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HOUSING ENTERPRISES

Potential Impacts of Severing Government Sponsorship

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Housing Enterprises: Potential Effects of Severing Government Sponsorship

GAO's testimony, based on its recently issued report,[1] discusses the potential effects of repealing the federal charters ("privatizing") of two government sponsored housing enterprises—Fannie Mae and Freddie Mac. Although the enterprises have improved the availability and affordability of housing finance, federal sponsorship creates a potential taxpayer exposure to $1.4 trillion in enterprise obligations. Privatizing the enterprises thus involves both benefits and risks that need to be considered and weighed carefully .

The federal government provides several direct economic benefits to the enterprises, such as exemptions from state and local income taxes, to assist them in developing and maintaining a secondary market for residential mortgage loans. The most important benefit that the government provides is an indirect one: the perception by investors that the federal government would not allow either enterprise to default on its obligations. This implied federal guarantee lowers the enterprises' funding costs and saves them billions of dollars each year. To some extent, the enterprises pass these savings on to homebuyers in the form of lower mortgage interest rates. However, federal sponsorship also involves significant risks, including the risk that U.S. taxpayers could be potentially liable for the enterprises' obligations.

GAO's analysis indicated that privatizing Fannie Mae and Freddie Mac could have major impacts on the enterprises, American homebuyers and taxpayers, and mortgage markets in general, including:

- substantial increases in the enterprises' cost of operations, and lower profits due to increased competition from other financial firms;
- higher interest rates on mortgages below $207,000, with an estimated $10 to $25 a month in additional payments on a typical mortgage of $100,000, and relatively higher increases for homebuyers representing greater default risks;
- increased competition in the mortgage markets, which GAO believes will likely prevent the reappearance of significant regional disparities in mortgage credit; and
- a decrease in taxpayers' risk exposure to enterprise obligations.

GAO also assessed several more limited policy options, such as imposing a fee on the enterprises to compensate taxpayers for their risk exposure.

[1]Housing Enterprises: Potential Impacts of Severing Government Sponsorship (GAO/GGD-96-120, May 13, 1996).

Each of these options also involves benefits and risks that need to be considered and weighed carefully.

Housing Enterprises: Potential Impacts of Severing Government Sponsorship

Mr. Chairman and Members of the Committee,

We are pleased to be here today to discuss our recently issued report analyzing what the potential effects might be if Congress decided to repeal the federal charters of Fannie Mae and Freddie Mac.[1] Although there is considerable uncertainty about what the actual effects of this so-called 'privatization'[2] would be, and room for honest differences of opinion, there is little doubt that these two federally sponsored enterprises, by creating and maintaining a national secondary market for residential mortgages, have been highly successful in improving the availability and affordability of housing finance. They are, in fact, two of the largest and most profitable financial corporations in the United States today. There is also little doubt that much of their success has come from benefits associated with their special status as federally sponsored enterprises. Federal sponsorship, however, also involves significant risks and potential costs, including the risk that U.S. taxpayers could be potentially liable for enterprise obligations that totaled $1.4 trillion as of year-end 1995. Repealing the enterprises' federal charters thus involves both benefits and risks that need to be considered and weighed carefully. We hope that our report will be of some help to Congress in this regard and commend the Chairman for holding hearings on these complex and important issues.

Federal Government Provides Substantial Economic Benefits and Restricts Enterprise Activities

Fannie Mae and Freddie Mac seek to fulfill their basic mission of promoting homeownership by operating in the secondary market and purchasing mortgages[3] made by primary lenders, such as banks, thrifts, and mortgage bankers. Through their secondary market operations, the enterprises have improved liquidity,[4] increased the supply of mortgage credit, and reduced the significant regional disparities in mortgage interest rates that once existed across the nation. The enterprises obtain the funds needed to purchase mortgages by issuing debt and stock and by pooling

[1]Housing Enterprises: Potential Implications of Severing Government Sponsorship (GAO/GGD-96-120, May 13, 1996).

[2]In its usual sense, privatization refers to a process whereby a government entity becomes privately owned. For Fannie Mae, this occurred in 1968 when Congress created a privately owned, for-profit corporation from part of a federal agency. Freddie Mac was established by Congress as a privately owned, for-profit corporation in 1970.

[3]Mortgages eligible for enterprise purchase are called "conforming" mortgages because they meet specific underwriting criteria established by the enterprises and fall below a statutorily established loan limit. This loan limit, which depends upon how many housing units are financed by a single residential mortgage loan, is currently set at $207,000 for a single-unit residence.

[4]A market is more liquid if investors can buy and sell large holdings of securities without affecting the prices of the traded securities.

mortgages and selling mortgage-backed securities, known as MBS, to investors. In return for fees, the enterprises guarantee that the purchasers of their MBS will receive timely payment of the interest and principal from the underlying pool of mortgages. As of December 1995, the enterprises had about $1 trillion in MBS obligations outstanding and $419 billion in debt obligations outstanding. They also had about $360 billion of mortgages in their own retained portfolios and about $16.8 billion in stockholder equity.

The federal government has provided substantial economic benefits to both Fannie Mae and Freddie Mac to assist them in developing and maintaining the secondary mortgage market. Such benefits include:

- $2.25 billion conditional lines of credit with the Treasury Department,[5]
- exemptions from paying state and local income taxes, and
- exemptions from Securities and Exchange Commission (SEC) registration requirements and fees.

We estimated that the exemptions from state and local income taxes and SEC fees saved the enterprises $469 million in 1995.[6] By far the most significant economic benefit, however, comes indirectly through investors' perception that the federal government would not allow either of these large, federally sponsored enterprises to default on their obligations. This lower perceived risk of holding enterprise debt and MBS reduces their funding costs below those of highly rated corporations. Our review of the available evidence indicated that this implied federal guarantee results in a cost saving of from 30 to 106 basis points on enterprise debt and from 5 to 35 basis points on enterprise MBS.[7] For 1995, we estimated that this funding advantage saved the enterprises about $1.8 billion to $7.8 billion.[8]

[5]The lines of credit are conditional because the Secretary of the Treasury has the option of purchasing up to $2.25 billion of each enterprise's debt.

[6]The enterprises are, however, subject to federal income taxes and paid $1.335 billion in such taxes in 1995. State and local taxes and SEC registration fees would be deductible expenses for federal income tax purposes. On an aftertax basis, we estimated that the enterprises' exemptions from state and local income taxes and SEC fees resulted in a savings of $328 million in 1995.

[7]A basis point equals one-one hundredth of a percentage point. So assuming hypothetically that the enterprises have a 50 basis point funding advantage on debt, they could borrow at 6.5 percent, while other companies would have to borrow at 7 percent or more.

[8]If the enterprises did not have these funding advantages, their additional funding costs would, of course, have been deductible expenses for federal income tax purposes. If one assumes that the enterprises would not be able to pass any of these increased expenses through to homebuyers and would suffer a corresponding loss in corporate income, the aftertax value of their funding advantage would have ranged from about $1.2 billion to $5.6 billion in 1995.

To some extent, the enterprises pass along the economic benefits of federal sponsorship to American homebuyers in the form of lower interest rates on mortgages eligible for enterprise purchase. Our review of the available evidence indicated that interest rates on eligible fixed-rated mortgages are, on average, from 15 to 35 basis points lower than they otherwise would be. For the $2 trillion of these outstanding mortgages, this equates to an annual savings to American homebuyers of from $3 billion to $7 billion in lower mortgage interest costs.[9] The estimated savings for a homeowner with a typical $100,000 mortgage would be from $10 to $25 a month.

In addition to providing economic benefits to Fannie Mae and Freddie Mac, the federal government also restricts their business activities. These restrictions include:

- confining their operations to the secondary mortgage market,
- imposing an obligation to be active in that market at all times across the country,
- limiting the size of mortgages they can purchase,
- establishing numerical goals for purchases of mortgages to low- and moderate- income families, and
- complying with capital requirements and safety and soundness regulations.

Risks and Potential Costs of Federal Sponsorship

As I mentioned before, Mr. Chairman, there are also significant risks and potential costs associated with federal sponsorship of Fannie Mae and Freddie Mac. These risks, which are both more indirect and more difficult to quantify than the benefits of federal sponsorship, include:

- Potential taxpayer exposure to $1.4 trillion in enterprise obligations: Even though the enterprises' securities are required to state that they are not guaranteed by the United States, there is still the possibility that the enterprises' special ties to the federal government will result in the federal government providing assistance if they become financially troubled. In fact, the federal government did provide limited tax and other relief to Fannie Mae when it experienced several years of losses in the early 1980s,

[9]It is important to note that these figures are based on the total amount of eligible conventional, single-family, fixed-rate mortgages outstanding and not on the amount of mortgages actually purchased by the enterprises. If this 15 to 35 basis point range was applied to the $1.249 trillion in mortgages financed by the enterprises as reported in the study by the Congressional Budget Office, the estimated savings passed through to borrowers by the enterprises would be from $1.9 billion to $4.4 billion.

and the government bailed out the Farm Credit System, another, much smaller government-sponsored enterprise, in 1987. Taxpayers are not compensated for this risk exposure because the enterprises do not pay fees for these insurance-related benefits.

- Potential for underinvestment in other sectors of the economy: By lowering the cost of housing through the economic benefits provided to the enterprises, the federal government steers limited investment dollars toward the housing sector and away from other sectors of the economy, such as investment in manufacturing plant and equipment.
- Potential for limited competition in the secondary mortgage market: Because of the cost advantages related to their special status as government-sponsored enterprises, Fannie Mae and Freddie Mac are virtually the only two competitors in the secondary market for those mortgages they are eligible to purchase. Limits to competition could adversely affect the efficiency of the marketplace and result in higher mortgage costs.

Potential Effects of Privatization and Other Policy Options

There are a number of different policy options that Congress can consider if it decides that adjusting this mix of benefits and risks would better serve the public interest. We believe that the option we were required to analyze in detail—i.e., eliminating their federal sponsorship—would have major potential impacts on the two enterprises, American homebuyers and taxpayers, and the mortgage markets in general.

For Fannie Mae and Freddie Mac, the likely effects include:

- a major increase in their costs of operations resulting from an erosion, if not a complete elimination, of their funding advantages and a loss of their tax and registration exemptions;
- decreases in their profits, stock values, and market shares resulting from their increased costs and an expected increase in competition from other firms; and finally
- an increase in opportunities to compete in lines of business other than the secondary mortgage market resulting from removal of their charter restrictions. Thus, the ultimate impact on their financial performance would depend on such other factors as their strategic business decisions and the quality of management.

For American homebuyers and taxpayers, the likely effects include:

- a decrease in taxpayers' risk exposure to enterprise obligations; and

- an increase in interest rates of about 15 to 35 basis points, on average, on fixed-rate mortgages below $207,000. These increases are likely to be greater than average for borrowers making smaller downpayments as the enterprises' guarantee fees become more risk-based. In addition, the availability and affordability of mortgage credit for low- and moderate-income borrowers could also be further affected if the enterprises' affordable housing goals are modified or eliminated.

For mortgage markets, the major likely effect is an increase in competition in the secondary market as other firms find it possible to compete with Fannie Mae and Freddie Mac without their special cost advantages and the enterprises, in turn, become able to purchase mortgages of any amount. Thus, we believe that competition in the secondary market would continue to be sufficient enough to prevent the reappearance of any significant regional disparities in the cost or availability of mortgage credit that are not related to differences in risk.

Our report also discusses some more limited policy options that Congress may wish to consider. One such option is lowering the $207,000 limit on mortgages that the enterprises can purchase. This option would further restrict the enterprises' activity in the secondary market and thus reduce the level of taxpayers' risk. It would also increase interest rates on mortgages that were no longer eligible for purchase by the enterprises.

Another option is imposing a fee to compensate taxpayers for their risk exposure. Such a fee could be structured in several ways and be based on either the amount of the enterprises' obligations or their net incomes. This option would raise federal revenue, but it would also increase mortgage rates to the extent that the enterprises passed such fees on to borrowers.

Thus, as is the case with privatization, each of these options has benefits, risks, and trade-offs that need to be considered and weighed carefully.

Mr. Chairman, this concludes my prepared statement, and I would be pleased to respond to any questions that you or other Members of the Committee may have.

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