

**THE CASE FOR A FULL FAITH AND CREDIT GUARANTEE OF FANNIE
MAE AND
FREDDIE MAC OBLIGATIONS**

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At AEI's March 1999 forum on Fannie Mae and Freddie Mac, I suggested that it was time for Congress to end subsidies to Government-Sponsored Enterprises (GSEs), including Fannie Mae, Freddie Mac, Federal Home Loan Banks, and the Farm Credit System. That would involve repealing (1) the authority of the Secretary of the Treasury to lend to the GSEs, (2) the provisions that exempt the GSEs from state and local income taxes and SEC registration, and (3) the provisions that treat GSE securities for various investment and collateral purposes as if they were direct obligations of the United States.

The case for ending the subsidies to GSEs is even stronger now, in light of the extraordinary recent growth in GSE debt, the current concerns over GSE expansion into new business areas, the recent increases and volatility in interest rates on GSE securities, and the added risks and potential costs to the government.

These issues have been thoroughly discussed here today and at the three AEI forums last year on Fannie Mae and Freddie Mac. They have also been the subject of extensive Congressional and administration studies over the past decade. This is the tenth anniversary of the first of three Treasury Department reports to Congress on these issues. So, it seems sensible at this point to consider what to do if Congress again fails to act to end subsidies to the GSEs.

I have two suggestions: (1) provide explicit guarantees of GSE securities and (2) invest federal trust funds in GSE securities. These measures would reduce GSE and government costs, as well as increase the investment earnings of the trust funds. While not my final answer to the GSE problems, they would be a great improvement over the status quo.

Conditions in the GSE securities market in recent months should have made the status quo unacceptable to all, including the GSEs, as investors reacted to the Clinton administration's support of Republican legislation for tougher regulation and elimination of GSE subsidies. The current market uncertainty should be resolved.

But first, I must respond to Fannie Mae's misrepresentation of my views on the question of the impact of GSE borrowing on the cost of Treasury borrowing. Fannie

Mae's website now includes a paper responding to Fannie Mae's many critics. The paper claims that Fannie Mae borrowing does not raise Treasury borrowing costs and cites as evidence to back the claim the following statement from my March 1999 AEI paper: "Market interest rates are subject to so many economic, financial, and other factors, that it is not possible to isolate precisely the impact of GSE borrowing on Treasury borrowing costs." Fannie Mae did not note that I went on to say, "Yet, GSE borrowing clearly does have a significant impact on Treasury borrowing costs," as I explained later in the paper.

Indeed, press reports at the time of the Treasury's disastrous 30-year bond financing in February this year cited several comments from private market experts stating that Fannie Mae's competitive 30-year bond announcement on the same day as the Treasury's sale had an adverse impact on Treasury's borrowing costs.

The Case for Explicit Guarantees

The government has not been getting full value for its implicit guarantee. Political assurances that the GSEs will not default are poor substitutes for explicit statutory guarantees. Some potential investors in GSE issues are understandably wary of the present statutory disclaimer that the issues are not guaranteed and are not obligations of the U.S. This wariness is particularly evident during periods of "flights to quality," as the spreads between Treasury and GSE issues widen in response to nervous investor reactions to market uncertainties. Congress should decide whether it really means to back up the GSEs; if so, Congress should make the guarantee explicit and thus reduce the cost to the GSEs, housing, and the Treasury. The present arrangement is irrational, if indeed investors are being paid for default risks they are not taking. The government guarantee should be either perfected or eliminated.

Recent Congressional and administration studies, discussed here earlier, concluded that approximately one-third of the federal subsidies to Fannie Mae and Freddie Mac are not passed through to housing. That is, assuming the subsidy to the GSEs is 50 basis points, only 33 basis points would reach the intended beneficiaries. I believe that calculation understates the inefficiency of the present subsidy transmission system. Assuming GSE debt investors now receive a subsidy of 25 basis points, the total federal subsidy is 75 basis points. Since only 33 basis points are passed on to housing, 56 percent of the total subsidy is not getting to the intended beneficiaries. Surely, we can do better.

Briefly, the advantages of explicit guarantees are,

-- The subsidy to investors in GSE obligations could be eliminated. If the implicit guarantees were instead provided up front, investor uncertainty would be eliminated and GSE borrowing costs would be reduced, so the benefit of the guarantees would go to the GSEs rather than to the investors.

-- The volatility in the interest rates on GSE obligations would be reduced. The extraordinary volatility in recent months, as legislation was debated to reduce the implicit subsidies to the GSEs, has been very costly to the GSEs.

-- The government would benefit from the guarantee fees, which would help offset any losses to the government under the guarantees. (There are no funds available to back up the current implicit guarantees.) Thus explicit guarantees would reduce, not increase, government costs. (Again, assuming Congress would bail out the GSEs anyway, with or without explicit guarantees.)

Terms and Conditions of Explicit Guarantees

Coverage. Guarantees should apply only to new GSE debt security issues. This is necessary to avoid windfall profits to holders of existing GSE securities, as the market value of their security- ties would increase if given the added protection of explicit government guarantees.

Coinsurance. "Full faith and credit" guarantees should not be interpreted as guaranteeing the full amount of the borrowing. Federal loan guarantees generally should not cover 100 percent of principal and interest payments due on the guaranteed obligations. In keeping with longstanding credit program principles and standards established by the Office of Management and Budget and the Treasury Department, there should be an element of coinsurance to encourage private lenders to exercise due diligence in establishing the inherent creditworthiness of the borrower. A 90 percent guarantee, as in the SBA's program of guaranteed loans to small businesses, should be adequate. Also, investors should bear the first 10 percent of losses from missed debt service payments, or share losses pro rata with the government, rather than have the first 90 percent of losses absorbed by the government. Otherwise, the government could be absorbing all losses so long as the GSEs were able to meet 10 percent of debt service payments.

Under present arrangements, there is no way of telling how Congress would react to a threatened or actual GSE default, or whether any relief granted would be more or less than the 90 percent guarantees proposed above. Would Congress react promptly? (It did not in 1986, as Farm Credit investors panicked and sold their securities at deep discounts before the eventual government bailout.) Would it protect investors against all, if any, losses of principal or interest payments, including losses from delayed payments? The legislative process is generally very slow.

An explicit 90 percent guarantee, combined with adequate capital standards to protect both the government and the guaranteed investors, should result in a significant reduction in GSE borrowing costs.

Fee structure. To provide an incentive to the GSEs eventually to give up the guarantees and the other federal subsidies, the guarantee legislation should provide for periodic increases in guarantee fees until they got so high that the GSEs would decide they would be better off without the guarantees. Thus, the ultimate goal of eliminating GSE subsidies would be achieved.

The fee should be at least high enough to cover the estimated costs to the government from any payments under the guarantee. An additional amount should be charged to cover the total value of all government subsidies to the GSEs, including the special treatment of their securities for tax, registration, investment, and collateral purposes. A

further increase in the fee would be necessary to eliminate the GSEs' funding advantage, that is, to bring the GSEs' net borrowing costs in line with the borrowing costs of their private competitors. Viewed another way, the fee should cover the opportunity cost to the government from not selling its guarantees to the private competitors.

Budget treatment. Under the Federal Credit Reform Act of 1990, the present value of the estimated costs to the government of the guarantees would be counted as a federal budget outlay, but only to the extent that the guarantee fees were not set high enough to offset the estimated costs of the guarantees. Accordingly, a guarantee fee higher than the estimated costs to government would result in a "negative outlay" and reduce (increase) the federal budget deficit (surplus). For example, the Office of Management and Budget or the Congressional Budget Office might determine that estimated cash costs to the government from the guarantees would be offset by a fee of .25 percent of the amount of new security issues; but Congress might determine that such a fee should be increased to .50 percent to cover the value of the other subsidies to the GSEs. Thus the federal budget deficit (surplus) would be decreased (increased) by one half of the fee income.

Regulation and Funding. Guarantees for all the GSEs should be administered by a single independent regulator with sufficient authority to protect the government's financial interests and require appropriate action by the GSEs in the event of default. The regulator would make any required payments under the guarantees from a reserve fund financed by guarantee fees. If the fund were not sufficient to meet such obligations, the Secretary of the Treasury would be authorized, under a permanent indefinite appropriation, to purchase obligations of the fund at a rate of interest based on Treasury's own current cost of borrowing.

Trust Fund Investment in GSE Obligations

A full faith and credit guarantee of GSE obligations would make them especially suitable for investment by federal trust funds, including Social Security trust funds. Trust fund investment in GSE obligations are now authorized, but in practice the trust funds are invested entirely in U.S. Treasury special nonmarketable debt issues.

The advantages of trust fund investment in GSE issues are:

-- It would broaden the market for GSE obligations and reduce GSE borrowing costs.

-- It would increase the investment income of Social Security and other trust funds, since interest rates on GSE securities are, and will be, significantly higher than the rates on Treasury securities. (Even 100 percent federally-guaranteed obligations must carry higher interest rates than Treasury obligations, because they lack the liquidity, investor acceptance, and transactional efficiency of the well-established Treasury securities market). It is ironic that the pension and retirement funds of state and local governments and private corporations are now benefitting from the higher rates on GSE securities, which are backed by the federal government, but the federal pension funds are not.

-- It would help maintain the viability of the Treasury securities market, as Treasury securities would then be issued to the market rather than to the federal trust funds. The growing Social Security trust fund surpluses could be invested largely in GSE securities rather than Treasuries. In recent decades the Treasury security has become the benchmark security for the pricing of mortgages and corporate and other debt issues, as well as the principal security to meet safety and liquidity needs of private and public funds throughout the economy. (Earlier this month, the Treasury Department accommodated a Congressional request to delay canceling the Treasury's regular 52-week bill offering, since that the yield on that T-bill is a statutory benchmark for certain private transactions.) Also, just as the U. S. dollar is the premier currency throughout the world, the Treasury security is the premier security, for foreign central banks as well as foreign private investors. Yet the President's budget would eliminate the Treasury securities market, as shown in the following table.

The diminishing trust fund investment returns. Under current budget plans, the supply of Treasuries will continue to decrease, so the price of Treasuries will tend to increase; so the yields on Treasuries will decrease, and the long-term financial problems of the Social Security trust funds will be compounded as they earn less on their investments in Treasuries. To avoid the resulting increase in Social Security taxes or decrease in Social Security benefits, Congress will soon need to change the investment policies of the Social Security trust funds.

Treasury's current program of buying back its long-term securities and cutting back on new issues of intermediate and long-term securities has reduced by at least one-half of one percent the interest rate on new issues of Treasury securities to the Social Security trust fund, because the law requires the interest rates on such issues to be based on current market yields on outstanding intermediate and long-term Treasury issues.

Based on the following table, the average balance in the Social Security trust fund over the next 13 years will be roughly \$2 to 3 trillion. So a reduction in investment income of one-half of one percent would be roughly \$10 to 15 billion a year on average, or \$130 to 195 billion over the 13-year period (plus compounding). This would seem to be a politically unacceptable outcome, which would require a legislative fix hopefully long before the last remaining Treasury securities became collectors' items.

The Diminishing Treasury securities market. The following table, based on the President's Budget for FY 2001, shows how the federal trust funds are "starving" the market for Treasury securities (while at the same time suffering a declining rate of return on their investments).

The table shows federal debt increasing from \$5.6 trillion in 1999 to \$6.8 trillion in 2013. Yet the entire \$6.8 trillion will be nonmarketable securities held by the Social Security trust funds and other government accounts. There will be a 21 percent increase in the public debt, but the private Treasury securities market, and Savings Bonds, will be eliminated.

Then, after 2013, the Social Security trust fund surpluses are expected to quickly disappear. So the fund's holdings of Treasuries will be quickly redeemed, and the

Treasury securities market will have to be born again (at significant start-up costs) to finance the resulting budget deficits.

Federal and GSE Debt Outstanding

	(trillions of dollars)		
	FY 1999	FY 2000e	FY 2013e
Gross Federal Debt	5.6	5.7	6.8
Less:			
Debt held by government accounts	2.0	2.2	6.8
Social Security	0.9	1.0	4.2
Other	1.1	1.2	2.6
Equals:			
Debt held by public	3.6	3.5	0
By Federal Reserve	0.5	0.5	0
Savings Bonds and other nonmarketable	0.4	0.4	0
Privately-held marketable	2.7	2.6	0
Foreigners	1.3	1.3	0
U.S. market	1.5	1.3	0
Net GSE Debt	2.5	2.7	N.A.
Fannie Mae			
Portfolio	0.5	0.6	
MBS	0.7	0.7	
Freddie Mac			
Portfolio	0.3	0.4	
MBS	0.5	0.6	
Federal Home Loan Banks	0.5	0.5	
Other	0.1	0.1	
Adjustments to net transactions among GSEs	-0.2	-0.2	

Source: *Analytical Perspectives*, Budget of the United States Government FY 2001, except that the components of debt held by the public are from the *Treasury Bulletin* for FY 1999 and from the author for FY 2000 and 2001.

Over the last 50 years the Treasury securities market has become the financial wonder of the world. It has provided a degree of efficiency to private financial markets that could not be matched by any other instrument. There is no other security that could possibly provide the liquidity and absolute safety that have become such an essential part

of our increasingly complex financial markets. It took decades after World War II, which had to be financed more with debt than with taxes, to develop the depth, breadth, and resiliency of the Treasury market as we know it today. The notion that this market could somehow be replaced with GSE securities is ridiculous.

It would be the height of fiscal irresponsibility, at a time when the federal debt is actually increasing, to let the Treasury securities market wither away, knowing that it would have to be reinvented and that the transition would involve substantial costs to the taxpayer, as well as costly disruptions of private financial markets.

The expanding GSE market. While the Treasury market has been shrinking, the GSE market has been rapidly expanding. In fiscal year 2000, GSE debt of \$2.7 trillion will, for the first time, exceed the amount, \$2.6 trillion, of privately-held Treasury marketable debt. Moreover, since foreigners now hold about 50 percent of Treasury debt in the market (see table), the U.S. market for Treasury securities has been reduced to just \$1.3 trillion -- about half the size of the \$2.7 trillion GSE debt, which is largely held in the U.S. market. (Replacing Treasury debt with GSE debt in foreign portfolios would require a significant increase in U.S. interest payments to foreigners.) This relative shortage of Treasuries, and glut of GSE debt, explains part of the recent widening of spreads between GSE and Treasury interest rates.

GSE debt has also exploded relative to the total U.S. economy. As a percentage of total net borrowing in U.S. credit markets, including federal, state and local government, business, household, and foreign borrowers, GSE net borrowing rose from 7.2 percent in 1980, to 12.8 percent in 1995, and to a high of 36.6 percent in 1998. (These numbers represent annual credit flows, rather than outstanding debt, as explained in Table 8-12 of *Analytical Perspectives* of the FY 2001 Budget.)

The securities selection process. The process for selecting which GSE securities would be purchased for federal trust funds should be based on some objective standard to avoid politically driven allocations. The ideal would be a privately managed bond fund charged with tracking an index which included all GSE issues, on a weighted market capitalization basis, with maturities of one year or more. Such an index could be easily constructed along the lines of the LBA Bond Index (which was selected by the Federal Retirement Thrift Investment Board as the basis for its long-term bond fund in the Federal Thrift Savings Plan). (The Thrift Board's 13 years experience with its LBA Bond Index fund, as well as with its S&P 500 Stock Index fund, demonstrated that a government agency can invest in private stocks and bonds without interfering with private business management or control.)

Indeed, an LBA Bond Index fund would be a prudent option for federal trust funds, since it is a well-diversified portfolio of high quality bonds, but such investment in private securities would require new legislation. The LBA Bond Index includes the entire U.S. market for investment-grade (Moody's Baa-rated or better or Standard and Poor's BBB or better) bonds with maturities of one year or more, and an outstanding par value of \$100 million or more. As shown in the following table, it consists of 32 percent U.S. Treasuries, 34 percent mortgage-backed securities, 25 percent private corporate issues, and 9 percent GSE portfolio debt. By that measure, federal and federally-assisted

debt now account for 75 percent of the U.S. bond market.

Composition of the U.S. Bond Market, March 31, 2000 (Based on the LBA Bond Index)			
U.S. Treasury notes & bonds	Mortgage-backed GSEs & GNMA	GSE portfolio debt	Private corporate
32%	34%	9%	25%

Note: The LBA Bond Index excludes tax-exempt municipal bonds.

Budget treatment. The principal focus now should be on trust fund investment in GSE securities. Yet the budget proposed by the President does not contemplate use of the Treasury's authority to make such investments, perhaps because of the political commitment to reducing the amount of privately-held Treasury debt.

The federal budget accounting for trust fund purchases of GSE issues would be a political decision. The budget rules generally would require such purchases to be counted as budget outlays (unlike the current purchases of Treasury issues). Yet, Congress now grants special budget treatment for the Social Security funds by excluding their expenditures from federal budget outlays (while including their surplus in the budget totals), so the budget rules have already been compromised for the biggest federal trust fund.

There is no economic, financial, or equity justification for shifting the ownership of the federal debt from the private market to, in effect, the private beneficiaries of the government trust funds. The shift will serve only the politics of the federal budget -- to give the appearance of debt reduction when there actually is a substantial federal debt increase.

Conclusion

As stated earlier, the above proposal for explicit guarantees and trust fund investments for GSE securities is based on the assumption that Congress will again fail to act to eliminate subsidies to GSEs. Clearly, the preferred proposal is to end all subsidies and subject the GSEs to the discipline of the private market, in which case trust fund investment in GSE securities should depend on the rating of the securities. Either proposal is vastly better than the status quo, which is fraught with uncertainties and involves needless costs to the government and to the GSEs.