Fannie & Freddie:An Overview

Lawrence J. White, Stern School of Business, New York University

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Fannie Mae's and Freddie Mac's Businesses

- They have two primary businesses
  - Issue mortgage-backed securities, with their guarantees as to credit risk (approximately 20 bps fee)
  - Invest in portfolios of residential mortgages (funded by debt)

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 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 with 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

Some Drawbacks

- They are allowed only to do residential mortgage finance
- They cannot originate mortgages
- They are subject to a maximum mortgage amount (the conforming loan limit)
  - 2004: $333,700
- They are subject to mission regulation by HUD
- They are subject to safety-and-soundness regulation by OFHEO

The Consequences

- The securities markets treat their obligations as special “agency” debt
- They can borrow at about 40 bps less than their financial position would otherwise justify
  - Differential varies over time, with financial conditions, and with nature of debt instrument

Further Consequences

- Conforming mortgages are about 25bps lower than they would otherwise be
  - But is this really a good thing when housing is already heavily subsidized?
  - Are they well focused on the true positive externalities from home ownership?
- Are they efficient? Is their expansion efficient?
- The financial markets believe that their securities have an implicit federal guarantee
  - Taxpayers may well be at risk

Recent Growth (1)

- 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

Recent growth (2)

- Credit risk on single-family res mtgs:

Fannie + Freddie*	Banks + Thrifts
1970: 5.1%	1970: 70.5%
1980: 7.2%	1980: 67.0%
1990: 27.2%	1990: 39.3%
2000: 38.8%	2000: 30.0%

* Mortgages in portfolio + MBS

Reasons

- Greater efficiency of the MBS process
- Differential capital requirements
  - Banks and thrifts need 4% capital to hold a mortgage, 1.6% capital to hold MBS
- Aggressive portfolio growth by Fannie and Freddie since 1990
  - Advantageous funding costs
  - Freddie went fully public in 1989
  - Differential capital requirements: Fannie & Freddie need 2.5% capital to hold a mortgage; specialist thrifts are constrained by the 5% leverage requirement

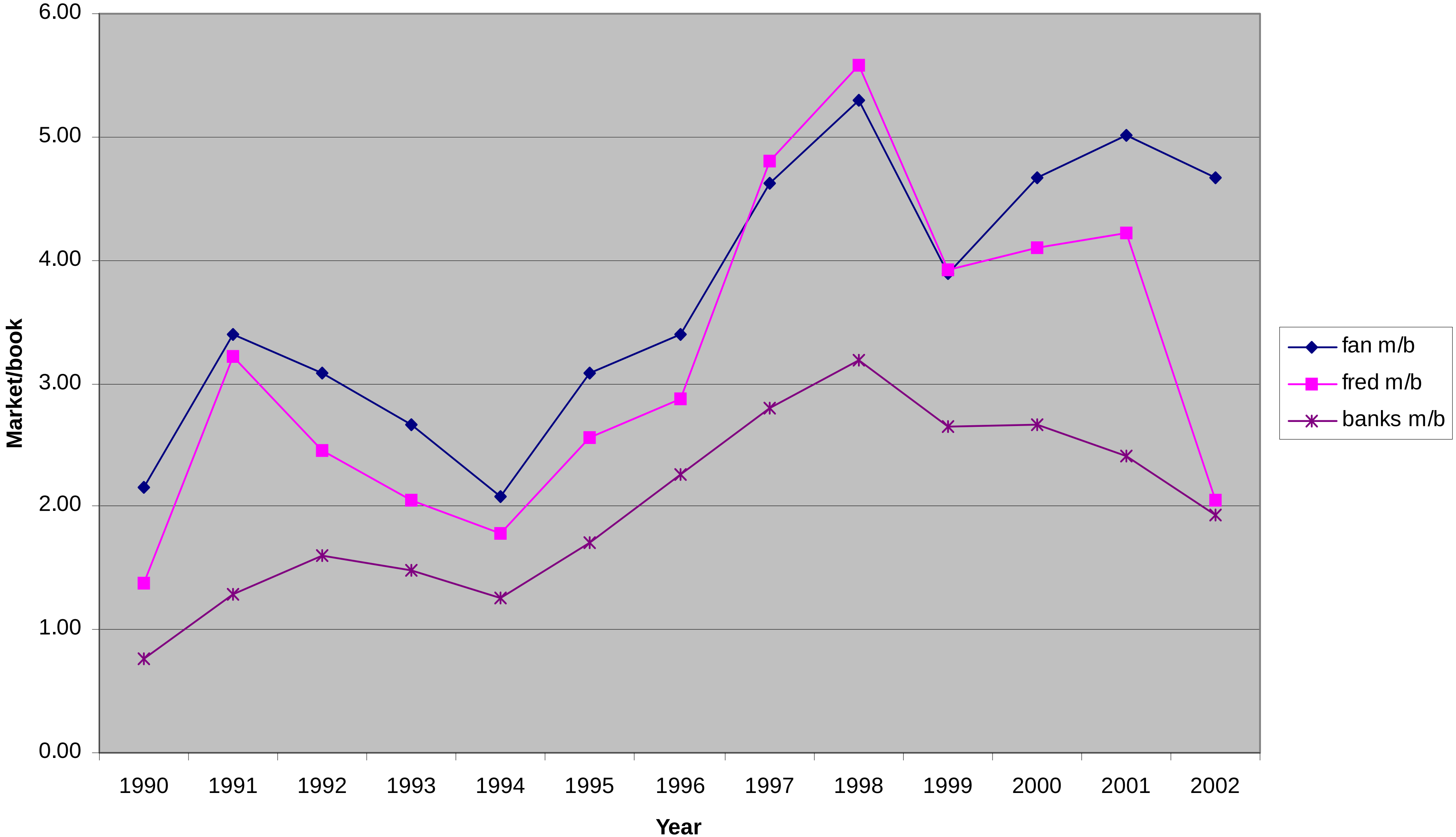
Some Emerging Competition Issues

- Two emerging sources of competition for Fannie and Freddie:
  - FHLB mortgage programs
  - Basel II
- Neither source of competition requires new legislation

Consequences of Heightened Competition

- Reduced profit margins for Fannie and Freddie
- Reduced franchise value for Fannie and Freddie
- Reduced effective capital levels for Fannie and Freddie
- Greater incentives for risk-taking
- Need for heightened regulatory scrutiny

Figure 1: Franchise Value (market/book of common equity), 1990-2002



Some Emerging Regulation Issues

- OFHEO was created in 1992
- Perceived as less effective than OCC, OTS, FDIC, Fed
  - Required 10 years to finalize risk-based capital regs
  - Fannie’s widened duration gap in 2002
  - Freddie’s accounting scandal in 2003

Issues in Rethinking GSE Regulation

- Structural issues
  - Location of the agency?
  - Include FHLBs?
  - Budgetary support?
- Authorities issues
  - Receivership powers?
  - Who can modify capital regs?
  - Who has mission regulation authority?

Conclusion

- Fannie and Freddie issues are important
- They are likely to be with us for a long time