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GSEs

Recent Trends and Policy

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Mr. Chairmen and Members of the Committees:

We are pleased to be here today to discuss the large and growing role of government-sponsored enterprises (GSEs) in the nation's credit markets. As you are aware, Congress originally created GSEs to enhance the credit available to homebuyers, farmers, students and colleges. Congress established GSEs as federally chartered, but privately owned and operated corporations, limited their activities to certain economic sectors deemed worthy of public support, and gave them certain advantages to help accomplish their public purposes.[1] Today, the outstanding volume of federally assisted GSE credit is large and rapidly increasing. As shown in Figure 1, Appendix I, the volume of GSE credit more than doubled between 1990 and 1996, from $874 billion to almost $1.8 trillion, and is now almost double the outstanding amount of credit made available through all federal direct loan and federal loan guarantee programs combined. As shown in Figure 2, Appendix I, GSE credit has also steadily increased as a percentage of the total net credit outstanding in our economy,[2] from less than 2 percent in 1970 to over 12 percent in 1996. By contrast, the share of total net credit accounted for by federal direct and guaranteed loans has declined substantially over this period from almost 13 percent in 1970 to less than 7 percent in 1996.

As shown in Figure 3, Appendix I, 95 percent of total outstanding GSE credit in 1996 was housing related, with the remaining 5 percent going for agricultural and educational purposes. In recent years, housing has also been the only sector where GSE credit has been growing as a percentage of the total available credit outstanding. In particular, as shown in Figure 4, Appendix I, the two largest housing GSEs, Fannie Mae and Freddie Mac, have increased their share of total residential mortgage debt from 23 percent in 1990 to over 37 percent in 1996.[3] By contrast, as shown in Figure 5, Appendix I, the share of farm credit supplied by the Farm Credit System, the largest agricultural GSE, actually declined between 1985 and 1995. And Congress passed legislation

[1]Appendix II provides more details on the creation and operations of each of the major GSEs. Appendix III provides a list of related GAO products.

[2]Total net credit outstanding in the economy includes debt owed by all domestic sectors except financial intermediaries, which are omitted to avoid double counting.

[3]Specifically, of the $3.0 trillion in outstanding mortgage debt at the end of fiscal year 1990, 12.5 percent was in Fannie Mae's portfolio or its guaranteed mortgage pools, while 10.7 percent was in Freddie Mac's portfolio or mortgage pools. By the end of fiscal year 1996, Fannie Mae's share of the $4.1 trillion in outstanding mortgage debt had increased to 22.5 percent, while Freddie Mac's share had risen somewhat less, but still by a substantial amount, to 14.6 percent. During this period, the share of total outstanding mortgage credit supplied by the Federal Home Loan Bank System actually declined from 3.9 percent to 3.7 percent.

in 1996 that allowed the two education GSEs — Sallie Mae and Connie Lee — to end their government sponsorship and become fully private corporations.

While the legal powers, organizational structures, and operating styles of GSEs differ, they have several common characteristics. For example, each GSE was chartered by Congress to help achieve a particular public purpose, each is privately owned and operated, and each operates under certain restrictions and obligations which would not apply to a completely private corporation. Each GSE was also given certain explicit advantages —such as exemptions from state and local corporate income taxes, lines of credit with the Treasury Department, or exemptions from SEC registration requirements and fees — to help achieve its public purpose. The most important benefit that GSEs receive from their government sponsored status, however, is an implicit one stemming from investors' perceptions that the federal government would not allow a GSE to default on its obligations. Although GSE obligations are not obligations of the United States Government, the lower perceived risk of holding GSE obligations allows GSEs to borrow at rates lower than comparably creditworthy private corporations that do not enjoy federal sponsorship. In our recent statement on the potential impacts of privatizing Fannie Mae and Freddie Mac, we estimated that this funding advantage saved the two GSEs from about $2 billion to $8 billion in 1995.[4]

Because of their federal sponsorship, GSEs also involve significant risks and potential costs to taxpayers, including the risk that taxpayers could be potentially liable for a GSE's obligations if it were to get into financial difficulty. In 1987, Congress did in fact authorize $4 billion in financial assistance to the Farm Credit System when it experienced financial stress.[5] Limited financial and regulatory relief was also provided to Fannie Mae when it suffered losses of $277 million between 1981 and 1984.[6]

The special nature of GSEs, and the potential taxpayer exposure to large, rapidly increasing GSE financial obligations, raises several important policy issues, including the adequacy of GSE regulation, the potential for expansion of GSE activities, and potential ways to limit GSE exposures. Over the past few years, we have performed several major evaluations of the

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[4]Housing Enterprises: Potential Impacts of Severing Government Sponsorship, GAO/T-GGD-96-134, June 12, 1996.

[5]Farm Credit System: Repayment of Federal Assistance and Competitive Position, GAO/GGD-94-39, March 10, 1994.

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

effectiveness of the various GSE regulators.[7] Based on our reviews, we developed the following five criteria for an effective GSE regulator:

- objectivity and arm's length status from the GSE,
- prominence in government,
- consistency in regulation of similar markets,
- separation of primary and secondary market regulation, and
- economy and efficiency.

Although Congress has enacted some recent legislative changes to strengthen and improve regulatory oversight of GSEs, our work has shown that none of the three housing GSE regulators — the Office of Federal Housing Enterprise Oversight (OFHEO), the Department of Housing and Urban Development (HUD), nor the Federal Housing Finance Board (FHFB)— meets all five of our criteria. In 1993 we recommended that OFHEO and the FHFB be merged to better meet these criteria and our ongoing work continues to support merging the housing GSE regulators and making one agency responsible for both GSE safety and soundness and mission compliance.

Based on our work, we have also developed several criteria that policymakers could use to evaluate proposals to expand the types of products or services that existing GSEs currently offer.[8] Under these criteria, any new GSE product or service should:

- add value and be consistent with the GSE's public mission,
- be properly priced to reflect risk,
- be within the GSE's area of expertise, and
- avoid competing with products and services offered by fully private companies or member institutions.

Because GSEs have been given the advantages of federal sponsorship to achieve particular public purposes, we believe that any proposals to

[7]Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks, GAO/GGD-91-90, May 22, 1991; Government-Sponsored Enterprises: The Government's Exposure to Risks, GAO/GGD-90-97, Aug. 15, 1990; FHLBank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness, GAO/T-GGD-95-244, Sept. 27, 1995; Government-Sponsored Enterprises: Development of the Federal Housing Enterprise Financial Regulator, GAO/GGD-95-123, May 30, 1995; Farm Credit System: Farm Credit Administration Effectively Addresses Identified Problems, GAO/GGD-94-14, Jan. 7, 1994; Federal Home Loan Bank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness, GAO/GGD-94-38, Dec. 8, 1993; Improved Regulatory Structure and Minimum Capital Standards are Needed for Government-Sponsored Enterprises, GAO/T-GGD-91-41, June 11, 1991.

[8]See, in particular, Federal Home Loan Bank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness, GAO/GGD-94-38, Dec. 8, 1993.

significantly expand their existing activities should be required to meet these, or similarly rigorous, criteria before they are approved.

Finally, we have also done work addressing ways that Congress might limit the taxpayers' potential exposure to GSE obligations. One obvious way to do this is to end their federal sponsorship. As I mentioned at the beginning of my statement, Congress passed legislation last year that would make two of the GSEs — Sallie Mae and Connie Lee — fully private entities. In 1996, we, along with the Treasury Department, HUD, and the Congressional Budget Office, produced reports that analyzed the potential impacts of privatizing the two largest GSEs — Fannie Mae and Freddie Mac.[9] While taking such action could eliminate taxpayers' risk exposure to these GSEs, it would also have major impacts on housing finance markets, including a likely increase in mortgage interest rates for certain borrowers. Our report also discussed some more limited policy options that would reduce the level of taxpayers' risk exposure to these two GSEs, such as imposing "user fees" or greater restrictions on their housing finance activities. As with privatization, however, each of the options that we presented had benefits, risks, and trade-offs that would need to be considered and weighed carefully.

Mr. Chairmen, this concludes my prepared statement, and we would be happy to respond to any questions that you or other members of the committees may have.

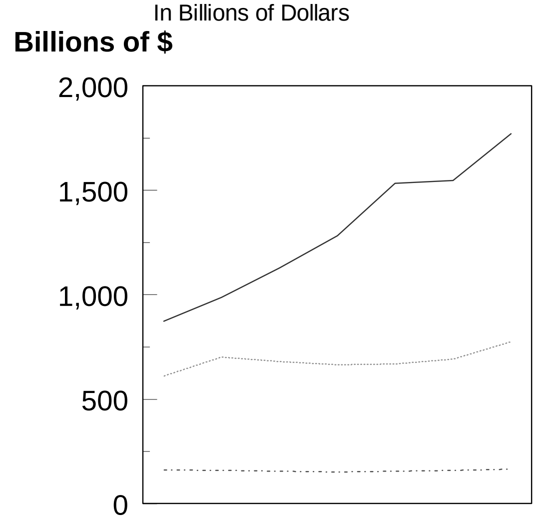
[9] Housing Enterprises: Potential Impacts of Severing Government Sponsorship, GAO/GGD-96-120, May 13, 1996; Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac, Congressional Budget Office, May 1996; Government Sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, United States Department of the Treasury, July 11, 1996; Studies on Privatizing Fannie Mae and Freddie Mac, May 1996, and Privatization of Fannie Mae and Freddie Mac: Desirability and Feasibility, July 1996, United States Department of Housing and Urban Development.

Figure 1

Rapid Growth in GSE Credit

Federal Loans & Guarantees & GSE Credit: 1990-1996

In Billions of Dollars



Fiscal Year	90	91	92	93	94	95	96
GSE Credit	874	988	1,129	1,282	1,533	1,548	1,771
Guaranteed Loans	611	701	680	666	668	693	775
Direct Loans	162	160	156	151	155	160	165

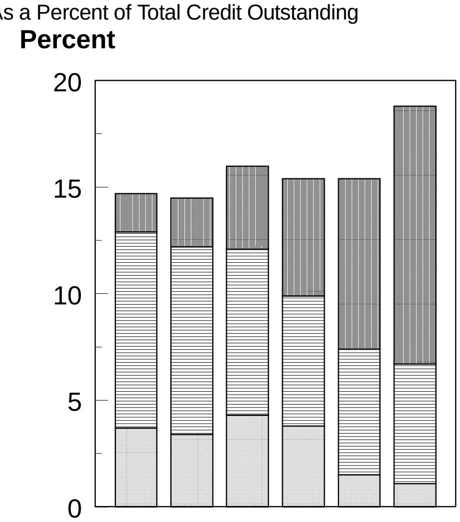
Source: U.S. Budget with GAO adjustment for Sallie Mae's holdings of guaranteed loans.

Figure 2

GSE Credit Affects Rising Share of Total U.S. Credit

Federal Loans & Guarantees & GSE Credit: 1970-1996

As a Percent of Total Credit Outstanding

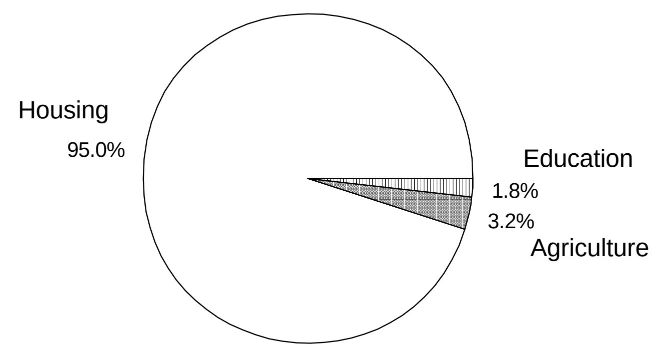


Fiscal Year	70	75	80	85	90	96
Direct Loans	3.7	3.4	4.3	3.8	1.5	1.1
Guaranteed Loans	9.2	8.8	7.8	6.1	5.9	5.6
GSE Credit	1.8	2.3	3.9	5.5	8.0	12.1

Source: U.S. Budget & Federal Reserve Board

Figure 3
Housing Gets Largest Share of GSE Credit

GSE Credit by Sector FY 96

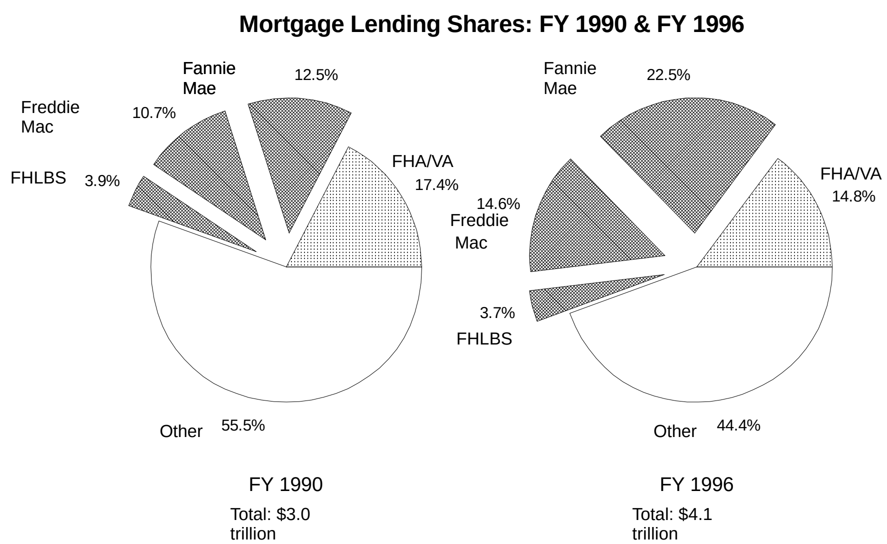


Total: $1.8 trillion

Source: U.S. Budget, FY 1998

Figure 4

GSE Share of Mortgage Credit is Rising

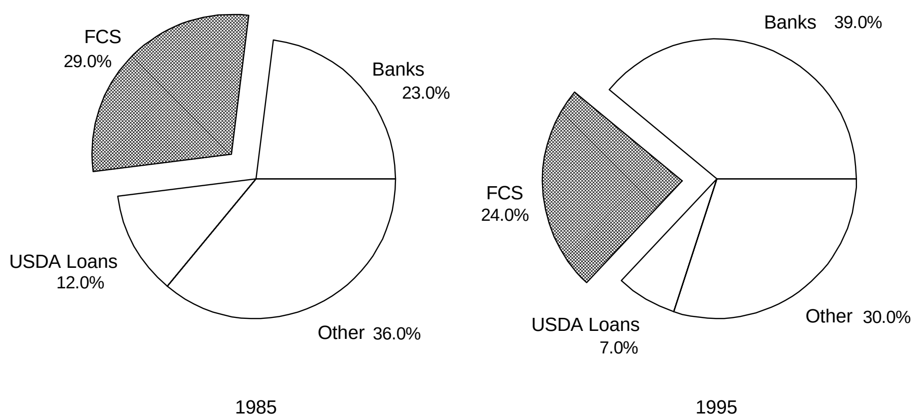


Source: U.S. Budget & Federal Reserve Bulletin

Figure 5

GSE Share of Farm Credit is Declining

Farm Credit Shares: 1985 & 1995



Source: U.S. Budget, FY 1998

Housing GSEs

The two major housing GSEs—Fannie Mae and Freddie Mac—were both created to improve the operations and efficiency of the housing credit markets. Although they were created in different circumstances and have operated differently, their charters and methods of operations have become much more similar.

Fannie Mae was first created in 1938 as a government-held association to buy FHA, and later VA and conventional, loans from originators, primarily mortgage banks, with funds raised by selling bonds. The initial goals of the program were to support the development of a national mortgage market and to improve liquidity through the creation of a resale market for mortgage loans. In the 1950s, Congress began the process of shifting Fannie Mae to private ownership. This was to be accomplished by requiring each mortgage seller to purchase a certain amount of common stock based on the amount of loans it sold to Fannie Mae, which would allow the gradual retirement of preferred stock owned by the Treasury Department.

The Housing and Urban Development Act of 1968 completed the transformation of Fannie Mae into a government-sponsored enterprise. The act separated Fannie Mae into two separate components. One component, Ginnie Mae, remained in HUD to provide support to FHA, VA, and special assistance programs. The other part was the government-sponsored, privately owned, for-profit Federal National Mortgage Association, which was to be concerned exclusively with attracting funding into residential mortgages. To accomplish this purpose, Fannie Mae used funds raised by selling bonds to purchase mortgage loans from originators and held them in its own portfolio.

Congress chartered Freddie Mac in 1970 in reaction to the loss of deposits in the savings and loan industry that was curtailing that industry's ability to fund and originate home mortgages. Its creation ensured that the savings and loan industry had access to funds to continue to fund mortgages. In comparison to Fannie Mae, Freddie Mac did not hold mortgages in its portfolio, but created mortgage-backed securities (MBS) and sold them to investors. However, Freddie Mac guaranteed timely interest and principal payments on these securities.

In the early 1980s, Fannie Mae and Freddie Mac experienced different financial results as short-term interest rates increased. Because Fannie Mae was funding the mortgages in its portfolio with short-term debt, sharp short term rate increases meant that the interest earned on the old mortgages in its portfolio was less than interest expenses on the newly issued debt. As a result, Fannie Mae experienced total losses of about $277 million between 1981 and 1984. In response to Fannie Mae's financial problems, the federal government provided limited tax relief and regulatory forbearance in the form of relaxed capital requirements. Freddie Mac's different method of operations meant that investors, and not Freddie Mac, bore the risks of changing interest rates. To avoid future losses from interest rate changes, Fannie Mae partially adopted Freddie Mac's strategy of issuing MBS and shifting the interest rate risk to investors.

The activities of Fannie Mae and Freddie Mac have largely converged. The effect of the Housing and Community Development Act of 1992, along with the GSE-related provisions in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), was to make the charters of Fannie Mae and Freddie Mac substantially the same. Both GSEs attempt to smooth the availability of mortgage funds across time and regions and promote liquidity in the secondary mortgage market. In addition to their traditional goal of improving the functioning of capital markets, the charters of both enterprises now include distributional goals. Both Fannie Mae and Freddie Mac have the additional purpose of providing access to mortgage finance for low-income families and underserved areas. A primary difference between the two GSEs continues to be Fannie Mae's relatively greater use of debt-financing to hold mortgages in its own portfolio, although Freddie Mac has increased its portfolio investment share in recent years.

The Federal Home Loan Bank System is the third housing-related GSE. It was established in 1932 to extend mortgage credit by making loans, called advances, to its member institutions, who in turn lend to homebuyers for mortgages. The System consists of 12 federally chartered, privately owned FHLBanks that raises funds by issuing consolidated debt securities in the capital market. The advances are secured by home mortgage loans or such other collateral as U.S. Treasury securities. These advances help member institutions, originally limited to thrifts, by enhancing liquidity and providing access to national capital markets.

With the evolution of national mortgage markets and the contraction of the thrift industry, the original justifications for the Federal Home Loan Bank System to support housing credit and the thrift industry have diminished. Rather than phase down its activities, Congress allowed the Federal Home Loan Bank System to expand its membership pool to include commercial banks, which now comprise 65 percent of the members.

Agricultural GSEs

The largest of the two agriculture GSEs, the Farm Credit System (FCS), raises money through bond sales and makes loans directly to farmers. FCS lends this money to the farming sector through a network of member-owned cooperatives with the purpose of ensuring a stable supply of credit to agriculture. Established in 1916, FCS became insolvent in the mid-1980s when inadequate interest-rate risk management and falling land prices depressed the value of collateral behind FCS credit and created large losses for the institution. This necessitated a federal bailout through the FCS Financial Assistance Corporation (FAC), which injected funds into FCS by issuing $1.261 billion in bonds.

Unlike direct loans and FCS loans, the other agricultural GSE—Farmer Mac—operates by promoting a secondary market for agricultural loans. Farmer Mac was created in 1987 by the same legislation that provided for the FCS bailout. Its purpose was to create and oversee a secondary market for, and to guarantee securities based on, farm real estate loans. However, unlike the GSEs in the housing sector, Farmer Mac was not able to establish a growing niche in farm credit markets by guaranteeing farm securities. As a result of the decline in Farmer Mac's capital base, the Farm Credit System Reform Act of 1996 expanded its powers. The 1996 Act transformed Farmer Mac from just a guarantor of securities formed from loan pools into a direct purchaser of mortgages in order to form pools to securitize. The expanded powers make it more attractive for banks to participate in Farmer Mac and permit Farmer Mac to act as a pooler. While the new powers are intended to boost Farmer Mac's revenues, it is too early to tell how this will affect Farmer Mac's role in agricultural credit. However, as a direct purchaser of loans with no required subordination, this increased role does have the potential to expose Farmer Mac to greater credit risk than on guaranteed pools, which require loan originators or other entities outside the pool to hold a 10-percent subordinated interest in pooled loans.

Education GSEs

The federal government created two GSEs to increase the availability of credit in the educational sector. The largest one, Sallie Mae, was created in 1972 as a for-profit, shareholder-owned corporation. Sallie Mae purchases insured student loans from eligible lenders and makes secured loans to lenders. It now holds about one-third of all outstanding guaranteed student loans. In 1996 Congress passed legislation establishing a process for restructuring Sallie Mae and ultimately terminating its federal government sponsorship.

The second education GSE, Connie Lee, was created in 1986 to insure and reinsure the financing of postsecondary education facilities. Connie Lee's financial condition has been strong, particularly since 1991, when it obtained the "triple-A" credit rating necessary to engage in the financial guaranty business as a direct writer of insurance. Legislation passed in 1996 privatized Connie Lee by repealing the corporation's enabling legislation and requiring the federal government to sell, and Connie Lee to purchase, the corporation's federally owned stock during fiscal year 1997.

Related GAO Products

Housing Enterprises: Investment, Authority, Polices, and Practices, GAO/GGD-97-137R, June 27, 1997.

Housing Enterprises: Potential Impacts of Severing Government Sponsorship, GAO/T-GGD-96-134, June 12, 1996.

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