CBO TESTIMONY

Statement of
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on
Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac

before the
Subcommittee on Capital Markets, Securities and
Government Sponsored Enterprises
Committee on Banking and Financial Services
U.S. House of Representatives

June 12, 1996

NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EDT), Wednesday, June 12, 1996.

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WASHINGTON, D.C. 20515

Chairman Baker, Congressman Kanjorski, and Members of the Subcommittee, I am pleased to be with you this morning to discuss the recent Congressional Budget Office (CBO) study of the public costs and benefits of the Federal National Mortgage Association (FNMA or Fannie Mae) and the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac). That study, mandated by the Federal Housing Enterprise Safety and Soundness Act of 1992, also considers the desirability and feasibility of privatizing those government-sponsored enterprises (GSEs). Today, I will focus my remarks on:

- The public policy issues raised by those entities, and
- Some alternatives to current policy.

BACKGROUND

For nearly three decades, the federal government has relied on Fannie Mae and Freddie Mac to ensure that home buyers have access to mortgage financing. By raising funds in the bond markets and making those dollars available to lenders, the enterprises have integrated local mortgage markets with national capital markets. As a result, loans to home buyers are more reliably available than in the past.

Furthermore, regional disparities in mortgage interest rates have diminished, and fluctuations in local real estate markets may have become more moderate.

In addition to their role of integrating regional and national financial markets, Fannie Mae and Freddie Mac have served as instruments for delivering a federal subsidy to housing. That subsidy consists of billions of dollars of reduced costs conferred on Fannie Mae and Freddie Mac annually by the federal government's grant of GSE status to the enterprises.

The federal implicit guarantee converts securities issued by the housing GSEs from A or Aa to "agency" or super Aaa grade and enables the two firms to borrow at lower interest rates than any fully private firm. Perhaps more important, the implicit backing of the federal government permits Fannie Mae and Freddie Mac to sell large quantities of unique financial instruments, including variable-maturity debt and interest rate swaps. It also gives them the singular authority to enter into financial obligations (off the balance sheet) with other parties who regard the transaction as free of the risk of default. CBO estimates that the government's implicit backing was worth $6.5 billion to the housing GSEs in 1995.

The explicit privileges provided to the sponsored enterprises, such as exemption from state and local income taxes and Securities and Exchange Commission registration fees, are worth an additional $500 million per year. The Congress

presumably intends the reduced funding costs and the savings from the tax and fee exemptions to be passed through to home buyers in lower mortgage interest rates.

POLICY ISSUES

The chief problem with Fannie Mae and Freddie Mac today is that the value of the subsidy and its allocation among potential beneficiaries are not under the control of the U.S. government. By controlling their rate of growth or by emphasizing a more risky line of business, the GSEs themselves largely determine the value of the economic resources provided to them by the federal government.

Moreover, inasmuch as GSE status is conferred exclusively on Fannie Mae and Freddie Mac, they face no significant competition in the secondary market for conforming, conventional mortgages. Consequently, they are able to determine how much of the benefit they receive will be passed through to home buyers in the form of lower interest rates. Furthermore, because the economic interests of management are closely aligned with those of shareholders, the housing GSEs have an incentive to retain a portion of the economic benefit for themselves rather than pass all of it on to home buyers.

In addition, the complexity of operations conducted by the GSEs and the proprietary nature of information about their business combine to make it almost impossible for the Congress to be sufficiently well informed about the conduct of Fannie Mae and Freddie Mac. It is a major undertaking just to estimate the subsidy the housing GSEs drew from federal taxpayers in a single past year. Determining how that subsidy was allocated is equally difficult: how much was spent at the discretion of GSE management, how much was passed through to home buyers, and how much accrued to shareholders? The inability of the Congress to monitor the fiscal activities of the GSEs, combined with their incentives to retain some of the subsidy, creates an environment in which some portion of the benefit intended for housing is bound to be diverted to unintended uses.

Where the Subsidy Goes

CBO estimates that in 1995 the housing GSEs passed through about $4.4 billion of their $6.5 billion in funding savings to home buyers in lower mortgage interest rates. Thus, Fannie Mae and Freddie Mac retained $2.1 billion, or nearly $1 for every $2 delivered to the intended beneficiaries. That performance suggested the characterization of the enterprises as "spongy conduits" in our recent report.

The retained portion of the subsidy affects the income statement of the housing GSEs. It appears as an unusually large, favorable gap between revenues from interest income and guarantee fees, on the one hand, and expenses for interest paid and credit losses, on the other. Once received, those funds are indistinguishable from all other cash flows of the enterprises. Accordingly, those funds may be used for any of several purposes: employee cash and noncash compensation, software development, academic studies, contributions to foundations and other charitable gifts, assistance to low-income borrowers, or political outreach. The ready availability of "free cash" may also weaken efforts by management to minimize general operating costs.

The subsidy that is not passed on to home buyers in lower mortgage interest rates or spent for other purposes is subject to federal taxation, along with earned net income. After-tax subsidies and earnings accrue to shareholders. Those may take the form of dividends or they may be retained by the enterprises, thereby bolstering shareholders' equity.

Where competition exists, financial intermediaries are compelled to pass through subsidies they may receive to customers, and they are similarly constrained in their ability to spend for purposes that do not produce revenues for the firm. Fannie Mae and Freddie Mac, however, have no competition in the secondary--or resale--market for conforming, conventional mortgages. The exclusive grant of the privileges of GSE status to the two shareholder-owned firms ensures their ability to keep out

potential competitors and to preserve their duopoly. The housing enterprises, therefore, are jointly able to determine the portion of the benefit passed through to consumers.

Assessing Public Costs

A central element in CBO's analysis is that taxpayers incur a significant cost from the operations of the government-sponsored enterprises, even though the federal government does not deliver the subsidy in the form of Treasury checks made out to Fannie Mae and Freddie Mac. In the entire federal budget, including all 1,174 pages of the appendix to the President's proposed budget, not a single dollar is slated to be paid as a subsidy to the housing GSEs. One would search the annual reports of the enterprises in vain for revenues reported under the heading of subsidies received from the federal government. If the government does not pay it and Fannie Mae and Freddie Mac do not receive it, how can it be a cost to taxpayers?

One element of the true costs to taxpayers is that the housing GSEs save about $500 million a year from the provisions of federal law that exempt them from state and local income taxes and Securities and Exchange Commission registration fees. Those exemptions impose a clear cost on taxpayers, who must replace those forgone revenues with larger out-of-pocket tax payments.

A more significant cost is the one taxpayers are bearing now by committing themselves to pay in the future if one or both of the housing GSEs should fail. CBO is not forecasting the insolvency of either of those enterprises. At the same time, the thrift debacle has taught us that the probability of a financial catastrophe over a period of time is not zero. Nor should we forget that 15 years ago Fannie Mae was deeply insolvent. The federal government collects no premiums from Fannie Mae and Freddie Mac to cover the expected loss from a GSE failure.

Most important, however, the grant of GSE status involves giving away one of the government's most valuable assets--namely, its credit standing. Government can transfer its credit standing to others by backing their promises to pay with guarantees, insurance, and other financial commitments. If the government auctioned the credit-enhancement services that it gives freely to the housing GSEs, private firms would bid billions of dollars a year for the privilege of getting to the head of the line for borrowed money. Giving the credit enhancement to Fannie Mae and Freddie Mac transfers those billions in public resources to the housing enterprises, which represents the lion's share of the government's subsidy to the GSEs.

The government needs to recognize when it is giving away its credit standing. The larger the volume of borrowing carried out under federal auspices, the larger the number of borrowers being pushed to the front of the credit line. Correspondingly, unassisted borrowers become more disadvantaged.

The Congress intuitively appreciates the costs and dangers of giving away the government's credit rating to for-profit firms, even those that would use that grant to provide benefits to citizens. That understanding probably explains the steadfast refusal of the Congress to confer the privilege of low-cost borrowing on other worthy companies. In fact, the cost to the government of granting its backing to an individual enterprise includes the risks that the sponsored company could fail and leave taxpayers and the government with big losses; the higher borrowing cost to be paid by others, including the government; the opportunities forgone by subsidizing the costs of this activity; and the losses in efficiency that could result from the eventual monopoly of that industry by one favored enterprise.

ALTERNATIVE POLICIES

Privatization was the solution highlighted in the legislation that mandated CBO's study. As directed, we have considered the feasibility and desirability of immediate repeal of the GSEs' charters. We conclude that although it would be feasible to privatize Fannie Mae and Freddie Mac, it might not be desirable to do so immediately.

Other analysts have considered at length the effects of repealing the charters of Fannie Mae and Freddie Mac. They conclude that such action could create a

temporary financial disturbance largely by reducing the market value of outstanding GSE securities. In addition, immediate privatization and complete withdrawal of the federal subsidy would increase the interest rates of conforming mortgages, at least until the secondary mortgage markets felt the offsetting effects of increased competition.

Accordingly, CBO focused on policy alternatives that would mitigate some of the primary weaknesses of the GSE approach to housing assistance. Specifically, we have sought to identify policies that would restrict the ability of Fannie Mae and Freddie Mac to control the amount and allocation of the federal subsidy they receive from their GSE status. Those options, which could serve as a transition to full privatization, include gradually reducing the ceiling on conforming mortgages, restricting GSE operations to the mortgage-backed securities (MBSs) line of business, imposing a cost-of-capital equalization fee on outstanding GSE debt, substituting explicit guarantees for the implicit one now provided to investors in GSE securities, and requiring increased disclosure of information by the enterprises.

Reduce the Ceiling on Conforming Loans

Lowering the ceiling on conforming mortgages would reverse the direction of annual changes in the maximum-size loan Fannie Mae and Freddie Mac are permitted to

purchase. Instead of increasing, the ceiling on single-family home loans would decline each year from the current level of $207,000, which covers more than 90 percent of all single-family conventional mortgages. The conforming ceiling is the maximum loan eligible for purchase by the housing GSEs; it is not the maximum purchase price of a house. For an assisted purchase with a loan-to-value ratio of 80 percent, the maximum house price is $258,750. By contrast, the average purchase price of a single-family home in the United States is less than $150,000, and the average loan amount is less than $115,000.

An advantage of this option is that it would restrict the ability of the housing GSEs to grow and to increase perpetually the value of their subsidy from GSE status. This policy change would also tend to target GSE assistance toward low- and moderate-income families. Most GSE mortgage purchases now serve families well above the median family income. For example, according to Freddie Mac, median income for an assisted borrower in 1993 was $56,000, or the same as for all single-family home buyers. However, national median family income for 1993 was about $37,000, and median household income was less than $32,000.

Adopting this policy would also reduce the size of the housing GSEs relative to their fully private counterparts. As the conforming limit receded, the conduits operating in the jumbo-loan market would experience an increase in their volume of business. That gradualist approach to shrinking the housing GSEs would enable

policymakers to assess the ability of fully private firms to provide securitization services. If private conduits were unable to perform at a satisfactory level, the downward adjustment in the conforming ceiling could be halted, or reversed if necessary.

One disadvantage of this approach is that it could raise interest rates for new mortgages that formerly would have been conforming but have become jumbos as a result of the lower ceiling. Of course, it is difficult to predict the behavior of the housing GSEs or to anticipate the potential competition that might evolve if that policy is adopted.

Both Fannie Mae and Freddie Mac oppose any reduction in the conforming-loan limit. In fact, the housing GSEs refused to reduce the maximum-size mortgage they would purchase in 1993, following a decline in the housing price index that determines the conforming ceiling.

Restrict the GSEs to Issuing MBSs

The housing GSEs package most mortgages they buy as mortgage-backed securities, but Fannie Mae particularly holds a substantial portion in its own portfolio. The subsidy rate to the GSEs is higher on debt issued to finance holdings of mortgages

than on MBSs because portfolio lending entails greater interest rate risk than securitization does. If the activities of Fannie Mae and Freddie Mac were limited to issuing MBSs, the housing GSEs would no longer be able to increase their subsidy by switching business from MBSs to portfolio lending. A prohibition on portfolio lending could be instituted gradually by requiring the existing portfolios to be securitized as the debt used to fund those holdings either matured or reached the age at which it could be called.

This policy option would significantly reduce the ability of management to control the size of the subsidy it receives without loss of market support by the housing GSEs. They would continue to purchase the same volume of mortgages, but they would be required to use the least-subsidized form of financing.

A disadvantage of this approach--like that of the previous option--is that it is difficult to predict the market behavior of the GSEs if such a policy was actually adopted. Unless constrained by increased competition, they might respond by reducing the subsidy pass-through rate to home buyers in order to maintain their current earnings performance. As a result, mortgage interest rates could increase across the board by as much as one-third of a percentage point.

Impose a Fee on Debt

An annual fee could be levied on the average volume of outstanding GSE debt, though not on MBSs. This option would provide some financial incentive for Fannie Mae and Freddie Mac to use MBS financing rather than more deeply subsidized debt. If successful, this alternative would also limit the ability of the GSEs to increase the value of the government's subsidy.

The major advantage of a fee on debt over the option of restricting the housing GSEs to issuing MBSs is that it would provide the government with the fiscal resources to achieve directly the objectives it hopes to achieve indirectly through the GSEs. For example, a fee of 20 basis points (or 0.2 percentage points) on outstanding debt would produce more than $800 million a year based on current levels of activity. At the discretion of the Congress, those collections could be targeted toward the housing needs of the homeless, low-income families, or first-time home buyers. Indeed, the government could recapture virtually all the benefits of GSE status in fees and use those fiscal resources to meet the nation's most pressing financial needs.

The principal disadvantage of fees is that, as they cut into the GSEs' net income and market value, management might have an increased incentive to take on more risks. Although no such reaction was observed when a fee was levied on Sallie Mae,

such a scenario would pose a challenge to the Office of Federal Housing Enterprise Oversight in administering regulations on safety and soundness.

Substitute Explicit for Implicit Guarantees

Because the federal guarantee of GSE obligations is implicit rather than explicit, using the sponsored enterprises as an instrument of federal policy creates difficulties. For policymakers, the difficulties include determining whether a real commitment exists to support the obligations of the enterprises. In fact, investors seem to have some residual doubts about federal backing, because the obligations of Fannie Mae and Freddie Mac pay higher interest than those issued by the U.S. Treasury. That extra premium for uncertainty is inefficient and wasteful if indeed the government would honor the implied guarantee in case of GSE failure. That needless uncertainty suggests that the implicit but real guarantee might be replaced with an explicit one to the benefit of policymakers, taxpayers, and investors.

Substituting an explicit guarantee for an implicit one would transfer control over the amount of the subsidy from the GSEs to the Congress. An implicit guarantee, whose existence can be doubted, cannot be limited or otherwise controlled. It is not sensible for the Congress to attempt to tell the enterprises that their guarantee is only implicit and then to state that it is limited to, say, $1.4 trillion. By replacing the

implicit guarantee with an explicit one, the Congress would be able to set limits on the use of the government's credit standing. It would also gain the ability to offer the guarantee to many users rather than restrict its use to the two housing GSEs. Only competition in the secondary market for conforming mortgages would restrict the ability of Fannie Mae and Freddie Mac to determine who receives the federal subsidy.

Require Increased Disclosure

Finally, if current estimates of the costs and benefits of the housing GSEs are considered too uncertain to justify significant changes in the federal government's relationship with Fannie Mae and Freddie Mac, policies could be adopted to reduce that uncertainty. One step to improve the ability of policymakers to monitor these entities would be to require increased disclosure of the sources and uses of funds by the housing GSEs. Another would be for the government to sell the rights to issue federally guaranteed MBSs. That step would help to obtain more reliable estimates of the value of the government's guarantee.

CONCLUSION

Fannie Mae and Freddie Mac performed a valuable service to the nation by demonstrating how local housing markets could be reliably and profitably linked to the capital markets. The success of the housing enterprises in achieving that goal is a tribute both to the management of the GSEs and to those policymakers whose foresight made those initiatives possible. The financial world has changed so fundamentally in the last 25 years, however, that public benefits that once had to be bought at a fairly steep price are now available freely and permanently.

Accordingly, the Congress may want to revisit the special relationship that exists between the government and Fannie Mae and Freddie Mac. If the Congress decides to modify that relationship in order to reduce the ability of the housing GSEs to control the benefits of sponsored status, then a variety of policies are available that would do so.