



September 2005

## Regulating Fannie Mae and Freddie Mac: Now It Gets Serious (Continued)

By Peter J. Wallison

*The GSE regulatory reform bill reported out of the Senate Banking Committee in July 2005 included a provision that would virtually eliminate the authority of Fannie Mae and Freddie Mac to acquire and maintain portfolios of mortgages and mortgage-backed securities. If this provision becomes law, it will sharply reduce the risks associated with the GSEs, as well as their profitability. The conventional wisdom in Washington and on Wall Street is that a bill this controversial, adopted on a party-line vote, will quickly die in the Senate, and that tough restrictions on the GSEs' portfolios will not become law. But this view fails to reckon with the determination of the White House—demonstrated over several years—to limit the risks that Fannie and Freddie create for both the taxpayers and the economy.*

In the last essay that dealt with the regulation of Fannie Mae and Freddie Mac (“Regulating Fannie Mae and Freddie Mac: Now It Gets Serious,” May 2005),<sup>1</sup> we noted that the only legislation then under consideration in Congress was a deficient bill that emerged from the House Financial Services Committee in April 2005. When that committee acted, its members had before them a proposal from the administration that would have placed significant limitations on the size of the mortgage portfolios that Fannie Mae and Freddie Mac would be permitted to accumulate. Had this provision been adopted, it would have virtually eliminated the risk that these government sponsored enterprises (GSEs) create for the taxpayers and the economy. But the committee punted. Its bill, HR 1461, failed to provide the necessary authority for the new GSE regulator to limit or reduce the GSEs’ portfolios, which at that point amounted to approximately \$1.5 trillion.

Nevertheless, because portfolio limitations were now on the table for discussion, a serious legislative debate was taking shape. This meant for the first time that all the congressional posturing about

creating a “world class regulator” might actually amount to something—not because Congress would actually create one (the House committee bill did not even give the new regulator all the authority of a bank regulator), but because if Congress actually managed to limit Fannie’s and Freddie’s portfolios it would finally have taken or authorized the one step that might reduce the risks associated with their operations.

Although the House committee whiffed, the Senate Banking Committee connected, adopting a bill (S 190) that actually contained tougher language on portfolios than what the administration had proposed. Now, Senate action is pending on a bill that would truly reform GSE regulation; undoubtedly—from the perspectives of Fannie and Freddie—things have gotten very serious indeed.

Limiting the GSE portfolios is serious business for the taxpayers and the economy, as well as for the GSEs. The taxpayers and the economy will benefit because they will be relieved of the risk of a GSE default, with a resulting taxpayer bailout and possible systemic effects. For the GSEs, however, the result will be a sharp reduction in profitability—perhaps as much as an 85 percent decline—as they are compelled to carry out their mission through the

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less risky technique of securitization and the issuance of mortgage-backed securities (MBS).

## Interest-Rate Risk

It is not always understood how and why the GSE portfolios create risks. When Franklin Raines was the chairman of Fannie Mae, he used to make speeches in which he questioned how anyone could think that Fannie was in a risky business. After all, he would say, Fannie's assets are the home mortgages of Americans, and everyone knows that homeowners go to great lengths to pay their mortgages. Moreover, he would point out, underlying these mortgages are the homes themselves, which as collateral are further protection for Fannie.<sup>2</sup> This argument was so disingenuous that it is remarkable he was able to get away with it for so long.

The risks that Fannie and Freddie take on when they hold mortgages and MBS in their portfolios are of two kinds: credit risk and interest-rate risk. Of the two, credit risk—the risk Franklin Raines was talking about—is substantially the smaller. The real risk is interest-rate risk. In fact, savings and loans could have made the Raines argument before they collapsed in the 1980s; their principal assets were also home mortgages, but they were unable to cope with interest-rate risk.

Interest-rate risk arises from the unusual fact that U.S. mortgages, by law, may be refinanced at any time without penalty. As a result, holders of mortgages and MBS can be seriously hurt *both* when interest rates rise and when they fall. A simple example will show how this can be true. Fannie Mae must borrow to buy the mortgages it holds in its portfolio. If it borrows at 4 percent and buys mortgages that are paying 5.5 percent, it profits from the 1.5 percent spread. However, if interest rates later decline to 3.5 percent, many homeowners will refinance their 5.5 percent mortgages to the new lower rate, and the 5.5 percent assets simply disappear from Fannie's books. Fannie can then acquire the new 3.5 percent mortgages, but it will still owe the original 4 percent rate on the funds it borrowed. In other words, it will now lose 0.5 percent on every 3.5 percent mortgage it holds with 4 percent funding. If interest rates stay low long enough, Fannie can lose a great deal of money, unless it can refinance its debt at the lower rate.

On the other hand, if interest rates rise, homeowners will not refinance their mortgages, but Fannie's 4 percent borrowings will eventually come due, and it will have to roll over its liabilities at a much higher rate. Now it may be paying 6 percent when its portfolio is only yielding 5.5 percent. Again it is losing money. A rising interest-rate

environment like this is what caused the savings and loan industry to collapse in the 1980s. Most of Fannie and Freddie's funding is short term, which makes the companies vulnerable to a sharp and prolonged interest-rate rise. With Fannie and Freddie now holding approximately \$1.5 trillion in mortgages and MBS, it is easy to see that this risk is enormous. To be sure, it is possible to hedge these risks by buying derivatives of one kind or another, but this entails its own risks, and also creates risks for the other large financial institutions that are counterparties to these instruments.

## What the Senate Bill Does to Eliminate this Risk

S 190 addresses this problem by requiring that the GSEs reduce their portfolios to near zero—permitting them only to accumulate mortgages for purposes of securitization. This single and simple step eliminates most of the risk that Fannie and Freddie create for the taxpayers and the economy, but this does not mean that they will no longer be able to assist the housing market. This they can do through securitization, which is likely to have the same effect on interest rates as their purchasing and holding of mortgages. In the securitization process, Fannie and Freddie create trusts that hold a portfolio of mortgages. The trusts then sell mortgage-backed securities to investors—banks, pension funds, mutual funds, and individuals—and Fannie and Freddie guarantee that the holders of the MBS will receive a stream of interest and principal payments on the mortgages.

In these transactions, the GSEs are guaranteeing only that the homeowners whose mortgages are in the pools will make their payments in full and on time. They do not guarantee that homeowners will not refinance their mortgages when interest rates fall. In other words, they are taking only credit risk—not the far more substantial interest-rate risk that comes from borrowing funds to buy and hold a mortgage portfolio. In securitizations, the interest-rate risk is borne by the MBS investors, and thus is spread throughout the economy—and to foreign investors<sup>3</sup>—rather than concentrated in Fannie and Freddie alone. It is the concentration of risk in Fannie and Freddie that worries the administration and the Federal Reserve. If either of the two GSEs should suffer serious losses because of large fluctuations in interest rates—up or down, as noted above—it could require a taxpayer bailout or, even more serious, create adverse effects throughout the economy.

Thus, if Fannie and Freddie are required to perform their mission through securitization rather than through buying and holding mortgages, taxpayer and systemic risks will be

minimized, and there will be no significant adverse effect on interest rates or the mortgage finance system. In fact, it is unlikely that homebuyers will notice any change at all in how the mortgage market functions. Of course, Fannie and Freddie and their supporters disagree with this analysis. But, as outlined in the May 2005 *Financial Services Outlook*,<sup>4</sup> their arguments do not seem well-founded.

## Prospects for the Senate Bill

The conventional wisdom in Washington and on Wall Street is that the GSE reform legislation is going nowhere in this session of Congress. To be sure, both the House and Senate bills face formidable obstacles. In the House, the bill is stalled because of Republican unhappiness about its general fecklessness and the fact that it contains provisions for a fund that would enable the two companies to reward their friends under the guise of assisting affordable housing. The problem is the opposite in the Senate. There, the bill is said to be stalled because it was so tough that it came out of committee on a party-line vote; without bipartisan support, some argue, there will be no action in the Senate.

The conventional wisdom, however, is wrong in this case; it has not taken into account the position of the administration, which since 2003 has shown itself to be relentless in seeking the toughest possible regulation of Fannie and Freddie. The bill that emerged from the Senate Banking Committee is exactly what the White House wants, and it is doubtful that this administration—and this particularly determined president—will let the opportunity pass. An administration that has gained some measure of tort reform, approval of the Central American Free Trade Agreement, bankruptcy reform, and an energy bill—none of which received significant bipartisan support—is unlikely to shrink from pushing through Congress a bill that achieves one of its most important government reform priorities.

In an essay in 2004,<sup>5</sup> we reviewed the many ways in which the administration had, since 2003, subjected Fannie and Freddie to a barrage of adverse action; this pattern has continued in 2005. A few of the most significant actions, among many others, are the following:

- The White House refused to appoint the five directors that the president is authorized by law to appoint to the boards of Fannie and Freddie;
- The administration opposed as too weak legislation that was adopted by the Senate Banking

Committee in 2004, and on the same grounds severely criticized the bill that emerged from the House Financial Services Committee in 2005;

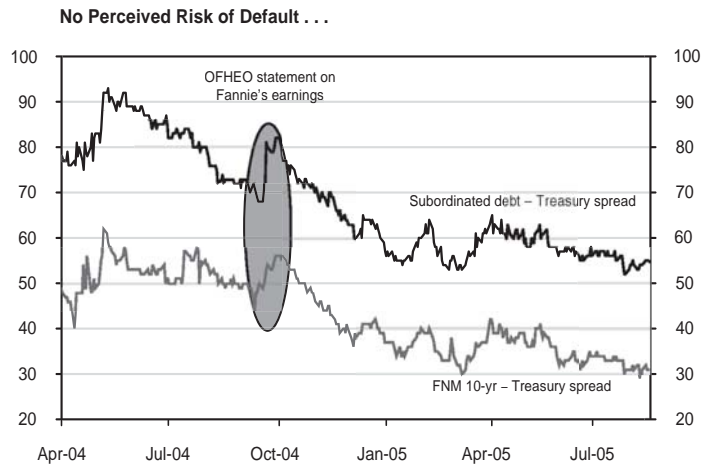
- The Office of Management and Budget (OMB), in analyses that accompanied the president's 2005 and 2006 budgets, declared that Fannie and Freddie were undercapitalized and were failing to perform their affordable housing mission;
- The Office of Federal Housing Enterprise Oversight (OFHEO), the GSEs' regulator, proposed tough new corporate governance rules, began a forensic audit of Fannie, imposed a 30-percent capital increase on Fannie, and ultimately forced Fannie to restate its financial reports;
- The Department of Housing and Urban Development (HUD) adopted substantially stronger affordable-housing regulations, which will force Fannie and Freddie to devote more resources to a riskier, underserved market;
- The chairman of the President's Council of Economic Advisers declared in a widely reported speech that Fannie and Freddie posed risks to the economy and had to be reined in with stronger capital regulations;
- Treasury officials expressed willingness to discuss the removal of the GSEs' so-called Treasury line of credit, one of the GSEs' key links to the government;
- The Department of Justice determined that the Treasury had the authority under existing law to restrict the GSEs' issuance of debt, and thus to stop by administrative means alone the accumulation of portfolios of mortgages and MBS;
- In a series of economic analyses, the Fed—obviously in tune with the administration—declared that the subsidy the GSEs receives from the government was considerably higher than previously estimated by the Congressional Budget Office, and that the benefit that Fannie and Freddie pass on to the market is only 7 basis points, considerably lower than any earlier estimate and the GSEs' claims; and

- Fed chairman Alan Greenspan called for the privatization of Fannie and Freddie, or—failing that—a limitation on the size of their portfolios of mortgages and mortgage-backed securities.

It would be naïve to believe that, after all these efforts to clip the wings of the GSEs, to question their contribution to housing, and to express alarm about the risks they are creating, the White House will give up and walk away simply because the Republican House and Senate are having difficulty enacting new legislation. As powerful as the GSEs and their constituent groups may be, regulation of the GSEs is really only an inside-the-beltway issue. Few lawmakers will hear anything on the subject from actual voters. A strong case can be made—and is being made regularly by economists in and out of government<sup>6</sup>—that home buyers and sellers will not see any difference in their mortgage rates if Fannie and Freddie are compelled to carry on their business through securitization rather than through the accumulation of mortgages and MBS. Lawmakers, in other words, need not fear retribution from back home if they vote to restrict the GSEs' portfolios. And while they will hear from the realtors and the homebuilders, they will get more intense pressure from the White House if they attempt to shrink from their responsibilities. They also know that if financial trouble at the GSEs actually does cause loss for the taxpayers and problems for the economy in general—which is what the administration and the Fed fear—they will face blistering criticism from their constituents.

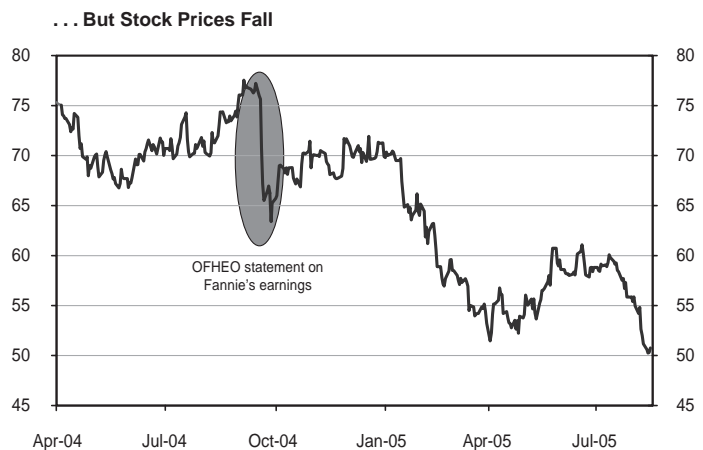
White House pressure to get legislation that curbs the size and risk of these portfolios is especially likely in light of the bond market's remarkable reaction to the recent troubles of the GSEs. Although neither company has been able to publish current audited financial statements—Fannie having recently reported that it will not be ready to meet this obligation until 2006 at the earliest—the bond market has been treating both companies as though they present no significant default risk. This is even true of their so-called subordinated debt, which was initially hailed as a market-based mechanism that would reveal through a growing spread over treasuries when the GSEs'

**FIGURE 1: Ten-Year Fannie Mae Subordinated Debt Minus Ten-Year Treasury and Ten-Year Fannie Mae Benchmark Note Minus Ten-Year Treasury**



SOURCE: *Morning Political Report*, International Strategy & Investment, August 19, 2005.

**FIGURE 2: Fannie Mae Stock Performance**



SOURCE: *Morning Political Report*, International Strategy & Investment, August 19, 2005.

financial condition was weakening. However, figure 1, which shows the spread over treasuries for Fannie's senior and subordinated debt, demonstrates clearly that the market is not pricing in any significant default risk for either security. It is even more remarkable that the spreads over treasuries for the subordinated debt continued to decline after the rating agencies announced that they would put the securities on watch for a possible downgrade. Indeed, in the past year, despite all Fannie's troubles, the spread of its debt over treasuries has narrowed considerably. Meanwhile, as shown in figure 2, the stock market has sharply discounted lower earnings for Fannie, making clear that

the company's financial troubles are well-recognized. It must be wholly unprecedented in the capital markets for the spread of a company's subordinated debt over treasuries to fall even as its earnings prospects also decline, and if there were ever further evidence needed that the GSEs are deemed to be government-backed, this is it.

The necessary conclusion to draw from this data is that if Congress wants to reduce the government's liability in the case of a failure of Fannie and Freddie, tougher regulation alone is not going to do it. Higher capital levels, closer scrutiny, and further restrictions on their business may reduce their profitability, but those measures will only convince the market that the two companies are even more tightly tied in to the government and will never be allowed to fail. In the end, then, those steps are self-defeating because they fail to eliminate the source of the risks that the GSEs create. Accordingly, the only way to reduce the systemic risk for taxpayers that is inherent in the GSEs' portfolios is substantially to reduce or eliminate the portfolios themselves.

The fact that no action has occurred thus far in either the House or Senate is not a sign that the legislation is in trouble. There are several ongoing government investigations of Fannie—by OFHEO, by the Justice Department, and by the Securities and Exchange Commission—and an internal investigation by an independent law firm retained by the Fannie board. Any of these could report dramatic new disclosures about Fannie's past behavior, and the repeated deferrals of the independent law firm's report suggest that serious issues have been encountered. The latest statement from the leader of that investigation, former senator Warren Rudman, is that the report for the Fannie board will not be completed until the late fall. Since an adverse report could give substantial new impetus to legislation, it only makes sense for the Senate and House leadership to await the outcome of one or more of these investigations before bringing legislation to the floor.

Nor is it reasonable to believe that Fannie and Freddie, no matter their political muscle, can avoid coming to terms with legislation—and the portfolio issue—at some point in the future. After the administration and the Fed have declared that the GSEs' portfolios are a dangerous source of taxpayer and systemic risk, the administration can hardly do nothing if Congress fails to act. In this respect, the administration always has a card to play—it can always use the Treasury's authority to restrict the GSEs' issuance of debt. The GSEs must realize this and must see that the only effective way to prevent the use of this authority in a wholesale manner is to reach a

legislative compromise of some kind. Simply opposing any further action on legislation is a losing strategy. It is likely therefore that at some time in 2006 legislation will pass the House and Senate and the differences between the two bills will be considered in conference. Then the hard bargaining will begin, but in the end—given the administration's determination on this issue—it is highly likely that legislation limiting or eliminating the GSEs' portfolios will be sent to the president's desk.

## Notes

1. Peter J. Wallison, "Regulating Fannie Mae and Freddie Mac: Now It Gets Serious," *Financial Services Outlook*, May 2005, available at [www.aei.org/publication22514](http://www.aei.org/publication22514).

2. For example, see Franklin Raines, "Government Policy and Financial Market Stability: The Case of Fannie Mae" (luncheon address, AEI, Washington, D.C., February 6, 2004): "Our debt funds mortgages. And there's a home behind every one of Fannie Mae's mortgages. The \$1.5 trillion in property value securing our debt represents some of the safest collateral in the world." The transcript of this address is available at [www.aei.org/eventtranscript742](http://www.aei.org/eventtranscript742).

3. In defending their accumulation of portfolios, Fannie and Freddie have argued that foreign investors will not take interest-rate risk on MBS, and thus that it is necessary for the GSEs to borrow and accumulate portfolios in order to bring funds from abroad into the U.S. mortgage markets. However, a recent front-page *Wall Street Journal* article described heavy foreign demand for MBS: Ruth Simon, James R. Hagerty, and James T. Areddy, "Housing-Bubble Talk Doesn't Scare Off Foreigners: Global Investors Gobble Up Mortgage-Backed Securities, Keeping Prices Strong," *Wall Street Journal*, August 24, 2005.

4. Wallison, "Regulating Fannie Mae and Freddie Mac."

5. Peter J. Wallison, "The Case for Privatizing Fannie Mae and Freddie Mac Grows Stronger," *Financial Services Outlook*, May 2004, available at [www.aei.org/publication20395](http://www.aei.org/publication20395).

6. See, for example, Dwight M. Jaffee, "On Limiting the Retained Mortgage Portfolios of Fannie Mae and Freddie Mac" (Working Paper 294, Fisher Center for Real Estate and Urban Economics, University of California, Berkeley, June 30, 2005), available at <http://repositories.cdlib.org/cgi/viewcontent.cgi?article=1031&context=iber/fcreue> (the same paper was presented at an AEI conference, "Should Fannie Mae's and Freddie Mac's Mortgage and MBS Portfolios Be Capped, Reduced, or Eliminated," April 26, 2005); Andreas Lehnert, Wayne Passmore, Shane M. Sherlund, "GSEs, Mortgage Rates, and Secondary Market Activities," June 7, 2005; Senate Committee on Banking, Housing, and Urban Affairs, *Statement of Alan*

Greenspan, 108th Congress, 1st session, February 24, 2004, 9-10 available at <http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=92>, as of May 12, 2005; Task Force on Housing and Infrastructure, House Committee on the

Budget, *Statement of Barbara Miles: Implications of the Debt Held by Housing Related Government Sponsored Enterprises*, 106th Congress, 2nd session, July 25, 2000, available at <http://financialservices.house.gov/banking/91200crs.pdf>.