

## THE COMMITTEE ON THE BUDGET

# UNDERSTANDING THE DILEMMA OF FANNIE AND FREDDIE

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## INTRODUCTION

The past actions of Fannie Mae and Freddie Mac, combined with a weakened housing market, have presented Congress and the administration with a significant challenge. Failure to respond could lead to a financial crisis (known as “systemic risk”). On the other hand, bailing out Fannie and Freddie puts the taxpayer in the position of absorbing the losses of these for-profit firms in bad times, while the firms’ employees and shareholders reap the rewards during good times (known as “moral hazard”).

To address the dilemma, the administration has requested that Congress give the Treasury unlimited authority, through 2009, to provide financial assistance to Fannie and Freddie that is not subject to the debt limit. The Congressional Budget Office has estimated this will increase the budget deficit by \$25 billion in 2009 and 2010.

This paper summarizes the intended role of Fannie Mae and Freddie Mac, the reasons for their current troubles, and the administration’s proposals for their rescue. The paper also suggests what the goals of any legislative remedy should be.

## WHAT FANNIE AND FREDDIE DO

Fannie Mae and Freddie Mac – formally the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation – toe a fine line between the public and private sectors. Their basic mission has always been tied, at least in theory, to socially desirable goals. Fannie, for instance, was originally created in the late 1930s in the midst of the Great Depression to promote homeownership by enhancing the supply of residential mortgage funding. Freddie was created in 1970 with a similar role.

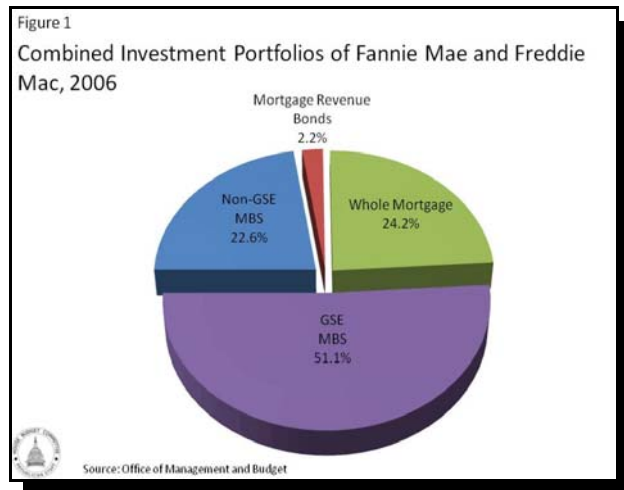
Although they are congressionally chartered firms – referred to as “government-sponsored enterprises,” or GSEs – they are shareholder-owned, for-profit companies whose operations are fully funded by private capital sources.

Today, Fannie and Freddie have two main lines of business.

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First, they purchase mortgages from banks, package these loans into financial securities (“mortgage-backed securities,” or MBS), and then sell these securities to investors in the secondary market. This process is known as “securitization.” Fannie and Freddie also guarantee the payments on these securities, ensuring investors that they will step in to make payments to investors if homeowners fail to meet their mortgage payments. (The firms have roughly \$3.5 trillion worth of guaranteed mortgage-backed securities outstanding in the market.) The resulting flow of funding from willing investors to mortgage originators (with Fannie and Freddie playing the role of intermediary) enhances the liquidity of the residential mortgage market and makes credit more widely available and less costly for homeowners. This is their core mission.

But a second line of business for Fannie and Freddie is to purchase assets (mainly mortgage-backed securities or whole mortgages) for their own investment portfolios to deliver profits to their private shareholders. This process raises various issues. First, the investment portfolios are fueled by the borrowing that Fannie and Freddie do – and they borrow at a preferential rate because they have the implied backing of the Federal Government. (Market participants believe the Federal Government would step in to make good on the debt of Fannie and Freddie if for some reason these firms fell into financial trouble.) Investors reward Fannie and Freddie for this implied backing by granting lower interest rates on their debt. Estimates suggest that the interest on their debt is roughly 30 to 40 basis points lower because of this implied Federal backing. Fannie Mae and Freddie Mac make their money on the spread between their relatively low borrowing costs and the investment returns on their assets.



The investment process has been a money-making machine for Fannie and Freddie (i.e. their private shareholders), and they have every incentive to maximize the size of their portfolios. In commenting on this dangerous business model, *The Wall Street Journal* says that Fannie and Freddie “combine the private sector’s appetite for profit with the government’s ability to borrow money.” Yet their portfolios, fueled by near-sovereign borrowing rates, serve no clear social purpose. According to research by the Federal Reserve, the investment portfolios of Fannie and Freddie have “no material effect on the cost or availability of residential mortgages.”

### SYSTEMIC RISK AND MORAL HAZARD

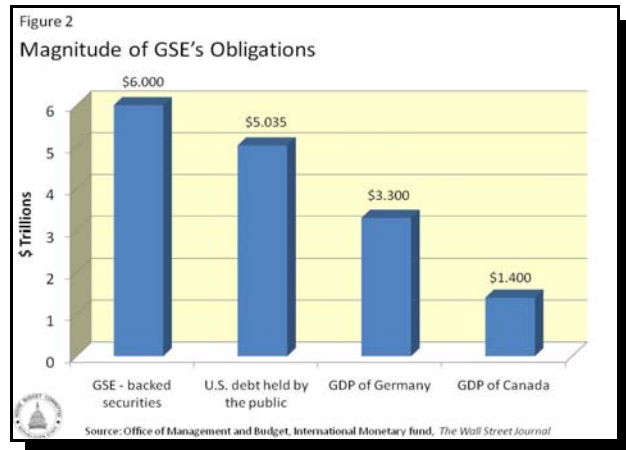
Since 1990, combined investment portfolios for Fannie and Freddie have grown tenfold, from \$135 billion to \$1.4 trillion as of late 2007. According to the administration’s Office of Management and Budget [OMB], the two firms now have about \$1.5 trillion in debt outstanding, “almost entirely for the purpose of funding these portfolios.”

These immense investment portfolios pose a so-called systemic risk to the broader financial system. That is, Fannie and Freddie have such a large presence in financial markets (through their

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large issuance of debt and mortgage-backed securities, as well as their sizeable positions in complex derivative securities used to hedge their investment risks) that their faltering could quickly spread and affect other important players in the market, here and abroad, causing serious economic consequences.

Figure 2 shows how large the financial market obligations of the housing GSEs are. Fannie's and Freddie's guaranteed mortgage-backed securities and their debt outstanding – held as relatively safe investments by financial institutions and central banks worldwide and often used as “good” collateral on short-term loans – total roughly \$5 trillion (\$3.5 trillion in guaranteed MBS, and \$1.5 trillion in outstanding debt). In addition, the Federal Home Loan Banks – GSEs that also facilitate mortgage funding – had outstanding market obligations of roughly \$1 trillion. So that the total GSEs' obligations are \$6 trillion. Total GSE financial market obligations exceed the Federal's Government's entire publicly held debt, and the gross domestic product [GDP] of such major industrialized countries as Germany and Canada.



A lack of market discipline also contributes to the possibility of systemic risk. Because the debt holders for Fannie and Freddie believe that they will ultimately be bailed out by the U.S. government in the event of trouble, the debt of these firms enjoy interest rates that are lower than other private sector firms could secure in the markets. In addition, the two firms do not operate with the same regulatory oversight on their accounting and operations as do other financial firms. This allows the firms to take profit from risks whose consequences they will not suffer – what is typically called “moral hazard.” In short, the moral hazard problem boils down to a situation in which individuals or institutions do not bear the consequences of their actions. As a result, they take excessive risks, knowing they will be rewarded in the event of a positive result but they will not have to suffer any consequences in the event of a failure (i.e. the government will simply shoulder the loss).

### WEAK REGULATOR

Unfortunately, this lack of market discipline is not made up for by effective and strong regulation. The Office of Federal Housing Enterprise and Oversight [OFHEO], created in 1992, is responsible for the “safety and soundness” of Fannie and Freddie, but its oversight lacks teeth and its standards are too lax.

For instance, all banks are required to hold adequate “capital cushions,” or protections against unexpected losses. Most commercial banks have capital-to-assets ratios of about 5 percent. Fannie Mae and Freddie Mac, though they have a wider variety of risks than banks, are only required to hold a “capital cushion” of *half* that share. (See further discussion in Box 1 on the next page.) According to the President's budget, this makes them particularly susceptible to unforeseen losses.

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In addition, under current law, even if the Federal Government determines, among other things, that either GSE “is not likely to pay its obligations” or “has concealed or is concealing books, papers, records, or assets of the enterprise,” it may be brought into conservatorship only if its Board of Directors or shareholders consent.

**Box 1: Capital Requirements**

The capital requirements for Fannie and Freddie are thin given their on and off balance sheet exposures, making them severely undercapitalized. For instance, their minimum capital requirements are 2.5 percent for on-balance-sheet assets, and only 0.45 percent for off-balance-sheet MBS that they guarantee. Fannie and Freddie hold about \$81 billion of

capital to cover their \$1.4 trillion of on-balance-sheet assets, and the \$3.6 trillion of off-balance sheet MBS they guarantee. By comparison, well-capitalized banks are required to have 10 percent capital against their total obligations, and a minimum capitalization of 5 percent. If a bank reaches the 5-percent minimum, the bank regulator begins to worry.

**CURRENT PROBLEMS**

Fannie and Freddie face a perfect storm in the current market environment. The U.S. is experiencing the worst housing market downturn since the Great Depression, and Fannie and Freddie have a huge exposure to this market. The glut of unsold homes on the market, combined with a contraction in demand, has caused national home prices to fall by double-digit rates over the past year, which has in turn led to a spike in home foreclosures.

Even before this combination of problems hit Fannie and Freddie, there were clear signals of problems. According to the President’s budget, released in February of this year: “As a result of earnings manipulation, poor accounting systems, lack of proper controls, lack of proper risk management, and misapplication of accounting principles, earnings at Fannie Mae were misstated by \$6.3 billion through June of 2004, and at Freddie Mac by \$5 billion through December of 2002.” With more homeowners defaulting on their loans, Fannie and Freddie have had to absorb losses on their sizeable stock of mortgage-related assets. The two companies reported losses of more than \$5 billion in the past year, the first combined loss among these two GSEs in 25 years. Although Fannie and Freddie tend to guarantee higher-quality, prime, fixed-rate mortgage-backed securities, more of even these homeowners are defaulting in the current market.

In addition, Fannie and Freddie have invested in certain subprime mortgage-related securities, which have suffered the sharpest value declines, through their investment portfolios. Market analysts believe that Fannie and Freddie will suffer even more losses in the future, as foreclosures mount and the housing market reaches bottom.

Faced with such a situation, Fannie and Freddie are in the position of raising more capital to cover these asset-value declines. As mentioned earlier, the two companies have just \$81 billion in capital, versus more than \$5.0 trillion in mortgage assets – a razor-thin 1.5-percent capital-to-asset ratio.

Declining asset values (and the prospect of more losses in the future) will drive down a company’s stock price. In addition, raising fresh capital means issuing new equity shares, which

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tends to dilute the value of current shareholders (i.e. the overall value of the company stays the same, but there are more shares to divide up). That is partly why the value of Fannie and Freddie stock has been falling sharply in recent weeks, and is down 80 percent from a year earlier.

### **TOO BIG (AND TOO IMPORTANT) TO FAIL**

Private companies in this sort of situation often see their borrowing costs increase. News reports last week raised fears that this could happen to Fannie and Freddie: if in fact they were in such bad shape, investors may start to shun their debt. With significantly higher borrowing costs (or, in a worse case scenario, without any access to private debt funding), the operations of Fannie and Freddie would be significantly impaired, and they would not be able to support the housing market to the extent they have been. The result would likely be an increase in mortgage interest rates and a sharper decline in the demand for homes, exacerbating the already-severe market downturn (setting off a destructive cycle of more home price declines and foreclosures).

Over the past year, Fannie and Freddie have become even more important in mortgage markets as subprime mortgage lenders went out of business and private banks tightened lending standards. By the end of 2007, Fannie and Freddie accounted for about 75 percent of new mortgages, according to OFHEO. Their stock of mortgage holdings also are huge. Fannie and Freddie own or guarantee about \$5.2 trillion of U.S. home mortgages, nearly half of those outstanding.

From the administration's standpoint, a failure of Fannie and Freddie would be catastrophic, from a systemic risk standpoint as well as from a housing market standpoint (in the short term, the supply of mortgage funding could become extremely scarce). That is why the administration has effectively made explicit the implied backing of Fannie and Freddie: they are seen as "too big to fail." But this raises the prospect of a severe moral hazard problem mentioned earlier, as investors become numb to risks because they believe the government will eventually bail them out – and the taxpayers are on the hook for the losses.

### **EFFECTIVENESS OF THE SUBSIDY TO FANNIE AND FREDDIE**

While it is clear Fannie and Freddie get a subsidy from the Federal Government, the question is how much of that is passed through to homeowners. According to the Congressional Budget Office [CBO], the Federal Government's implied subsidy to the GSEs amounts to roughly \$23 billion per year (latest estimate is for 2003). Slightly more than *half* of this sum gets passed along to mortgage borrowers in the form of lower interest rates. The rest is simply retained by GSE executives and shareholders.

Researchers at the Federal Reserve, while using a slightly different methodology to capture the GSEs' Federal subsidy, come to a similar conclusion. In the words of CBO, both it and the Fed find that "the housing GSEs receive large subsidies and that only a portion of those subsidies reach borrowers." Other research quantifies *how much* the GSEs' implied Federal backing enriches its private shareholders. In a 2005 study, the Federal Reserve found that roughly 40 percent to 80 percent of the GSEs' market value is derived from their congressional charters.

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## THE ADMINISTRATION'S PROPOSAL

In an effort to shore up the financial situation for Fannie and Freddie, and retain confidence in their smooth functioning, the administration and the Federal Reserve unveiled proposals on 13 July 2008. The Federal Reserve has granted both Fannie and Freddie access to the Fed's so-called "discount window," a facility that will provide the companies short-term loans, in exchange for collateral, in the event of funding pressures. This measure was approved by the Federal Reserve system itself and did not need to be approved by Congress. The main benefit of this move, from the standpoint of the administration, was that it provided Fannie and Freddie with access to funding *immediately* while the Treasury proposal works its way through Congress. The administration's legislative proposal has three elements:

- First, it proposes to give the Treasury unlimited authority through 2009 to lend funds to the GSEs.
- Second, the plan provides unlimited authority to the Treasury, through 2009, to purchase equity in Fannie and Freddie to "ensure the GSEs have access to sufficient capital." These authorities would not be subject to the debt limit and the assistance would be deemed an appropriation from Treasury when granted.
- Third, the plan would provide the Federal Reserve authority to "access information and perform a consultative role in the new GSE regulator's process for setting capital requirements and other prudential standards."

In providing the \$25-billion cost estimate for the administration's proposal, CBO also raised the question of whether Fannie's and Freddie's operations should be part of the budget. CBO's analysis said in part: "A strong argument can be made that if the Treasury used the proposed authority, the GSEs' operations should be incorporated directly into the Federal budget."

## GUIDING PRINCIPLES FOR REFORM

Congress and the administration have little choice but to focus on the current problem and prevent possible additional detrimental effects on the economy and the housing market.

By taking actions to address this problem, Congress and the administration effectively remove any doubt about the Federal Government's guarantee of these firms operations. As a result, policymakers need to weigh carefully the kind of environment that will exist *after*, and as a result of, enactment of a rescue plan.

There are three basic options to address the systemic risk and moral hazard the GSEs pose, while retaining their important housing missions:

- Strengthen their regulatory requirements and their regulator.
- Privatize their commercial operations and give their low-income housing mandates to government programs, such as the Federal Housing Administration.
- Make them government operations fully subject to government oversight and control.

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**SOURCES AND ADDITIONAL INFORMATION**

Additional information concerning Fannie Mae and Freddie Mac can be found at the following locations:

CBO estimate of the administration’s proposal for Fannie Mae and Freddie Mac, 22 July 2008  
<http://www.cbo.gov/ftpdocs/95xx/doc9574/07-22-GSEs.pdf>

*Updated Estimates of the Subsidies to the Housing GSEs*, CBO (April 2004)  
<http://www.cbo.gov/ftpdocs/53xx/doc5368/04-08-GSE.pdf>.

GSE discussion in *Analytical Perspectives* of the President’s fiscal year 2009 budget, pages 77-81. OMB <http://www.whitehouse.gov/omb/budget/fy2009/pdf/spec.pdf>

The GSE Implicit Subsidy and the Value of Government Ambiguity, Federal Reserve (September 2005) <http://www.federalreserve.gov/Pubs/feds/2005/200505/200505pap.pdf>

“GSE Portfolios, Systemic Risk, and Affordable Housing,” speech by Chairman Ben S. Bernanke, Federal Reserve, (March 2007).  
<http://www.federalreserve.gov/newsevents/speech/Bernanke20070306a.htm>

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