COMPETITIVE ENTERPRISE INSTITUTE

On The Future Of The GSEs
Fannie Mae and Freddie Mac

Testimony of
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Before the Capital Markets Subcommittee
Of the U.S. House of Representatives
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INTRODUCTION

My name is Fred Smith. I head the Competitive Enterprise Institute, a pro-market public policy group. CEI has focused for many years on the ***moral hazard*** problem which is the topic before this Committee. Clearly Fannie Mae and Freddie Mac were created for "good" purposes – now the issue is whether the special privileges they've been granted, specifically their implicit government "insurance" policy, act to distort and destabilize the marketplace.

CEI has been active in examining such moral hazard concerns over the last 16 years. We have long been critical of corporate welfare. We have done extensive work on the comparative value of private as opposed to political insurance, questioned the ability of the IMF to act as "credit doctor" to the sick economies of the world, and criticized the capability of OPIC to better address the risks of overseas investment. Perhaps most relevant to the issue today, we were very active in the policy debates surrounding the S&L deposit insurance crisis of the 1980s.

As others have noted, there is a disturbing similarity between the confused mix of explicit (to the smaller depositor) and implicit (to all depositors and, in effect, to the S&L itself) guarantees available to the S&Ls under the deposit insurance program, and the similar explicit and implicit taxpayer guarantees to Fannie Mae and Freddie Mac (and indeed the other GSEs) which arise from their partially private/partially political nature.

This Committee is asking the right questions. It may indeed be the case that these subsidies are warranted. If so, then let us bring these agencies into a normal reporting relationship with the executive branch (possibly within Treasury) and have the appropriate oversight committees in Congress decide their powers, budget, operating authority and compensation schedules. There should be no subsidies to private parties without holding these parties accountable to the elected representatives of the people: *No subsidies without representation*!

On the other hand, if these subsidies are not warranted, then let us eliminate them and privatize these entities as expeditiously as possible. What I would hope this Committee will not do is to perpetuate the mixed status these organizations now enjoy. To paraphrase William Shakespeare: Fannie Mae and Freddie Mac are neither private "fish" nor political "fowl." No one knows how to evaluate them – it is time to end this confusion.

Privatizing the profit side of the ledger while socializing the loss side is a sure-fire recipe for disaster. It was exactly that problem that so exacerbated the plight of the S&Ls in the 1980s. The smartest investors in the world found it highly rational to invest in some of the worst managed thrifts. These investors realized that the high interest rates offered by these failing institutions *did not* entail any excessive risk. Indeed, they entailed almost no risk at all, since the guarantor of these investments was not the individual S&L, but rather the U.S. government (and thus the U.S. taxpayer). Of course, investors had to exercise due diligence – you had to be careful to ensure that you placed your deposits in a "safe" failing S&L (one that was *Too Big To Fail*) rather than an "unsafe" failing S&L (that is one that was *Too Small To Save*).

And, of course, you had to move faster than the regulators and pull your money out before they actually got around to closing down the institution. But that wasn't difficult. The result?

Sophisticated investors profited massively. Hundreds of billions of capital dollars flowed from well-managed parts of the economy into poorly managed S&Ls. From 1981 to 1984, S&L assets ballooned from $600 billion to around $1200 billion, during a time when this industry was failing badly. Almost all of those assets flowed into the bankrupt part of the industry and, not surprisingly, most of those assets were also badly invested by the S&Ls.

The costs of that misallocation of capital were borne by the taxpayers directly, but the costs also included the waste of misallocated resources, evidenced by empty office buildings and abandoned housing developments in many American cities. The costs were not only in the S&L sector; prudent investors in insurance and other sectors of the economy who operated without government subsidies found that their investments were no longer profitable because of S&L over-investment. Business cycles are painful enough without the additional instabilities created by such subsidy-induced market distortions.

BASIC PRINCIPLES

In assessing the wisdom of the confused private/political nature of these institutions, keep in mind that the basic task of a market economy is *to allocate capital*. The entrepreneur is responsible for considering the available array of returns and risks, and then selecting investments which are most likely to yield the "best" return. The possibility of both profit and loss provides the discipline for the entrepreneur to choose the best use for capital based on consumers' demand – to become more knowledgeable, to explore possible technological and institutional innovations, to improve investment skills over time.

In the American free enterprise system, we entrust the entrepreneur with this critical task. She gains profits (sometimes very large profits) if she is right; she loses (sometimes sharply) if she is wrong. The entrepreneur's risk management skills—in selecting those individuals who receive loans, in supervising the lending operation, in diversifying the loan portfolio—together with uncontrollable circumstances, determine success or failure. The unhampered market is the most effective way to encourage such vital entrepreneurial activity.

The moral hazard problem arises when we bail out investors when things go wrong, when we move toward a "profit-side capitalism/ loss-side socialism" strategy. This is what happened in the S&L crisis and the costs were massive. "Moral hazard" is always a risk when an activity is insured – but the private sector is far better at policing such induced risk. When it's your money at stake, you're more careful. Political money managers faces weaker market disciplines: if they fail, they only share in the loss. Government risk subsidies anaesthetize our sensitivity to risk. As Treasury Undersecretary Gary Gensler noted: "Promoting market discipline means crafting government policy so that creditors do not rely on governmental intervention to safeguard them against loss."

Determining the seriousness of the risks that America faces because of the guarantees granted GSEs is not an easy task. However, we do know that the current system resembles that of the S&Ls . The moral hazard risks associated with government guarantees have not gone away; indeed, one might argue that they have now been *concentrated* in Fannie Mae and Freddie Mac.

These institutions hold a much larger portfolio of housing-related financial instruments (and a more concentrated form of assets) than did any S&L in days past. A systemic downturn in the housing market may lead them into increasingly risky lending practices as it did the S&Ls in years past.

Indeed, the rapid growth of these agencies over the last decade and the rational (or perhaps not-so-rational) exuberance that has caused their stock values to appreciate so rapidly is indicative of a heady expectation that they represent a low-risk investment to investors – if not to society. Certainly, much has been made of the skill of Fannie and Freddie in creating a secondary market in home mortgages and, undoubtedly, they merit some applause here.

However, while the risk of a packaged portfolio of risky loans can be lower than the risks of the loans on an individual basis, the risk of such a portfolio can also be *higher*. How well have Fannie and Freddie packaged such loans? If these were private firms, one could be reasonably sure that the purchasers had checked all this out – they would be the ones who would lose if the packaging was careless, after all. Given the implicit guarantees enjoyed by Fannie and Freddie, is anyone really ensuring that all of these factors have been taken into account? Markets are very effective regulators, but Fannie/Freddie operate only partially in the free market.

The fact is that, we can never be totally sure of the safety or insecurity of the GSE system. Still, the S&L crisis is a very good moral lesson. Most S&Ls were well run by fiscally responsible individuals. It was only when the system got into trouble that older managers began throwing "Hail Mary" passes, and newer go-go managers were attracted to the scene. The situation moved from tranquility to chaos in a very short period of time; reasonable losses became catastrophic in only a few years. The problem was manageable until it became intractable.

That's the problem with Fannie Mae and Freddie Mac. It isn't raining yet – and Franklin Raines seems like a pretty good manager. What will all of this look like if the economy turns sour, if many of these over-extended new homeowners begin to default? What will happen to Fannie Mae if it becomes less attractive to investors? Furthermore, is the move of the GSEs into newer lending areas – necessary if they are to continue their rapid growth – really wise? Is it really fair to enterprises who do not enjoy these agencies' special privileges?

Now is an ideal time to address this problem. The major GSEs seem healthy; stock values seem upwardly less volatile than in years past (therefore, one might anticipate that current values reflect less of an expectation of super growth in coming years). The economy at this time is still robust and the managers of these institutions seem confident of their competency and the soundness of their institutions. Indeed, they seem proud of their ability to manage risk. Good – then let's quickly eliminate the features that now weaken the market disciplines facing them and their customers.

Too often, Congress does nothing when things seem to be going well – and then finds itself unable to take disciplinary action when the crisis occurs. At that late point in the process, the pain would be too great and the political resistance too strong. When it's not raining, the roof isn't leaking – when it's raining, it's too difficult to fix it. Surely we can do better, and you, Mr.

Chairman and this Committee, deserve full credit for your foresight in addressing this problem at a time when corrective action can be taken at relatively low cost.

Of course, you will have opposition to any effort to wean the Fannie Maes of the world away from their federal subsidies. My casual observation suggests you may face even more opposition from the newspapers and Fannie Mae's ad agencies. (I've never seen a private firm spending so much on such "public service" ads.)

HAVE FREDDIE AND FANNIE OUTLIVED THEIR USEFULNESS?

To ask this question is to risk heresy, as the reader of today's (6/14/00) *Washington Post* can quickly ascertain. Absent these building blocks of the Great Society, American home ownership would be curtailed, mortgage rates would soar, the terms of our mortgages would be far less favorable, and, they seem to say, we'd all be far worse off. Indeed, these ads suggest that the secondary markets in mortgages would somehow disappear without Freddie and Fannie.

Moreover, they argue that their chartered privileges aren't really relevant to the institutions themselves. They seem to suggest that Fannie and Freddie would exist pretty similarly in a purely private setting. However, the costs of housing would go up. They note that even if one accepts the $6.5 billion per year subsidy level estimated way back in 1995 (at a time when these institutions were much smaller), that at least two/thirds of that subsidy is passed along to consumers in the form of lower interest rates.

Still, they obviously do receive and enjoy these special privileges – why else would they be lobbying so aggressively not to have them taken away? In part, I suppose, this must reflect the salary levels of this organization which are certainly more generous than those typical in the political side of the coin. (Raines' salary alone would probably finance the top echelon of the Treasury.) There's nothing wrong with high salaries, of course, but one wonders whether these would be available absent the special treatment. (All this recalls the story about the missionaries to Hawaii who came to do good and did very well indeed! There's a lot of money in public service – at least at Freddie and Fannie.)

In preparing for this testimony, I was amused at the number of stock analysts who called to ask me whether I thought that GSE reform was even remotely likely. They couched their remarks in questioning tones: "Well, why are you opposed to GSEs?" When I suggested the case outlined above, they pressed me to be more explicit. When I asked why they cared, they explained that they rate Fannie and Freddie. So I asked if they would change the ratings if the agencies' special privileges were removed. "Sure," they responded – and, of course, that's what's going on here. If a reasonable lobbying effort can retain these privileges, then Fannie Mae and Freddie Mac will have lower costs of business and be able to quash their competitors. It's good for them – but not so good for the American taxpayer or for competing financial institutions in the free market.

After all, would the ending of these institutions special status really create any serious problems? Perhaps, but I doubt it. After all, these institutions were created at a period when federal and state financial service regulations blocked the geographic diversification necessary for stabilizing loan markets, for arbitraging to smooth out the roughness that made loan rates so variable around the nation. It was not that markets failed or that entrepreneurs weren't innovative -- but rather that markets were crippled, handicapped by excessive regulation.

The innovations that the GSEs have so benefited from today – the packaging of securities so as to reduce the overall risk of the portfolio and the subsequent securitization of that portfolio both to diversify risk and to expand the market for such risks – were pioneered, after all, outside the Freddie/Fannie world by Michael Milken and others. Secondary markets would exist regardless of what this committee may elect to do.

Fannie and Freddie were granted special privileges in their charters. They are exempt from SEC registration (an exemption estimated to save them hundreds of millions annually) and from state and local taxes (another "savings" in the hundreds of millions – and one that is especially troubling here in the District of Columbia). Banking rules allow their securities to be held in unlimited amounts by banks and other deposit-insured institutions (based on the presumption that they are somehow "riskless" securities). They were also granted an explicit line of credit from the Treasury. Most importantly, there is a widespread presumption that in the event of problems, the full faith and credit of the U.S. government will be called upon – that Fannie/Freddie are *Too Big To Fail!*

As I note below, HR 3703 calls all of these exemptions into question. Indeed, in today's world, deregulation, technological and institutional innovation, and globalization have eliminated whatever original rationale may have existed for the special privileges these entities still retain. There is already a robust market for securitizing a range of securities – entrepreneurial investment bonds, consumer loans (including auto, boat and home improvement loans), accounts receivables. Indeed, the move by Fannie and Freddie into the second mortgage/home equity loan area threatens these now private-sector areas. After all, a "home equity" loan can be used for anything – Fannie Mae may well be financing jacuzzis. How would they know?

To date, there has been too little thought given to eliminating these anomalous creations. Indeed, these institutions have taken advantage of their special privileges to grow rapidly. They now control vastly more resources than do individual thrifts or most banks. Indeed, if current trends continue, their indebtedness will exceed that of the U.S. Treasury within the next few years. America has spent much energy in working its way out of the massive federal debt that we accumulated over the last century –a public debt that was explicit and highly visible, and thus. clearly accountable to the American taxpayer. We are now at risk of building debt that would be largely invisible to the checks and balances of our political process, a debt that would be hidden behind the implicit guarantees enjoyed by Fannie and Freddie.

Mortgage rates might go up somewhat should these agencies' special privileges be taken away, but that's happened for the last several years and it hasn't created any noticeable problem in housing markets. Most of the benefits of these programs go to people who would buy or refinance in any event – mostly to middle and upper income beneficiaries. Fannie and Freddie certainly are not in the business of alleviating poverty. They pay some healthy fees to gain local good will, but that is public relations (not economics or welfare). There would be some very good aspects of ending all this. Any market gains by Fannie or Freddie would reflect their superior abilities rather than their special status. There would be no crowding out of current firms providing creative services in the consumer credit and insurance fields. If these agencies are out-competed, so be it.

We should realize that the capital that is attracted to the housing markets by Fannie and Freddie doesn't come out of thin air: it is diverted from other possible end uses in the market. These uses include the financing of small businesses, technological startups, municipal and state programs, and foreign investments. Artificial shifts of capital into the housing market, of course, benefit somewhat those now purchasing homes, yet it disadvantages all of the above groups. Whether, on net, these loses are offset by the potential gains of additional home ownership is unclear. Would America be better with a marginally smaller home ownership ratio but a somewhat higher marginal rate of successful small business start ups?

The Inherent Unfairness of Fannie and Freddie

Other panel members will address the proposition that these agencies are anti-poverty programs – that they are a means of providing "affordable" housing to low-income and minority consumers. Housing subsidies raise the price of housing – this is a well-known phenomena that reduces the desired impact of most subsidies. As noted above, much of the estimated subsidy (about one-third according to a CBO study) benefits the management and the shareholders of these private firms.

Can anyone imagine Congress approving a $2 billion plus appropriation bill to benefit the management and shareholders of any other private sector firm? The wording of the CBO study was colorful: "As a means of funneling federal subsidies to home buyers, therefore, the GSEs are a spongy conduit – soaking up nearly $1 for every $2 delivered." For that matter, can one imagine an honest debate about the merits of authorizing $4 billion to reduce home ownership costs for middle- and upper- income Americans?

Moreover, while home ownership is a "good thing," so also are other values that may well be harmed by the Fannie/Freddie distortions. Luring undercapitalized individuals into debts beyond their ability to repay does them no favor. Society must tread a very narrow path between pricing the poor out of the market, and exposing them to excessive financial risk. Moreover, the major problems with affordable housing are not borrowing costs, but rather regulatory costs, which fall outside the purview of Fannie and Freddie. Determining the level of debt that can reasonably be handled by people of varying incomes has been one of America's greatest achievements (made possibly by the creative use of credit information). Freddie and Fannie seem to do this very well – but they hold no exclusive rights to this technology.

The features of your bill are positive and some may improve the current situation. I comment on them now:

- A Revised Board: This might be useful; but Fannie and Freddie will still be able to run circles around regulators. Market regulation is the only way to discipline markets.

- More Frequent Reviews/ Approval of New Lines of Business: This may be necessary given the liability that allowing these groups to enter new lines of business would entail. However, bureaucrats will not find it easy to determine whether allowing Fannie and Freddie into new lines of business will be a good idea or not. Recall that Franklin Raines himself criticized the S&L regulators for allowing those institutions to move outside the traditional mortgage field during their crisis.

  Yet, studies of how S&Ls used those expanded powers found that failure rates were not associated with the use or non-use of these expanded line-of-business freedoms. That is, an S&L that stayed within its traditional line of business was as likely, but not more likely, to fail than one that went into non-traditional fields. Fixed-rate long-term securities are not a risk free investment area, after all. The concern here is real – why should subsidized firms be able to compete with private tax-paying firms? Still, the solution is probably not to second guess Fannie and Freddie but rather to privatize them.

- Similarly, the goal of assessing the riskiness of the various elements in the capital reserves of these entities is worthwhile but not easily undertaken by bureaucrats. Capital is a fluid term and many of the newer financial instruments may more adequately protect the security of a firm than traditional securities.

- Repeal the Freddie and Fannie Line of Credit: This is an excellent idea but how can one make that repeal credible? The current size of these institutions argues against any realistic attempt to give them a "haircut." What might be done? It is a good idea but the question is how to make that repeal credible. Politicians weren't even willing to let a large S&L collapse during that crisis.

  I suggest that we consider using the skills of Jamie Gorelick to address this problem. In the study contemplated by this Committee, we might well have her design an appropriate privatization/divestiture plan. Fannie could readily be broken up into two or four national diversified firms, and cut loose from federal subsidies. Ms. Gorelick's experience at DOJ suggests that carving up "too large" corporations is a skill that she has acquired. Why not put it to good use?

- Receivership status: It is always a good idea to plan for a possible disaster before it occurs. Developing a procedure for handling the possible failure of GSEs is a good idea.

- Standardizing the Regulatory and Tax Treatment of Fannie and Freddie: In general, I find these reforms reasonable; however, one must question whether the current SEC rules are rational and thus whether expanding their ambit is a good thing.

- Study – a good idea but I would broaden the study. I would suggest several other issues:
    - Examine the incentives that might face the Freddie/Fannie management if a severe crisis occurs. The S&L crisis triggered behavior that was very different from that characteristic of the industry in calmer times; moreover the leadership attracted to the S&L sector was very different than the cautious blandness of earlier days. Could this also be true of the GSEs?
    - Conduct a distributional analysis of who actually benefits from these programs – how are the interest savings distributed by income groups.
    - A comparative analysis of other secondary markets – "junk" bonds, accounts receivable, auto loans – how did these markets arise, how well do they perform vis a vis the secondary home mortgage markets.
    - A comparative analysis of housing markets in other nations. How do the differential patterns in the housing markets track the differential patterns in consumer markets more generally. Europe, for example, has less friendly housing markets but also less friendly consumer credit markets. What factors account for these differences? How much (if any) credit should go to Freddie and Fannie for our more consumer friendly housing market?

Let me end with a comment on the overall wisdom of the whole concept of Government Sponsored Enterprises. Isn't this oxymoronic? At best, this mixing of private and political incentives creates marketplace confusion; at worst, it leads to a serious misallocation of capital and an increasing risk for American taxpayers. George Orwell noted that in the political world, words can be linked together to suggest almost anything. His writings also suggest that the results of that process are destructive.

Again, I commend this Committee for raising the issue of the appropriateness of GSEs generally and the Fannie/Freddie pair in particular. Change in this area will come slowly, but the first step is opening up the door and letting in fresh air. These hearings are doing that, and from my readings of earlier witnesses, doing it well.