American Enterprise Institute for Public Policy Research

News Release

An Interview with Peter J. Wallison, coauthor of *Privatizing Fannie Mae, Freddie Mac, and the Federal Home Loan Banks*

Q: *What are the risks for the taxpayers and the economy created by Fannie Mae and Freddie Mac?*

A: There are two kinds of risks. First, these companies are enormous financial institutions, and there is little doubt that if they get into financial trouble Congress will come to their rescue. Since between them Fannie and Freddie have obligations approaching $4 trillion (including straight debt and guarantees of mortgage-backed securities), bailing either or both of them out could entail enormous costs for the taxpayers.

Second, because both companies are dominant factors in the housing industry, their financial difficulties will have an immediate and major adverse impact on mortgage rates and home building and thus on the economy as a whole. This is true whether or not Congress eventually comes to their rescue, since any delay in action by Congress—a delay that is likely because of the enormous size of the potential bailout and uncertainty about whether debtholders should bear any of the cost—will spread quickly from the housing industry to all the other activities and industries that depend on housing.

Q: *Why is regulation insufficient to protect the taxpayers and the economy against financial losses at Fannie and Freddie?*

A: Unfortunately, politically powerful companies and industries have the ability to forestall unpopular regulatory actions by putting pressure on Congress and the administration. This is what occurred during the savings and loan association (S&L) crisis, when the industry was able to prevent a regulatory crackdown until the losses had become so large that they could no longer be ignored. Fannie and Freddie are among the most politically powerful companies in the United States, and their constituency encompasses other powerful industries, including the homebuilders, realtors, and securities industry. If a regulator in the future attempted, for example, to require them to stop growing or to hold more capital, this would have an adverse impact on both Fannie and Freddie and their constituent industries, all of which would go to Congress and request that the regulatory action be stopped. Judging from the support Fannie and Freddie were able to garner merely to oppose new regulatory authority, it is highly likely that they would be able to stop tough regulatory *action* until large losses had accumulated.

Q: *Why don't you just recommend that Fannie and Freddie's various links to the government be repealed? Why propose this complicated plan?*

A: If Fannie and Freddie were simply allowed to turn themselves into private companies, they would immediately become the dominant companies in the residential mortgage markets, simply because of their size and the tremendous amount of information on homes and homebuyers that they already have in their data bases. They might also be considered too big to fail, and thus continue to receive the favorable interest rates that they are receiving today as government-sponsored enterprises. The purpose of the plan, developed for AEI by Thomas H. Stanton, is to permit the orderly winding down of Fannie and Freddie without disrupting the mortgage markets, while assuring that when the wind-down is complete, they will be competitors in the financial markets but will no longer be the dominant players in residential finance. This will encourage strong competition, which in turn will benefit homebuyers with more innovation and lower rates.

Q: *What do you propose to do about the information you say is so important to Fannie and Freddie's market power? Won't that guarantee them a dominant position after privatization?*

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A: The plan requires that they spin off their automated underwriting technology and their data bases to independent companies, which will then license both the technology and the information to all comers at market rates. Fannie and Freddie will be able to keep copies of both, to use them in their business, and eventually transfer them to private-sector holding companies they are permitted to establish. The licensing process, again, should encourage the development of a highly competitive secondary mortgage market, with Fannie and Freddie as only two of the competitors and not the dominant ones.

Q: *Won't the shareholders of Fannie and Freddie be hurt by this substantial change in their operations and relationship to the government?*

A: It is entirely possible that the shareholders will be beneficiaries rather than victims of the plan. In the first place, they become shareholders of the holding companies that will control Fannie and Freddie for five years from the date of enactment as Fannie and Freddie wind down their activities. There is no reason to believe that they will not operate profitably during this period. Fannie and Freddie's shareholders will also become shareholders of the independent companies that will be spun off to license Fannie and Freddie's technology and data bases. This should provide the shareholders with a further return on the investment they made in Fannie and Freddie. Ultimately, of course, no shareholder was guaranteed that Fannie and Freddie would be backed forever by the government, and there have been many warning signs that both companies had grown so big that some government action would have to be taken to limit their risks.

Q: *Even assuming that there is no disruption of the mortgage markets under this plan, won't there be significant increases in interest rates for homebuyers if Fannie and Freddie no longer exist as government-backed companies?*

A: No. First, even in their current form, Fannie and Freddie do not significantly lower interest rates for homebuyers. Most studies have shown that they reduce interest rates by about a quarter of a percent by passing along about two-thirds of the subsidy they receive from the government (the balance apparently goes to the shareholders and to management compensation). One recent study by the Federal Reserve says that they reduce interest rates by about seven basis points, which is about 1/14th of 1 percent. To put this in perspective, every time the Fed raises interest rates a quarter of a point (which it has already done twice this year), it has the same effect of eliminating Fannie and Freddie entirely as government-sponsored enterprises.

Second, part of the plan is an innovative mortgage financing proposal by Bert Ely that offers the prospect of reducing mortgage rates below the rates offered by Fannie and Freddie, without any government support.

Q: *We'll get to the financing plan in a moment, but first I want to know about affordable and low-income housing. Won't that be sacrificed if Fannie and Freddie are no longer available to support it?*

A: No. Again, study after study has shown that Fannie and Freddie do not lead the market in making financing available to buyers of affordable and low-income housing. In fact, some studies seem to show that they are redlining (not making loans in certain neighborhoods). The fact is that they buy fewer mortgages in low income and minority areas than banks make, so there will be no net loss of affordable or low-income housing when Fannie and Freddie are privatized. The Department of Housing and Urban Development has proposed regulations that would force Fannie and Freddie to give greater priority to low-income housing, but the two companies have thus far been successful in stimulating strong opposition in Congress and elsewhere. One of the arguments that the companies make against tougher regulation is that it will reduce their profitability. This shows that attempting to use a profit-making company to perform a government mission is a mistake. If the government wants to stimulate minority and low-income home ownership, it should subsidize these things directly, not expect that a private company profit-oriented company will do it voluntarily.

Q: *It is very hard to see how it would be possible for companies that are not getting government backing to offer interest rates that are lower than those of Fannie and Freddie. How does this work?*

A: In the United States, banks, bank holding companies (BHCs), S&Ls, and all their subsidiaries are required to hold both a minimum amount of risk-based capital and a minimum amount of non risk-based capital to limit their leverage. Because of the leverage capital requirement, it is costly for these regulated institutions or their subsidiaries to hold mortgages in their portfolios. Accordingly, most mortgages in the United States are originated with the assumption that they be sold off to third parties like Fannie Mae and Freddie Mac. There are a large number of costs associated with preparing mortgages for sale to third parties, including the costs of appraisal, title insurance, flood certification, termite inspection, application fee, credit

reports, mortgage broker fees, government fees and taxes, closing and settlement costs, courier charges, and miscellaneous expenses. These costs, known as origination costs, are generally paid by the borrower and can amount to as much as fifty basis points annually in additional interest over the life of a typical mortgage. If these costs can be eliminated or reduced, all-in mortgage costs (the interest rate, plus these origination costs) can be less than the all-in costs of a mortgage that is ultimately financed by Fannie Mae or Freddie Mac.

In order to achieve this reduction, it is first necessary to change the regulation that all subsidiaries of banks, BHCs, and S&Ls be subject to a leverage capital requirement. The financing plan in the book contemplates that a special subsidiary of these regulated institutions be exempted from the leverage capital requirement. This subsidiary, called a mortgage holding subsidiary (MHS), would not take deposits, and its capital would be fully deducted from the capital of its parent company so that any adverse financial results of the subsidiary would not have an impact on the capital of the parent. Under these circumstances, no leverage requirement would be necessary to protect the parent company.

Once the leverage requirement is removed, it would become financially feasible for banks, BHCs, and S&Ls to hold mortgages as investments through a MHS vehicle. If so, these mortgage originators would be able to save many of the origination costs described above and thus lower the all-in costs of a mortgage. This is because it is likely that they will already know a lot about the properties involved—such as the condition of their titles, the likelihood that they will hold their value, and whether they are subject to flooding. These savings—which can add fifty basis points to the cost of a mortgage over its normal life—could reduce the all-in financing costs of a mortgage below the rate (plus origination costs) of a mortgage ultimately financed by Fannie Mae or Freddie Mac.