The Fannie/ Freddie Time Bomb

BY PETER J. WALLISON

What happens to these giants when interest rates rise?

Paul Sarbanes: Call your office!

Ever since the Enron collapse came to light, Fannie Mae and Freddie Mac have encountered renewed pressure to disclose more about their operations so that government officials, analysts and investors will be able to develop a better sense of the risks presented to taxpayers. One of the most successful efforts to increase disclosure has been a proposal to require Fannie and Freddie to register their securities with the Securities and Exchange Commission. Among the privileges these government-chartered companies enjoy is a statutory exemption from the requirement that their securities be registered with the SEC. Although Fannie and Freddie argued that they already voluntarily furnished much of the information that companies provide, critics (including OMB) pointed out that voluntary disclosures can be abandoned just when the information is most needed.

Finally, in mid-July, 2002, the government-sponsored enterprises (GSEs) reached a compromise with the Treasury and the SEC and agreed to register their equity securities under the Securities Ex-

Peter J. Wallison is a Resident Fellow at the American Enterprise Institute and a former General Counsel of the Treasury.

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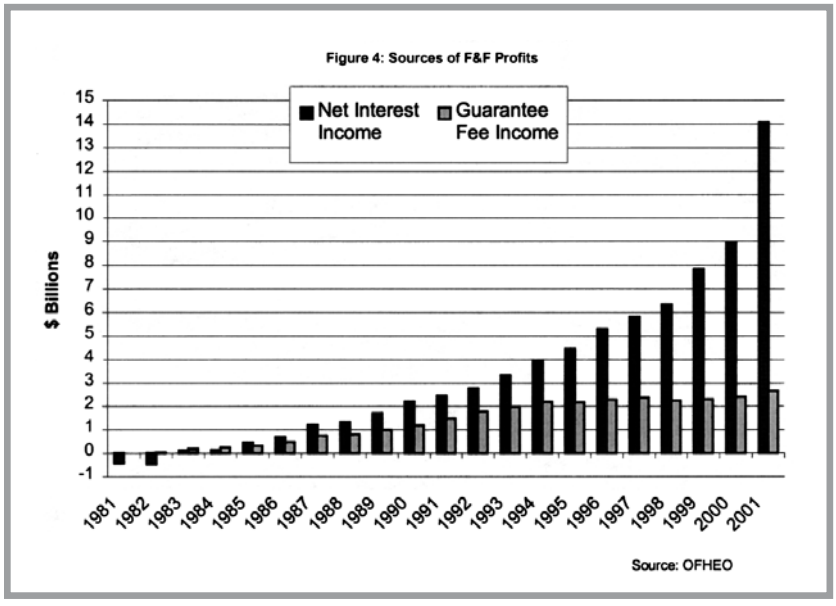
888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

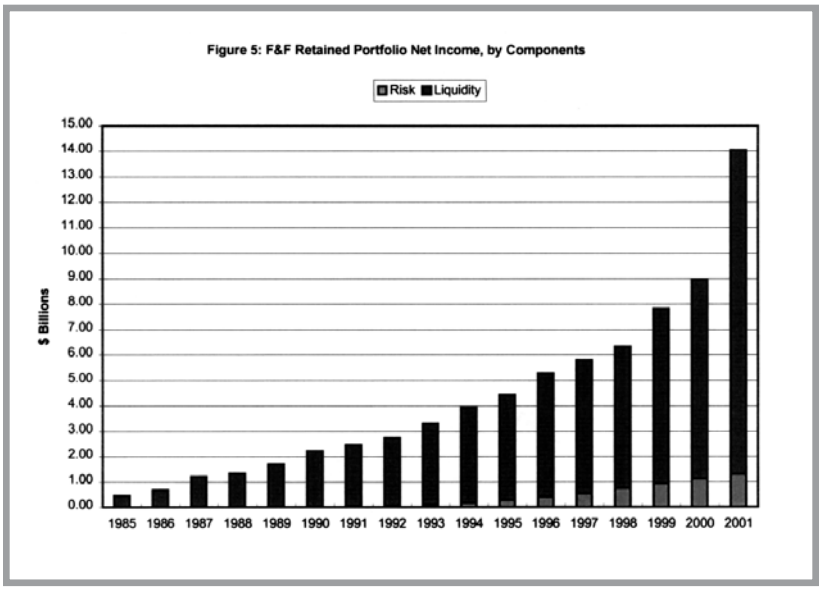
change Act of 1934, but not the debt and mortgage-backed securities (MBS) that they issue day to day. There is a significant difference between these two forms of registration. Under the 1934 Act, companies register securities that are already in the hands of the public and commit to make annual and periodic reports to the SEC, which are then available generally to investors and analysts on the SEC's website. But this information is generic information about registrants and will be generic information about the GSEs. Although it will allow investors (and taxpayers) to get a sense of the financial condition of Fannie and Freddie, it will not give investors any additional specific information about the securities Fannie and Freddie are offering to sell at any given time. In order for these securities to be covered, Fannie and Freddie would have to agree to register their securities under the Securities Act of 1933, which covers disclosures that have to be made to investors to whom securities are being offered for sale by the issuer.

Still, the agreement to register is a significant one, and is a significant piece of positive fallout from Enron, WorldCom and the others. It is another step in which Fannie and Freddie have been giving ground to their critics since 2000. The first of these was an agreement with Congressman Richard Baker (R-LA) in October 2000, in which the GSEs agreed to issue a form of subordinated debt and to take other steps that were supposed to enhance their liquidity and safety and soundness. The second step was Fannie's placing its proxy statement on its website for the first time in 2001; prior to this, Fannie's proxy statement—which contained information about the compensation of its management—was only available to investors. The third concession was Fannie's agreement after the Enron collapse to report purchases and sales of securities by its directors and management—another SEC requirement with which, as exempt companies, they had not been required to comply.

These concessions are important, not so much for what they represent in terms of disclosure, but because they reflect the fact that the GSEs' political muscle in Congress is weakening. Before they started to receive serious criticism in 1999, the GSEs, and particularly Fannie, could thumb their noses at their critics. Their support in Congress was so unassailable that they could consider their political risk to be negligible, no matter who was in the White House. Now, apparently, despite their legions of lobbyists, and their careful financial and political attention to lawmakers who are in a position to help or hurt them, they are beginning to feel some heat. The most recent concession—the agreement to register their shares under the 1934 Act—followed on growing (although still limited) support for H.R. 4071, a bill introduced by Congressmen Christopher Shays (R-Conn.) and Edward Markey (D-Mass.) that would have required the GSEs to register under both the 1933 and 1934 Acts.

While the press has not noticed the significance of this trend, investors have. Investors have long known that the principal risks faced by the GSEs were political risks—primarily the possibility that Congress would withdraw or modify some of the links they have to the government, and thus reduce the confidence of investors that the US government will stand behind the GSEs if they encounter financial difficulties. The first signal that this political risk was growing occurred in March 2000, when Gary Gensler, an undersecretary of the Treasury, testified before Congressman Baker's committee that Treasury would back a repeal of the $2.25 billion so-called line of credit that each of the GSEs has at the Treasury. Considering how small this benefit is for companies the size of Fannie and Freddie, the market reaction was enormous, with a sudden widening of





the spread between Treasury securities and GSE debt, and a decline in the GSEs' share prices. Suddenly, it seemed, investors had become aware that the GSEs did not have their political risk fully under control. Since then, the markets have been increasingly skeptical that Fannie and Freddie will be able to manage their political risk, and correspondingly their price/earnings ratios relative to the S&P Financials group have declined from 130 percent of the average P/E of that group in 1999, to almost 60 percent in 2002.

The GSEs' tactic of throwing ballast overboard in order to keep the boat afloat—most recently exemplified by their "voluntary" agreement to register their shares under the 1934 Act—is unlikely to end the questions of their critics or restore their former support in Congress. The Enron and other scandals have shown Congress that financial statements are not always reliable, and that companies that parade unusually high earnings and seemingly solid balance sheets may have earned them by clever (or, occasionally, deceptive) accounting practices rather than their business acumen. It had now become somewhat risky for a lawmaker flatly to oppose disclosure by Fannie and Freddie, since either of them could turn out one day to have Enron-like characteristics, so Congressmembers were hedging their bets. It was also not lost on Congress that after the CEOs of the GSEs—in an effort to revive their sagging P/Es—promised Wall Street double-digit increases in earnings many years into the future, Warren Buffett sold out his GSE holdings, apparently saying privately that he was not comfortable holding the securities of companies that make such promises. Speculation arose that Buffett's concern was that the managements of these companies had the potential to play with their numbers in order to meet extravagant promises, and he wanted no part of it.

On July 15, Congressman Ron Paul (R-TX) introduced a bill that would eliminate all the GSEs' links to the government, and thus eliminate the risk that the taxpayers may have to pick up Fannie and Freddie's losses in the future. H.R. 5126 would repeal not only the GSEs' line of credit at the Treasury, but also all their other special privileges. These include their SEC exemption, their exemption from state and local taxes, the president's authority to appoint five members of their board of directors, the authority of the Treasury to approve their debt issues, and the authority for national banks to make unlimited investments in the GSEs' obligations.

For all the concern on Capitol Hill about the possibility of an Enron-like meltdown of Fannie and Freddie, H.R. 5126 has a long hill to climb. It's important to remember that the Shays-Markey proposal, requiring merely registration of the GSEs' securities—although it is gaining support—is still not likely to be enacted any time soon. Fannie and Freddie still retain a vast amount of support among lawmakers, and are adept at the care and feeding of their Hill constituents. Moreover, the GSEs have been successful in creating the impression on Capitol Hill that tinkering with their privileges will cause mortgage interest rates to rise—at the moment a more dangerous prospect for lawmakers than the possible taxpayer losses down the road. Nevertheless, the Paul bill reflects continuing interest in Congress in doing something about the increasing risks that the government and taxpayers will bear as Fannie and Freddie grow inexorably larger.

If this is the motivation on the Hill, there is an easier way at this time to reduce taxpayer risks while not significantly affecting the mortgage markets. This can be done by prohibiting the GSEs from building their portfolios of mortgages through repurchasing MBS they have already sold to investors.

The GSEs perform their secondary mortgage market function in two ways: by acquiring and holding whole mortgages originated by banks and other lenders, and by guaranteeing to investors that they will receive full payment of principal and interest on MBS which are backed by pools of mortgages. Both of these activities transfer some of the implicit subsidy they receive to homebuyers, but the GSEs' guarantees of MBS are far and away the most important. The GSEs purchase and hold relatively few whole mortgages in their retained mortgage portfolio.

However, Fannie and Freddie do have large portfolios of MBS, which they have acquired by repurchasing the guaranteed MBS they or others have already sold to investors. In fact, by the end of 2001, the GSEs together held in their own portfolios about one-third of all MBS then outstanding, about $1.2 trillion. Why would the GSEs repurchase the MBS that were already in the hands of investors? The answer is earnings.

There are two basic risks associated with MBS—credit risk (that the mortgages in the pool will default) and interest rate risk (that interest rates will rise). When the GSEs guarantee MBS, they are taking only the credit risk of these mortgages. The interest rate risk is assumed by the investors in the MBS. For taking the credit risk, the GSEs receive a guarantee fee, but the credit risk on the MBS is not very great, and the guarantee fees they receive do not add significantly to their bottom line.

What does add to their bottom line is the gap between what they have to pay for their funds—only slightly more than what the Treasury itself pays—and what they can earn on a portfolio of MBS. How much profit this offers is shown by Figure 4, which was prepared by Professor Dwight Jaffee of Berkeley for an American Enterprise Institute conference in June. In the chart, the GSEs' "net interest income" is the difference between what they pay in interest to carry their portfolio of MBS, and the yield on that portfolio. Clearly, acquiring and holding their own MBS is what makes the GSEs so profitable.

But this same activity, also makes them risky. Repurchasing their own MBS requires the GSEs to issue huge amounts of debt—almost $1.4 trillion—to carry their MBS portfolio. This increases the risk that taxpayers may one day have to shoulder this debt, and it requires them to take interest rate risk in addition to the credit risk they were already taking through their guarantee. In fact, the spread between their cost of funds and the yield on their MBS portfolio—the source of their interest rate risk—accounts for the vast bulk of the profit that the GSEs earn on their MBS portfolios. Figure 5, also prepared by Professor Jaffee, shows that the GSEs earn most of their MBS profits from taking the interest rate risk (which Professor Jaffee calls liquidity risk) and not the credit risk on the MBS.

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Not surprisingly, since most of the profit in the MBS is the result of taking interest rate risk, this risk also creates almost all of the risk of loss and default that the GSEs—and hence the taxpayers—ultimately bear. Although the GSEs say that they hedge these risks, the disclosures of their hedging techniques are not adequate to determine how effective these hedges are or how much of their risk these hedges actually cover. One of the benefits of SEC registration may be that the GSEs will now be forced to disclose more about the degree to which they are exposed to interest rate risk on their MBS portfolios. Moreover, many observers are skeptical that the GSEs can be as profitable as they claim if they are fully hedging their interest rate risks. After all hedges—where some other party is assuming the hedged risk—are not cheap.

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The important and ironic fact in all of this is that although the GSEs are taking most of their risk by acquiring MBS already held by investors, this activity does not have any substantial impact on mortgage interest rates. Most observers, and government officials who have testified on the question, do not believe that the GSEs' purchase of MBS have any effect—positive or negative—on interest rates in the mortgage market. It appears, then, that Fannie and Freddie are voluntarily taking the substantial interest rate risk associated with repurchasing MBS they have already sold to investors solely for the purpose of increasing their profits, not in pursuit of their housing mission. In other words, the taxpayers are bearing a risk that does not even foster lower interest rates for residential mortgages; the only effect it has is to increase the profits of Fannie and Freddie.

This state of affairs opens an easy road for Congress to reduce taxpayer risks without affecting the mortgage markets. Although eliminating all the privileges of the GSEs, and their links to the government, would be the preferred way to protect the taxpayers in the long run, it will be difficult to achieve in the short run. Because Congress is afraid of adversely affecting mortgage interest rates, it will be reluctant to adopt legislation as far-reaching as Congressman Paul's bill. That's the hard way to protect taxpayers. The easy way is simply to prohibit the GSEs from repurchasing the MBS they have already placed in the hands of investors. It will have no effect on mortgage interest rates, it will eliminate the need for the GSEs to issue substantial amounts of debt, and of course it will eliminate their substantial interest rate risk. ◆