Fannie & Freddie: An Overview

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Presentation at Brookings
October 5, 2004
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:

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