual Report].
19. P.L. 102-550, 106 Stat. 3941. For a side-by-side summary of the four reports, as well as the views of Fannie Mae and Freddie Mac on each of the major issues discussed in the reports, see Office of Federal Housing Enterprise Oversight, "Summary of Privatization Studies," August 29, 1996, pp. 3-21.
20. 12 U.S.C. 4602(a). More specifically, Congress directed the reporting entities to examine the "effects of such privatization on (1) the requirements applicable to [Fannie Mae] and [Freddie Mac] under Federal law and the costs to the enterprises; (2) the cost of capital to the enterprises; (3) housing affordability and availability and the cost of homeownership; (4) the level of secondary mortgage market competition subsequently available in the private sector; (5) whether increased amounts of capital would be necessary for the enterprises to continue operation; (6) the secondary market for residential loans and the liquidity of such loans; and (7) any other factors...deem[ed] appropriate to enable the Congress to evaluate the desirability and feasibility of privatization on the enterprises." 12 U.S.C. 4602(b). Also, five studies commissioned by the agencies responsible for the Privatization Reports, along with relevant commentary, are contained in U.S. Department of Housing and Urban Development, "Studies on Privatizing Fannie Mae and Freddie Mac," Office of Policy Development and Research, May 1996 [hereinafter, Commissioned Studies].
21. HUD Report, pp. 1, 4. The specific elements HUD focused on in arriving at the conclusion included the current unmet housing needs of lower-income and minority families, the likely post-privatization increase in interest rates and its concomitant adverse impact, especially on lower-income individuals, the relatively short time since implementation of performance-based goals imposed by HUD on the GSEs, the potential negative impact of privatization on the liquidity of the secondary market, the removal of OFHEO as primary regulator of the GSEs despite a potential existing liability after privatization, and the difficulty of formulating and implementing an effective plan to reach the ultimate goal of privatization. HUD Report, pp. 5-6.
22. Treasury Secretary Rubin has recused himself from this report because of a "long-standing close personal relationship." Lawrence H. Summers, "Written Responses of Deputy Secretary Summers to Certain Oral Questions Posed at July 24 Hearing," undated, p. 1. The relationship is reportedly with James Johnson, chairman of Fannie Mae.
23. U.S. Department of the Treasury, "Government Sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation," July 11, 1996, p. 10 [hereinafter, Treasury Report].
24. *Ibid.*, p. 11.
25. *Ibid.*, pp. 10, 42.

26. Ibid., p. 11.

27. Snigdha Prakash, "With Heat On, Fannie and Freddie Press for Relief," *American Banker*, June 5, 1996, p. 1; "Treasury Pressured on GSE Report," *Mortgage Marketplace*, June 3, 1996, p. 1; Stan Wilson, "Freddie, Fannie Campaign against Privatization Raises Hill Hackles," *Bank Letter*, May 27, 1996, p. 1; "GAO Ponders Privatized Fannie, Freddie," *Mortgage Marketplace*, May 13, 1996, p. 1.

28. Oversight of the Federal National Mortgage Association [Fannie Mae] and the Federal Home Loan Mortgage Corporation [Freddie Mac], Hearings before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises, 104th Cong., Sess. II, No. 104-55, p. 150. See also Snigdha Prakash, "Report on Privatizing Fannie, Freddie Ripped," *American Banker*, July 25, 1996, p. 10.

29. General Accounting Office, "Housing Enterprises: Potential Impacts of Severing Government Sponsorship," May 1996, GAO/GGD-96-120, pp. 6-7, 38-49 [hereinafter, GAO Report].

30. Ibid., pp. 7-8, 54-70.

31. Ibid., pp. 8-9, 78-94.

32. Congressional Budget Office, "Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac," May 1996, p. 31 [hereinafter, CBO Report].

33. Ibid., pp. xii, 31.

34. Ibid., pp. xiv, 16-20. These estimates were derived by comparing the GSEs' reduced funding costs resulting from their special status to the differential between conforming mortgages and jumbo mortgages.

35. Ibid., p. 32.

36. Ibid., pp. 35-36. The CBO Report did note that this was despite an appearance of diligence and competence displayed by the agency's staff.

37. Ibid., p. xiv.

38. "Reports Counsel No Quick Action on Privatizing GSEs," *National Journal's Congress Daily*, July 12, 1996, p. 1.

39. Richard W. Stevenson, "Report Is Skeptical of U.S.-Backed Home Mortgages," *New York Times*, May 30, 1996, p. D1. In the same article, Anne Schnare, senior vice president for corporate relations at Freddie Mac, was slightly more tempered in her critique of the CBO study: "We don't think this study would pass the scrutiny of anybody familiar with the industry. It displays a total lack of regard for consumers and an indifference to the impact that removing our charter would create." Jeffers was also quoted as saying: "This is a case of policy wonks piling their own prejudices on top of faulty analysis, and if these digit-heads could figure out a better way of delivering credit to millions of families with the use of private capital markets, while paying the government billions of dollars in federal taxes, then they can get a real job in Washington." Albert Crenshaw, "CBO Faults Subsidies for Two Finance Firms," *Washington Post*, May 30, 1996, p. D9.

40. Robert E. Zoellick, executive vice president, Fannie Mae, Testimony before the House Banking and Financial Services Committee, Subcommittee on Capital Markets, Securities and Government-Sponsored Enterprises, July 31, 1996 [hereinafter, Zoellick Testimony].

41. Ibid., p. 2.

42. Ibid., p. 19.

43. Ibid., pp. 5-6.

44. Ibid., pp. 7-14. Many of these same points are made in the GAO Report, pp. 71-77. This litany of benefits includes lowering interest rates for home buyers, giving substantial service to minority borrowers, making housing finance available in all markets, providing stability to the mortgage market by preventing credit crunches, providing tens of billions of dollars each year to finance homeownership and affordable housing for low-, moderate-, and middle-income families and communities, investing in technologies to reduce the cost of getting a mortgage for every home buyer, acting as a constant source of innovation and outreach for the entire housing finance industry, and being one of the nation's top taxpayers as well as a highly efficient private company that creates value for its shareholders by fulfilling a public mission to help home buyers.
45. Zoellick Testimony, p. 4.
46. GAO Report, pp. 71-72, 75-77.
47. "Fannie Mae Review of the Hermalin-Jaffee Paper," Commissioned Studies, p. 315.
48. Zoellick Testimony, p. 2.
49. Treasury Report, pp. 8, 78.
50. It is important to note that even without the GSEs, federal policy would still be biased in favor of the housing industry via the tax code.
51. Consumer Installment Credit, *Federal Reserve Bulletin*, Table 1.55 (December 1996), p. A36; Consumer Installment Credit, *Federal Reserve Bulletin*, Table 1.55 (March 1993), p. A38. For further information on securitization of automobile loans see Tamar Frankel, *Securitization: Structured Financing, Financial Assets Pools, and Asset-Backed Securities* (Boston: Little Brown and Company, 1991), Vol. I, pp. 37-38.
52. For a further discussion of the Herfindahl-Hirschman Index, see Thomas D. Morgan, *Modern Antitrust Law and Its Origins*, pp. 751-53 (Discussion and examples), 895-96 (Department of Justice and Federal Trade Commission Merger Guidelines) (St. Paul, Minn.: West Publishing, 1994). Briefly, the Herfindahl index involves a calculation that adds the squares of the market shares of all the firms in an industry. For example, if 5 firms have equivalent market shares of 20 percent, the calculation would be 20 to the power of 2 summed 5 times, or 2,000. If 10 firms have equivalent market shares of 10 percent, the calculation would be 10 to the power of 2 summed 10 times, or 1,000. The higher the index, the more concentrated the industry.
53. Benjamin E. Hermalin and Dwight M. Jaffee, "The Privatization of Fannie Mae and Freddie Mac: Implications for Mortgage Industry Structure," Commissioned Studies, p. 243 [hereinafter, Hermalin and Jaffee study].
54. Ibid., pp. 243-55.
55. "Too Big to Fail," p. 993.
56. G. Pascal Zachary, "Mortgage Deduction Comes under Fire," *Wall Street Journal*, August 15, 1995, p. B2.
57. Given that these data are compiled at the time of origination, they do not take into account the improved financial position of mortgage holders throughout the life of the loan. So if a household's income is increased over the life of the loan, relative to the median income, that improvement is not captured.
58. Welfare here is defined as being subsidized for doing nothing or being subsidized for doing something that would likely be done even without a subsidy.
59. The analysis of benefits to the GSEs of their special status must be broken into two segments: the measurement of explicit legislative benefits that can be measured fairly easily and the implicit benefits that cannot be as easily measured. The gross annual benefit for the GSEs of explicit benefits approaches \$500 million, while the net benefit after taking federal taxes into account is approximately \$350 million.

The analysis of the benefit derived from the implicit guarantee is admittedly less precise, but the benefit does exist as recognized in the CBO, Treasury, HUD, and GAO Reports. The two reports that estimate the net benefit retained by the GSEs, the CBO and the Treasury Reports, both came up with a figure of approximately \$2 billion.

60. OFHEO Testimony, p. 7.

61. Most forms of corporate welfare are subsidies or loopholes whose ultimate impact is budgetary, in that they either reduce government revenues or increase outlays. But the conferral of GSE status and its concomitant benefits also falls within this definition. The process whereby the federal government's credit standing is offered, without compensation, to reduce the borrowing costs of the GSEs, ultimately providing benefits to these two private corporations, is arguably more unseemly based on its sheer complexity.

62. See Accounting for Contingencies, Statement of Financial Accounting Standards No. 5 (Fin. Accounting Standards Bd. 1975). In the Budget of the United States Government, there is no disclosure akin to this statement but there is a section on Government-Sponsored Enterprises, which includes financial information on Fannie Mae and Freddie Mac "because of their relationship to the Government." *Budget of the United States Government, Appendix, Fiscal Year 1998*, p. 1155.

63. HUD Report, pp. 6, 15, 29, 47. CBO Report pp. x, 7, 10-14. GAO Report, pp. 3, 17-18, 40-41, 98. Treasury Report, pp. 9, 79-81.

64. A. Michael Fromkin, "Reinventing the Government Corporation," *University of Illinois Law Review*, Vol. 1995, No. 3, p. 559 [hereinafter, Government Corporation].

65. HUD Report, p. 39 n 11; CBO Report, p. 13; Treasury Report, p. 19; Hermalin and Jaffee Study, p. 275, which references E. Kane and C. Foster, "Valuing Conjectural Government Guarantees of FNMA Liabilities," Proceedings: Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, May 14-16, 1986. Fannie Mae's insolvency was caused by its practice of holding long-term mortgages in portfolio and funding them with short-term debt. When that practice combined with an increase in rates, interest earned on the long-term mortgages was often less than interest expense on newly issued debt, which caused losses to Fannie Mae. The government provided tax relief and regulatory forbearance throughout the period. Freddie Mac, which held relatively fewer of its mortgages in portfolio, did not experience equivalent financial difficulties. GAO Report, p. 27.

66. Government Corporation, p. 604; "Too Big to Fail," p. 1000. For an extensive discussion of farm credit system problems during the 1980s, see James Bovard, "The Farm Credit Quagmire," Cato Institute Policy Analysis no. 122, July 27, 1989.

67. This does not imply that such a bailout would be of the same magnitude as the problems of the savings and loans.

68. GAO Report, p. 51. This section highlights comments made by the GSEs on the content of the GAO Report.

69. 61 FR 29592 (June 11, 1996).

70. *Budget of the United States Government--Analytical Perspectives, Fiscal Year 1997*, p. 132 [hereinafter, 1997 Budget--Analytical Perspectives].

71. Fannie Annual Report, Notes to Financial Statements, pp. 34, 42-44. Freddie Annual Report, Notes to Financial Statements, pp. 40, 45-48. Office of Federal Housing Enterprise Oversight, *1996 Annual Report* (Washington: 1996), pp. 43-44, 52-54. The report notes that with regard to Fannie Mae, "[w]hile the quality of interest-rate risk management is generally strong, certain aspects need to be strengthened....OFHEO concluded that the Board of Directors, however, should require expanded reporting by management, and the Board should be more involved in setting broad policies. OFHEO also made recommendations to improve specific areas of oversight, risk management processes, and internal controls. Such improvements can be made in the normal course of business."

72. 1997 Budget--Analytical Perspectives, p. 133. Counterparty risk is the default risk arising from the possibility that



the other party to an agreement will not fulfill its obligations. Frank J. Fabozzi, *Bond Markets, Analysis and Strategies*, pp. 549-50 (Upper Saddle River, N.J.: Prentice Hall, 1996).

73. Fannie Mae, *1995 Annual Report*, (Washington: 1996) p. 16; Freddie Mac, *1995 Annual Report*, (McLean, Va.: 1996) p. 17.

74. 1997 Budget--Analytical Perspectives, p. 133. HUD Report, pp. 92-93, discusses that a few of the programs developed by Freddie Mac and Fannie Mae that allow for lower down payments than conventional mortgages, including one Fannie Mae product that allows a down payment of as little as 3 percent (i.e., a 97 percent loan-to-value ratio).

75. Karen Talley, "Split over Subprime Push by Fannie, Freddie," *American Banker*, June 24, 1997, p. 10; Kenneth R. Harney, "Freddie Mac Studies ABCs of Risky Buyers," *Washington Post*, June 14, 1997, p. E1; Karen Talley, "Freddie Mac Launches Program of Securitizing Subprime Mortgages," *American Banker*, June 3, 1997, p. 1; "Freddie Mac Moves More Definitively into B&C Market with New Structured Transaction Involving First Union," *Inside Mortgage Finance*, May 23, 1997, p. 4; "Freddie Mac Says It Will Soon Dominate Subprime Lending Market," *Home Equity News*, February 12, 1996, p. 1.

76. 12 U.S.C. 1454(a)(1) (Freddie Mac); 12 U.S.C. 1719(a)(1) (Fannie Mae).

77. "Leach Calls for GAO Investigation of Freddie Mac Investment Policies," *Currency--The Committee on Banking and Financial Services, U.S. House of Representatives*, April 10, 1997, p. 1.

78. "Leach Seeks HUD Review of Housing GSEs," *Currency--The Committee on Banking and Financial Services, U.S. House of Representatives*, April 24, 1997, p. 4 [hereinafter, Leach Press Release]; Jim McTague, "Munificent Macs: Freddie and Farmer Borrow Low, Lend High on Enterprises Far from Housing and Ag Loans," *Barron's*, April 21, 1997, p. 12.

79. Karen Talley, "Fannie Launches N.Y. Ad Blitz for Reverse Loans," *American Banker*, May 29, 1997, p. 10.

80. Karen Talley, "First Union Loan Sales Will Give It Competitive Edge," *American Banker*, June 3, 1997, p. 20; Snigdha Prakash, "Big Mortgage Lenders Go After Small Markets in Effort to Grow," *American Banker*, November 20, 1995, p. 1.

81. "Fannie Mae's MPP Product Transformed from Money Maker to Affordable Housing Initiative," *Inside Mortgage Finance*, June 6, 1997, p. 3; "HUD Rules That Fannie Mae Must Seek Formal Program Approval for New Insurance Product," *Inside Mortgage Finance*, May 23, 1997, p. 3; "Statement of Rep. James A. Leach on HUD's Order Regarding Fannie Mae's Proposed Mortgage Protection Plan," *Currency--The Committee on Banking and Financial Services, U.S. House of Representatives*, May 20, 1997; Leach Press Release.

82. Leach Press Release.

83. "CBO's Answers to Follow-Up Questions from the Hearing on GSE Privatization Studies," June 12, 1996, before the House Banking Committee, Subcommittee on Capital Markets, Securities and GSEs, Undated, p. 2 [hereinafter, CBO Follow-Up]. This responds to the committee's question, "Why do you think that Fannie and Freddie reacted so harshly to the CBO Report?"

84. For example, James A. Johnson, "Why Mess with Success?" *Washington Post*, April 22, 1996, p. A21 (Johnson is chairman and CEO of Fannie Mae); John P. Gibbons, "Freddie Mac Fires Back," *Investor's Business Daily*, August 21, 1996, p. A1 (Gibbons is Chief Financial Officer of Freddie Mac).

85. Leland C. Brendsel, chairman and chief executive officer of Freddie Mac, testimony before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises, August 1, 1996; Zoellick Testimony.

86. CBO Report, p. 36.

87. *Ibid.*, p. 36.

88. Michael Rust, "Reforming the Biggest Lobby," *Washington Times*, October 23, 1995, p. 8, discusses efforts to limit the ability of government agencies to use taxpayer money to oppose efforts to reduce agency power. Legislation in the 104th Congress was offered by Representative Clinger (HR 3078, "Federal Agency Anti-Lobbying Act") to prohibit the use of appropriated funds by federal agencies for lobbying activities.

89. The results of a *Roll Call* review of such expenditures, using Lobbying Disclosure Act of 1995 data, is in Ed Henry, "Who's the Biggest Lobbyist of Them All? New Forms Show It's Philip Morris at \$11 Million," *Roll Call*, September 12, 1996, p. 1.

90. See Prakash; "Treasury Pressured on GSE Report"; Wilson; and "GAO Ponders Privatized Fannie, Freddie."

91. Neal R. Peirce, "Flat Tax and Fairness: Who Benefits from the Mortgage Interest Deduction?" *Washington Post*, February 24, 1996, p. E3; Tom Diemer, "Agency Denies Tax Conflict," *The Plain Dealer*, February 18, 1996, p. 14A; Jerry Knight and Maryann Haggerty, "Fannie Mae, Freddie Mac Stir Furor with Tax Ads," *Washington Post*, February 15, 1996, p. A1.

92. Barbara L. Miles and G. Thomas Woodward, "User Fees for Fannie Mae and Freddie Mac," Congressional Research Service, May 31, 1996, p. 17 [hereinafter, User Fee Report].

93. "Freddie Mac/Fannie Mae User Fee Debate Resumes," *Mortgage-Backed Securities Letter*, November 27, 1995, p. 1; "GSE Power Shoots Down Leach Proposal," *The Mortgage Marketplace*, October 30, 1995, p. 1.

94. Celia Viggo Wexler, "Bipartisan Fix for S&L Fund Going before House Panel," *American Banker*, July 25, 1996, p. 1; Celia Viggo Wexler, "Leach Pushing Hard for Proposal To Bill Fannie, Freddie for Bailout," *American Banker*, July 24, 1996, p. 3.

95. Karen Talley, "Incoming Vice Chairman Sees Healing Role for Fannie Mae," *American Banker*, May 16, 1997, p. 9.

96. Gorelick's experience has been as deputy attorney general, as general counsel for the Defense Department, and as an attorney specializing in civil and criminal litigation. "Clinton Names Chair and Members of Advisory Committee on Critical Infrastructure Protection," *U.S. Newswire*, June 6, 1997.

97. See citations, Table 5. It might be said that Freddie Mac benefits from the free rider effect.

98. These data were compiled by the Center for Responsive Politics based on data downloaded from the Federal Election Commission as of April 1, 1997. For an article limited to a discussion of contributions during 1995, see "Freddie, Fannie Contribute Quarter Million," *National Mortgage News*, August 26, 1996, p. 16. This analysis by no means argues that such soft money contributions should be banned. The appropriate response to such contributions is to expose them publicly via full disclosure as is done in this analysis.

99. These data were also compiled by the Center for Responsive Politics.

100. These data were also compiled by the Center for Responsive Politics. Johnson also has a reputation for holding political fundraisers at his home. Jaret Seiberg, "Fed's Longtime Agent Wields Clout on Hill with Low-Profile Style," *American Banker*, August 27, 1996, p. 2.

101. The CBO estimates that the annual savings for Fannie Mae on its D.C. taxes is \$299 million and for Freddie Mac on its Virginia taxes is \$95 million. CBO Report, p. 24; GAO Report, p. 45.

102. A number of articles in the *Washington Post* have highlighted this phenomenon, particularly two page-one articles, in a series entitled "The Money Machine, How Fannie Mae Wields Power": David A. Vise, "Fannie Mae Lobbies Hard to Protect Its Tax Break," *Washington Post*, January 16, 1995, p. A1 [hereinafter, Money Machine--Part

III]; David A. Vise, "The Financial Giant That's in Our Midst; Special Tax Break in District Adds to Fannie Mae's Riches," *Washington Post*, January 15, 1995, p. A1 [hereinafter, Money Machine--Part I]. Also see Albert B. Crenshaw, "Fannie Mae Shareholders Reject D.C. Tax Proposal; Local Activists Sought to End Exemption," *Washington Post*, May 17, 1996, p. F3; Rudolph A. Pyatt Jr., "Its Charitable Plans Are Laudable, But Fannie Mae Owes the City More," *Washington Post*, January 4, 1996, p. D11; Albert B. Crenshaw, "Protesters Hit Fannie Mae on Taxes; Mortgage Firm Insists It Pays Fair Share to the District," *Washington Post*, May 19, 1995, p. F3; Hamil R. Harris, "Fannie Mae Tax Break Protested," *Washington Post*, February 23, 1995, p. A10. It should be noted that Fannie Mae might well leave D.C. if such a tax were a serious possibility.

103. Susan Wachter, James Follain, Peter Linneman, Roberto G. Quercia, and George McCarthy, "Implications of Privatization: The Attainment of Social Goals," *Commissioned Studies*, p. 337.

104. "Fannie Mae Review of the Wachter et al. Paper," *Commissioned Studies*, p. 383.

105. Jackie Calmes, "A Challenged Fannie Mae Can Rely on Its Clout--Reports Will Raise Idea Again to Privatize or Charge Fees," *San Diego Union Tribune*, May 26, 1996, p. H1.

106. Austin Fulk and Stuart Nolan, *Patterns of Corporate Philanthropy, Giving in the Clinton Era*, (Washington: Capital Research Center, 1996), pp. 67-68; Stuart Nolan, *Patterns of Corporate Philanthropy, Public Affairs Giving and the Forbes 250* (Washington: Capital Research Center, 1994), pp. 62-63. Fannie Mae also contributed \$20,000 to The Brookings Institution during that period, and James Johnson, chairman of Fannie Mae, acts as chairman of the board of Brookings. Fannie Mae reportedly reexamined its giving patterns during 1995 to direct more funding to free-market-oriented institutions.

107. The Money Machine--Part I, p. A1.

108. CBO Follow-Up, p. 2. In its enabling legislation, OFHEO was given the power to prohibit the enterprises from providing to any executive officer compensation that is not reasonable and comparable with compensation for employment in similar businesses involving similar duties and responsibilities; but it has not used such authority yet. 12 U.S.C. 4518(a).

109. Freddie Mac, "Financing America's Housing: The Vital Role of Freddie Mac," July 30, 1996, p. 14.

110. CBO Report, p. 31.

111. Examples are drawn from CBO Report, pp. 39-43; GAO Report, pp. 100-05; and Treasury Report, pp. 81-83.

112. This option is discussed more fully in User Fee Report.

113. CBO Report, pp. 42-43.

114. Thomas H. Stanton, "Restructuring Fannie Mae and Freddie Mac: Framework and Policy Options," *Commissioned Studies*, pp. 33-35 [hereinafter, Stanton Study].

115. Paul R. La Monica, "Norwest Sets Its Sights on a Place in Top Ranks in Securitizing Jumbo Loans," *American Banker*, October 24, 1996, p. 10; Karen Talley, "Quality of Securitized Loans Seen Improving," *American Banker*, August 20, 1996, p. 14; Karen Talley, "The View from the Top at Residential Funding," *American Banker*, February 27, 1996, p. 15.

116. Stanton Study, pp. 3-4. For further discussion of the Sallie Mae privatization, see Carl Horowitz, "Sallie Mae Ready to Go Private; Will Other Government Entities Follow?" *Investor's Business Daily*, October 21, 1996, p. B1. Comparisons between the mortgage GSEs and Sallie Mae do not always work well given that Sallie Mae privatized itself voluntarily.

117. The Sallie Mae plan has not gotten off to a smooth start. See "Sallie Plans Yearly Vote; Dissidents Not

Mollified," *American Banker*, March 25, 1997, p. 22; "Sallie Mae Rebels Push Own Privatization Plan; Special Meeting Sought before May Deadline; Sallie Says Issue Is Control," *American Banker*, March 12, 1997, p. 18.

118. Stanton Study, pp. 41-42.

119. *Ibid.*, pp. 38-41. It is not clear whether the most recent major Supreme Court case in the area of financial contracts with the government, *U.S. v. Winstar Corp., et al.*, 116 S.Ct. 2432 (1996), would be applicable. In that case, there were clear situations of supervisory merger agreements on which the government, by ensuing legislation, reneged. In the case of GSE shareholders, Stanton argues that reliance would be on the fact that the Fannie Mae Charter Act of 1968 represents a contract between the federal government and FNMA's shareholders. Any legislation altering this "contract" would thus result in a breach.

120. Stanton Study, p. 40.