A Discussion of GSE G-Fees: Comments on Brinkmann

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F&F's Businesses (1)

- Fannie Mae and Freddie Mac (F&F) are engaged in two lines of business
  - Investing in residential mortgages and MBS
    - Portfolio lending (highly leveraged)
    - Credit risk and interest-rate risk
  - Swapping (issuing) MBS for mortgages
    - Guarantying timely payment of principal and interest to investors
    - Credit risk

F&F's Businesses (2)

- Both lines of business are very large today
  - Fannie: \$1.0 trillion in assets; \$1.3 trillion in net (outstanding) MBS
  - Freddie: \$800 billion in assets; \$770 billion in net (outstanding) MBS
- Both lines of business have grown rapidly since the 1980s

Recent Growth

- Mortgages and MBS:

	Fannie		Freddie		Tot Mkt
Year	Mtgs	MBS	Mtgs	MBS	
1980	$56B	$0	$5	$17	$1,105
1990	$114	$288	$22	$316	$2,907
2000	$608	$707	$386	$576	$5,543
2002	$798	$1,030	$590	$749	$6,842
2003	$902	$1,300	$660	$769	$7,715

F&F’s Businesses (3)

- Both F&F are highly profitable
  - Fannie’s average ROE 1998-2003: 33% (no year below 25%); Freddie’s average ROE 1998-2003: 29%
  - Fannie’s average ROE 1989-2003: 29%; Freddie’s average ROE 1989-2003: 25%

Fannie Mae and Freddie Mac Are Special

- They are publicly traded companies; but
- They have congressionally legislated charters
- The President can appoint 5 of their 18 board members
- They pay no state or local income taxes
- They are not required to register their securities with the SEC; exempt from fees

Specialness (continued)

- They each have a potential line of credit from the Treasury of up to $2.25B
- Their securities can be purchased in unlimited quantities by banks and thrifts
- Their securities can be purchased by the Federal Reserve for open-market operations
- They can use the Fed as their fiscal agent
- Insolvency must be resolved by Congress

Guaranty Fees (1)

- F&F’s guaranty fees on the MBS that they issue appear to be relatively high (relative to losses) and quite profitable

Implied ROEs and Actual ROEs

	Fannie Mae			Freddie Mac		
	Average G-Fee	Implied ROE	Actual ROE	Average G-Fee	Implied ROE	Actual ROE
1995	22.0	31%	21%	23.8	25%	22%
1996	24.0	32%	24%	23.4	24%	23%
1997	22.7	33%	25%	22.9	26%	23%
1998	20.2	31%	25%	21.4	31%	23%
1999	19.3	31%	25%	19.8	31%	26%
2000	19.5	34%	26%	19.3	33%	39%
2001	19.0	28%	40%	23.6	35%	20%
2002	19.1	26%	30%	22.0	29%	47%
2003	20.2	26%	50%	23.0	30%	17%

Guaranty Fees (2)

- Guaranty fees are not uniform
  - Apparently not risk-based
    - Though losses are greatest in early years, fees are constant as a % of UPB
  - Apparently related to size of seller
  - ???
- Guaranty fees appear to be the result of oligopolistic market structure

Avenues of Change

- F&F clones?
- Regulatory mandates?
- Basel II?
- FHLBs?
- True privatization?

More Charters Like F&F's?

- More F&F charters could bring more competition
- More charters are unlikely

Regulate the Guaranty Fees?

- Price regulation of the guaranty fees would create a highly inflexible structure
- More regulation in this dimension is <u>not</u> what's needed

Basel II (1)

- U.S. regulators are likely to require the 10 largest U.S. banks to use AIRB for determining capital; next 10 are likely to opt in
- These 20 largest banks account for 2/3 of all domestic banking assets and just over half of all depositories' holdings of residential mortgages

Basel II (2)

- Basel I requires banks to hold 4% capital for residential mortgages, 1.6% for MBS
- Basel II may allow as little as 1% for residential mortgages, 0.56% for MBS

Basel II (3)

- Heightened incentives for these banks to hold residential mortgage assets, especially whole loans
  - The loans that will be retained will be higher quality; lower quality will be sold/swapped to F&F
- Overall, likely reduced demand for guaranties (and poorer quality swapped) and more competition for F&F's retained portfolios
- What will happen to Basel I banks?

FHLBs

- MPF and MP programs represent expansion by FHLBs into holding mortgage assets: $113B in 2003
  - The originating bank/thrift provides a credit guaranty; competition with F&F
  - The FHLBs compete with F&F’s retained portfolio
- If FHLBs securitize their holdings, more competition for F&F’s MBS

Privatization

- Without specialness, F&F’s borrowing costs would increase and their role in the residential mortgage markets would shrink
  - Rates on residential mortgages would increase by about 25bps
    - This is all to the good; the U.S. already excessively subsidizes housing
    - F&F don’t do a good job of dealing with the potential home buyers who really do need help
    - F&F’s specialness should be replaced by on-budget subsidies to low- and moderate-income first-time home buyers

Conclusion

- F&F's guaranty fee structures appear to be the result of their oligopolistic market structure
- Regulating the fees is surely not the right approach
- Change may well be on the way
- Stay tuned!