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Government Sponsored Enterprises (GSEs): Why is Effective Government Supervision Hard to Achieve?

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> "Concern about the apparent imbalance between the costs and benefits of the housing GSEs extends beyond the $ 2 billion a year that they retain. One further concern is that Fannie Mae and Freddie Mac rather than public officials substantially control the amount of the subsidy provided to the GSEs." Congressional Budget Office (CBO), *Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac* (May 1996)
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> "This [CBO Study of Fannie Mae and Freddie Mac] is a case of policy wonks piling their own prejudices on top of faulty analysis, and if these digit-heads could figure out a better way of delivering credit to millions of families with the use of private capital while paying the government billions of dollars in federal taxes, then they can get a real job in Washington." Fannie Mae Vice President for Corporate Relations, *Washington Post*, May 30, 1996[1]

The federal government creates government sponsored enterprises (GSEs) to help carry out public purposes. Yet, public officials often lack the ability to adjust the balance between public benefits and public costs of the GSEs. Why is government supervision so ineffective?

Several answers suggest themselves: (1) the government subsidy allows GSEs to expand and increase their risk-taking without facing the market discipline that constrains other companies; (2) the GSEs have both incentive and ability to influence or dominate the political process; and (3) the unusual legal structure of GSEs involves complexities that policymakers may not fully understand. This paper contends that all of these factors make government supervision difficult, if not impossible, and also make it difficult for the government to devise an exit strategy.

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I. The Market Effects of the Government GSE Subsidy

In chartering a GSE, the federal government provides it with an array of subsidy benefits, including tax and regulatory preferences. One of the most important is the authority to borrow in the so-called federal agency debt market and to issue debt obligations and mortgage-backed securities (MBSs). These obligations and securities are not backed by the full faith and credit of the United States. Nevertheless, they convey the impression of an implicit government guarantee.

Most GSEs can also issue debt obligations, and MBSs or other guarantees, that are backed by much less capital than the government would require for a bank or thrift institution in the same kind of business. These two statutory benefits give several of the GSEs enormous economies of scale.

The government buttresses these benefits by limiting the number of GSE charters, and thereby creating substantial barriers to entry. As a general proposition, the holders of a GSE franchise need not worry about competition from new institutions that could enter the market and compete on similar terms.

Freddie Mac's Chief Economist Robert Van Order has described the competition of GSEs against commercial banks and other firms as a system of "dueling charters." Success in the marketplace under this system rewards the firm with the most favorable government charter, rather than necessarily the most efficient firm. Simply put, when the government applies unequal standards of safety and soundness, and especially capital standards, to different kinds of financial institutions that provide comparable services, it creates serious financial distortions.

In the mortgage market, for example, the low capital standards for Fannie Mae and Freddie Mac offer substantial opportunity for regulatory arbitrage across institutions. Thus, if a bank or thrift must maintain at least four percent capital to back a residential mortgage that it buys, but a GSE must maintain much less capital to hold or fund the same mortgage, it benefits both the bank and the GSE for the bank to sell the mortgage to the GSE, or at least to swap that mortgage for a GSE-backed MBS. Robert Van Order's "dueling charters" thus raise the specter of Stanton's Law: *risk will migrate to the place where the government is least equipped to deal with it*.

The results in the marketplace are easy to see. The two largest GSEs, Fannie Mae and Freddie Mac, have roughly doubled in size every five years since Freddie Mac was chartered in 1970. Table 1 shows their combined growth, in terms of their outstanding debt obligations plus outstanding mortgage-backed securities, between 1970 and 1999:

Table 1

1970	1975	1980	1985	1990	1995	1999
$15.2 Billion	$ 37.2 billion	$ 76.6 billion	$ 261.3 billion	$ 768.0 billion	$ 1.3 trillion	2.1 trillion

Source: CBO (1991)[2] and OFHEO (2000)[3]

Table 2 shows how Sallie Mae too has doubled in size every five years (again in terms of GSE obligations outstanding), for about two decades. Sallie Mae's growth rate then diminished as it sought and in 1996 received authority to transform into a company that ultimately would operate without government sponsorship.

Table 2

1970	1975	1980	1985	1990	1995	1999
n.a.	$ 0.3 billion	$2.7 billion	$13.4 billion	$39.0 billion	$47.5 billion	$ 42.0 billion

Source: CBO (1991) and Sallie Mae annual financial statements[4]

A cooperative GSE's dynamics differ from those of an investor-owned GSE, but time constraints do not permit me to discuss these differences[5] or the unusual financial activities of the Federal Home Loan Banks. It bears noting, however, that the Federal Home Loan Bank System also has grown rapidly, in terms of its consolidated obligations outstanding:

Table 3

1970	1975	1980	1985	1990	1995	1999
$10.5 billion	$ 16.4 billion	$ 37.3 billion	$ 75.6 billion	$ 117.9 billion	$ 231.4 billion	$ 525.4 billion

Source: CBO (1991) and FHLBS annual financial statements

The investor-owned GSEs also have achieved super-normal profits, commensurate with their market power. They make money first by driving competing firms out of the best parts of the markets that their charters permit them to serve. Second, they can push their government sponsored advantages forward from the secondary market into the primary market. Fannie Mae, Freddie Mac, and Sallie Mae all have used technologies to achieve this result. Figure 1 is taken from a 1995 report of the Office of Federal Housing Enterprise Oversight (OFHEO). It shows how Fannie Mae and Freddie Mac have been able to use the combination of market power and technology to absorb

functions into the secondary market, along with the associated profits, that formerly were carried out by primary market lenders.

Today, Fannie Mae and Freddie Mac, the largest GSEs, are moving rapidly to shape the primary mortgage market in their own interests. GSE-supplied technology will allow many smaller firms to originate mortgages while a few larger firms use economies of scale to service them. The impact of government-sponsored duopoly on the residential mortgage market could be a useful study in market organization.

The third way that the GSEs can earn supernormal profits is by moving into higher risk activities. This is especially important for a GSE because of the way that its special purpose legal charter otherwise may limit it to dealing in a narrow range of assets. A notable example is Freddie Mac. Over the 1970s and 1980s, Freddie Mac had conducted most of its funding activities through securitization rather than building a large portfolio. This prudent method of operation had protected Freddie Mac from the interest-rate mismatch that almost brought Fannie Mae to its knees in the early 1980s.

In 1989, Freddie Mac's Chairman told the Congress that Freddie Mac would continue to rely on securitization and would not grow a large mortgage portfolio.[6] That is not the case. Freddie Mac today conducts a much of its funding activities through a growing portfolio. Stock analysts regularly value Fannie Mae and Freddie Mac stock according to their portfolio growth. Growing Freddie Mac's portfolio is a way to increase earnings, even if this increases risk to the government. The balance of public benefits and public costs could be increased by limiting or probably even eliminating Fannie Mae's and Freddie Mac's portfolios in favor of funding through guarantees of mortgage-backed securities.[7]

The expansion of GSEs in the marketplace is fueled by the subsidy that they gain from their federal charters rather than unambiguously from offering more efficient combinations of quality and price. When a GSE increases its risk profile by growing a large mortgage portfolio, for example, or by increasing its leverage more generally, the perception of an implicit government guarantee shields GSE shareholders from the financial consequences. Even after the Farm Credit System announced in the mid-1980s that it could not meet its obligations, that GSE continued to have access to the debt markets at interest rates better than those for conventional "A" rated corporations. When Fannie Mae and Freddie Mac issued so-called subordinated obligations earlier this year, the rating agencies gave this debt an "AA" rating, based largely on the perception of implied government backing. (For a firm without government sponsorship, subordinated debt generally trades as a "junk bond," in terms of perceived credit quality.)

The perception of implied government backing means that a GSE's market discipline is seriously attenuated. This places a much greater burden on government regulation to try to promote safety and soundness of a GSE than if market discipline played a more significant role.

II. GSEs and the Political Process

The GSEs are formidable players in the political process, spurred by the immense benefits that the government provides vis-à-vis other firms. Conversely, adverse policies can diminish GSE shareholders' financial prospects. Sallie Mae decided to give up GSE status because of a number of unwelcome developments. These included the government's creation of a direct student loan program, to compete with the guaranteed student loan program in which Sallie Mae was the dominant player, and Congress' 1993 decision to impose a 30 basis point (0.3 percentage point) "offset fee" on Sallie Mae to help level the playing field between it and its bank competitors.

In short, a GSE can live or die according to the political process. A federal charter means that politics rather than the market determines its major issues. These include which fortunate individuals receive the GSE charter, whether government will charter other firms on the same terms, how much capital the GSE should hold, the extent that the government will constrain risk-taking by the GSE, and whether the GSE will go out of business when its net worth drops to zero.

With so much at stake, it is no surprise that the GSEs seek to leverage their market power into political power. Representative Jim Leach (R-IA) made these comments during the political struggle to create the Office of Federal Housing Enterprise Oversight to regulate Fannie Mae and Freddie Mac:

> "[I]t is not surprising that Fannie and Freddie are beginning to exhibit that arrogant characteristic of a duopoly, controlling 90% of the market. Such market dominance allows for heavy-handed approaches to competitors, to financial intermediaries, and to consumers. Competitors such as community based savings and loan associations and commercial banks are also users of GSE services. They are understandably apprehensive about expressing reservations about their practices in fear of retaliation. Likewise, would-be competitors such as securities firms run well known market risks if they object or attempt to compete with Fannie and Freddie. The two GSEs distribute billions of dollars of business on Wall Street and have a reputation of not cottoning to challengers of the status quo."[8]

A review of some news headlines from the *Wall Street Journal*, the *New York Times*, and other sources gives the flavor of the determination with which a GSE may try to hold on to its charter privileges:

- "Inquiry into Fannie Mae Pressure," *New York Times*, May 4, 1983, p. D1
- "Debate on New U.S.-Backed Mortgage Security Stirs Charges of Greed, Government Domination," *Wall Street Journal*, April 20, 1987, p. 48

- "Power of the Mortgage Twins: Fannie and Freddie Guard Autonomy," *New York Times*, November 12, 1991, p. D1
- "Powerful Corporation Persuades House Panel to Retreat on Tax," *New York Times*, June 24, 1993, p. A-18
- "The Money Machine: How Fannie Mae Wields Power," *Washington Post*, January 16, 1995, p. A1
- "A Medici With Your Money: Fannie Mae's Strategic Generosity," *Slate*, February 22, 1997
- "HUD to Query Fannie Mae on Underwriter's Withdrawal From Freddie Mac Debt Deal," *Inside MBS & ABS*, May 28, 1999
- "AEI Conference on Fannie, Freddie Spawns Crossfire," *Dow Jones Newswire*, September 9, 1999
- "Fannie Mae Hit on Lobbying Bid: 2 Lawmakers Criticize Letter Campaign," *Washington Post*, May 17, 2000, p. E3
- "Firms Report Fannie Mae, Freddie Mac Threats," *Wall Street Journal*, March 8, 2001, p. A3

GSEs are tough and stubborn. In 1996, the Treasury Department reported on the difficulty of adjusting GSE charter acts to take account of changing public priorities:

> "When creating a GSE, Congress defines the problem (i.e., the market imperfection) it seeks to overcome, provides benefits (subsidies), and imposes limitations on the GSE. But if Congress wishes to revise those decisions in response to changing public needs, it no longer has the same freedom of action. In addition to the usual constraints of the legislative process, it must contend with the private interests of the GSE and its shareholders. Congress must consider, and legislate, any such changes through a process in which the GSEs are significant participants. As a private company, the GSE will act to fulfill its fiduciary responsibilities by promoting and protecting the interests of its shareholders."[9]

Treasury itself came under intense GSE pressure in writing its 1996 report, to the point that the department substantially weakened its statements about removing government sponsorship from Fannie Mae and Freddie Mac.[10] More recently, in response to growing controversy about their roles in the mortgage market, Fannie Mae and Freddie Mac have expanded their already substantial presence in the political process.

In 1999, Fannie Mae and Freddie Mac increased their lobbying spending to over $ 11 million, in response to lobbying by private mortgage market companies that seek to limit the expansion of the two GSEs. They also greatly increased their "soft money" political contributions.[11] Political action does have limits, especially if a GSE falters or fails. Nonetheless, these powerful institutions make government supervision, and even the enactment of appropriate safety and soundness legislation, difficult at best.

Some corporations have more or less affable or aggressive institutional personalities than others, but that is not my point. Rather, the drive to dominate the political process is related directly to the GSE's unusual legal structure, and its statutory charter in particular. Our history reveals a number of instances of the intemperate application of political power by private institutions that the government chartered to carry out public purposes. In the 19th Century, these included the Union Pacific Railway and the second Bank of the United States, the lineal ancestor of today's GSEs.[12]

III. The Complicated and Unusual Legal Structure of GSEs

Thus far, the argument has addressed two issues, (1) the government subsidy benefits that attenuate or even displace market discipline and complicate government supervision of GSEs, and (2) the political dominance that the GSEs try to achieve to preserve and expand their charter benefits. A third issue is also important: GSE charters are extraordinarily complex legal instruments that may not be well understood by policymakers.

Two recent proposed charter act amendments illustrate the dangers of a process of legislative enactment of provisions that only the GSEs may understand. One was a proposed amendment to the Federal Home Loan Bank Act in 1998 that was a small part of a larger financial regulatory relief package. The other was a 1999 amendment to the Freddie Mac charter act that actually became law. It was so ill-conceived that the Congress was forced to reverse it in new legislation only two weeks later.

The Federal Home Loan Bank Act amendment circulated in the Senate.[13] It consisted of a fifteen sections that purported to allow modernize the charter act of the Federal Home Loan Banks (FHLBanks) and authorize them to serve community banks, especially in rural areas. The FHLBanks would make advances collateralized by additional types of loans, such as loans for small business, agriculture, rural development, or low-income community development. In fact, however, the amendment contained a much broader provision than that. Under one section of the amendment, the FHLBanks would be permitted to lend directly to virtually any borrowers by investing in a broad range of assets including (1) mortgages, (2) mortgage-related securities, and (3) such assets as fiduciary and trust funds may hold under state laws where the individual FHLBank is located.

This latter language, though obscure, was sweeping in its implications. Some state laws expressly permit investment in oil wells and mining ventures, farms, livestock, timber and agricultural operations generally, and also permit the trustees to vote their equity interests. In other words, the broad language of this section of the amendment would have permitted a FHLBank to issue agency status debt to acquire and operate commercial ventures without regard to restrictions that prevent commercial banks from mixing finance and commerce.

The community banks that supported this amendment did not point out to their congressional supporters that the new powers would permit the FHLBanks to lend money

in competition with their member institutions. The amendment also included a provision allowing the FHLBanks to limit if not essentially eliminate their cooperative governance structure.

Fortunately, after financial experts and think tanks sounded the alarm, the Senate sponsor withheld the amendment and reworked it to become a more modest piece of legislation. If enacted as written, it would have given a GSE power to displace community banks from many of their most profitable lending activities, if not put many of them out of business altogether, all in the name of helping community banks.

In another instance, in the closing days of the 105th Congress, Freddie Mac attempted to secure enactment of a charter amendment that would have allowed it to bear the financial risk on low-down payment mortgages, rather than requiring them to be covered by private mortgage insurance. Since 1970, both the Freddie Mac and Fannie Mae charters provided that, when they purchased a conventional mortgage, each GSE would need to be sure that private mortgage insurance covered any credit risk above an 80 percent loan-to-value ratio. Freddie Mac sought a charter change to permit it to assume that credit risk and eliminate any requirement for private mortgage insurance.

Freddie Mac obtained the support of the then-Chairman of the Senate Banking Committee, who obtained the addition of the Freddie Mac charter amendment to a bill in a House-Senate conference committee, at the final stages of the legislative process.[14] The President signed it into law shortly thereafter. If it had prevailed, the amendment would have permitted Freddie Mac to take over much of the core business of many mortgage insurance companies. Faced with a drastic drop in their companies' value, the mortgage insurance industry mounted a hasty campaign to reverse the provision.[15]

These two legislative initiatives, although ultimately unsuccessful, highlight GSE powers today. First, GSE legislative provisions are arcane and often poorly understood by the legislators who sponsor them and the relevant congressional committees.

Second, seemingly small changes in a GSE charter can have substantial implications for the financial system. Not only GSEs' current competitors, but also other firms in markets the GSEs may want to penetrate, should remain alert. GSEs can make an appealing argument for change; the change, for example that it will enable the GSE to offer more services at lower cost, and can obscure the larger implications.

The GSEs can enhance later interpretations of new legislation by providing floor statements and committee report language that become a part of the legislative history in ways that policymakers may not have intended. Once enacted, GSEs and some regulators can infuse meaning into the arcane provisions and thereby permit GSEs to enter entirely new lines of business such as (in the two examples above) making equity investments or providing coverage to replace private mortgage insurance.

The consequences are particularly serious when statutory provisions involve safety and soundness. While private competitors of the GSEs may scrutinize legislation

that affects them, it is primarily the government, on behalf of taxpayers, that has a direct stake in the quality of supervision of the safety and soundness of a GSE.

The most recent example is H.R. 4019, the "Secondary Mortgage Market Regulatory Improvements Act," introduced on April 5, 2001. On its face, it would improve the government's statutory basis for addressing GSEs' safety and soundness. Among other provisions, it transfers to the Federal Reserve Board responsibility for supervision of Fannie Mae and Freddie Mac. However, instead of basing the government's authority on well-tested statutes applicable to federal bank regulators, H.R. 4019 builds on the dubious foundations of the current statutory structure for oversight of Fannie Mae and Freddie Mac.

This will create problems. The congressional sponsor of H.R. 4019 states that, "Congressional appropriations approval is not required" to provide funds for the GSE regulator. That is not the case. The bill would continue to require that assessments by the regulator be placed in a fund in the Treasury. The Constitution states, in Article I, Section 9, that, " No money shall be drawn from the Treasury, but in consequence of appropriations made by law..."

Even if a court should find that the money going into the Treasury fund were private, the regulator still would need an appropriation to get it out. A court would be buttressed in this conclusion because of other parts of the assessments provision as well.

Thus, the congressional sponsor, even if he were to succeed against the odds in getting his bill enacted, would not achieve the results that he intends. The trap hidden in this provision is likely to spring only if the affected parties find themselves in a time of crisis or controversy. If the Federal Reserve Board anticipates receiving responsibility under H.R. 4019, it would behoove its lawyers to take care that the Fed receives a full regulatory toolbox before it tries to carry out its nominal supervisory authority.

IV. Where do we go from here?

The problems of (1) lack of adequate market discipline, (2) GSEs' political dominance, and (3) legal complexities that undercut even well intentioned pieces of legislation, are formidable obstacles to effective government oversight. Yet, the GSEs must know that they cannot continue to double in size every five years. Indeed, the rate of growth appears to be tapering off for the largest GSEs.

Needed is an exit strategy.[16] Similar to the exit strategy for Sallie Mae from government sponsorship, the government will need to take advantage of windows of opportunity to push GSEs into giving up government sponsorship.

This will not be easy. This paper will close, as it began, with words of wisdom from the Congressional Budget Office:

"Of course, such options [to prepare for removal of government sponsorship] beg a question: why would the GSEs agree to those policies as a first step toward the withdrawal of their subsidy? That admission simply acknowledges that once one agrees to share a canoe with a bear, it is hard to get him out without obtaining his agreement or getting wet."[17]

[1] Albert B. Crenshaw, "CBO Faults Subsidies For 2 Finance Firms," *Washington Post*, May 30, 1996, pp. D9, D17; See also, Richard W. Stevenson, "Report is Skeptical of U.S.-Backed Home Mortgages," *The New York Times*, May 30, 1996, p. D1.

[2] Congressional Budget Office, *Controlling the Risks of Government-Sponsored Enterprises*. Washington, DC, April 1991, Table 3, p. 12.

[3] Office of Federal Housing Enterprise Oversight, *2000 Report to Congress*, Tables 4 and 14, p. 103 and 113.

[4] A small amount of the 1999 borrowing may be non-GSE debt; the 1999 SLM Holding Corporation financial statements are not completely clear on this point.

[5] See, e.g., Thomas H. Stanton, "Elements of Institutional Design in Financial Services Legislation," presentation to the Fall 1999 Research Conference, Association for Public Policy and Management, November 6, 1999.

[6] "Government-Sponsored Enterprises," Hearing before the Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, Serial 101-65, September 28, 1989 (Testimony of Leland Brendsel, CEO of Freddie Mac), at pp. 99-100

[7] Barry P. Bosworth, Andrew S. Carron and Elisabeth H. Rhyne, *The Economics of Federal Credit Programs*, (Washington, DC: Brookings Institution, 1987), p. 72; see also, Office of Federal Housing Enterprise Oversight, *2000 Report to Congress*, Washington, DC: 2000, at p. 28.

[8]Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives (1991), page 115. (Dissenting views of Representative Jim Leach.)

[9] U.S. Department of the Treasury, *Government Sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation*, July 11, 1996, p. 81.

[10] See, e.g., Jackie Calmes, "Federal Mortgage Firm is Facing New Assault to Privileged Status: But Fannie Has Clout to Counter the Agencies That Seek to Privatize it," Wall *Street Journal*, May 14, 1986, p. 1; Subcommittee on Capital Markets, Securities, and Government-Sponsored Enterprises, Committee on Banking and Financial Services, U.S. House of Representatives, "Oversight of the Federal National Mortgage Association [Fannie Mae] and the Federal Home Loan Mortgage Corporation [Freddie Mac]," July 24, 1996, pp. 136-141 (comments of Chairman Richard Baker).

[11] "Mortgage-Related Groups Spend Record $ 18 Million in Political Lobbying in 1999," *Inside Mortgage Finance*, (Bethesda, MD), June 30, 2000; "Freddie Mac Setting Record in Terms of Soft Money Donations to Political Parties," *Inside MBS & ABS*, (Bethesda, MD), August 11, 2000.

[12] For further discussion of this issue, see Thomas H. Stanton, "Nonquantifiable Risks and Financial Institutions: The Mercantilist Legal Framework of Banks, Thrifts and Government-Sponsored Enterprises," in *Global Risk Based Capital Regulations*, Vol. 1, edited by Professors Charles Stone and Anne Zissu, (Irwin Professional, 1994).

[13] "Federal Home Loan Bank System Modernization Act of 1998," discussion draft, amendment to be proposed to S. 1405

[14] Connor, John. "Freddie Mac May Get Authority to Buy Riskier Down-Payment Mortgages." *Wall Street Journal*, October 7, 1998, p. B2

[15] Dao, James. "D'Amato's Mortgage Measure Faces a Repeal by Congress; His Plan Favored a Campaign Contributor." *New York Times*, October 20, 1998, p. A28

[16] It must be conceded that this represents something of a change in position. When I published *A State of Risk* about GSEs in 1991, the *Economist* magazine review of the book (May 25, 1991, p. 98) chided me that I possessed, "an (American) liberal's instinct that they [the GSEs] could be valuable instruments of federal policy in pursuit of wooly-sounding social goals."

[17] Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac, p. 44.