STATEMENT OF
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FOR THE HEARING ON
"THE PRESENT CONDITION AND FUTURE STATUS
OF FANNIE MAE AND FREDDIE MAC"

BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

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Chairman Kanjorski, Ranking Member Garrett, and members of the Subcommittee: My name is Lawrence J. White, and I am a Professor of Economics at the NYU Stern School of Business. During 1986-1989 I served as a Board Member on the Federal Home Loan Bank Board. In that capacity I also served as a Board Member of Freddie Mac. Thank you for the opportunity to present my views on the present condition and future status of Fannie Mae and Freddie Mac.

Since early September 2008, both companies have been in government conservatorships, operating under the auspices of the Federal Housing Finance Agency (FHFA). Both companies are deeply insolvent: The value of the assets of each company is inadequate to cover the value of that company's liabilities. In February of this year the U.S. Treasury stated that it was setting aside $200 billion for each company to cover their potential losses.

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The hybrid private-public model that was at the heart of both companies is clearly broken and should not be reconstructed. Instead, after the current financial crisis has receded, both companies should be truly privatized, with all ties to the federal government severed. To replace their implicit broadbrush effects in the U.S. housing markets, targeted programs that provide explicit on-budget subsidies to encourage low- and moderate-income households to become first-time home buyers should be expanded.

The remainder of this statement will expand on these ideas.

A. Background.

Until their government takeover in September 2008, Fannie Mae and Freddie Mac were two large, hybrid (private-public) companies that dominated the secondary residential mortgage markets. They engaged in two lines of business: securitizing mortgages that generally conformed to high lending standards, with the mortgage-backed securities (MBS) carrying their guarantees if the mortgage borrower failed to repay; and investing directly in similar mortgages, funded overwhelmingly (around 96%) with debt.

Though they were publicly traded companies with shares listed on the New York Stock Exchange, the two companies were also creatures of Congress that had special governmental ties and advantages, as well as limitations (e.g., they were restricted to secondary mortgage markets, there was a ceiling [the conforming loan limit] on the size of mortgage that they could buy or securitize, and they were subject to prudential regulation) and obligations (they were expected to make a special effort to support lending to lower-income households -- an obligation that was tightened in 2003). Within the past few years the term "government-sponsored enterprise" came into common use to describe the two companies (as well as the Federal Home Loan Bank System, a wholesale bank for banks and thrifts that similarly enjoys special privileges and limitations).

As a consequence, the financial markets believed (correctly, as it turned out) that if Fannie Mae or Freddie Mac were ever in financial difficulties, the federal government would likely keep their creditors whole.

This belief in the federal government's "implicit guarantee" meant that Fannie Mae and Freddie Mac were able to borrow in the bond markets (in normal times) at about 0.35-0.40 percentage points less (i.e., at lower interest rates) than their financial condition would otherwise have justified. In turn, they caused interest rates for the mortgages that they could securitize or hold to be about 0.20-0.25 percentage points lower than otherwise would have been the case.

Both Fannie Mae and Freddie Mac grew rapidly in the 1990s and in the early years of this decade. Accounting scandals at Freddie Mac in 2003 and at Fannie Mae in 2004 caused their growth to slacken, especially for the mortgages that they held in their portfolios. Nevertheless, at year-end 2007 their holdings of mortgages and their outstanding mortgage-backed securities (which carried their guarantees) together totaled about $5 trillion, or over 40% of the total residential mortgage market.

It is easy to understand the political popularity of their hybrid structure, since they appeared to be providing a "free lunch": lower interest rates on mortgages, some efforts to expand lending to lower-income households, and no explicit cost to the federal government. The way that these outcomes were reconciled with adequate returns to shareholders was through low capital requirements (only 2.5% for holding a mortgage in portfolio; only 0.45% to support the guarantees on their MBS) and thus high leverage.[1]

The creation and expansion of Fannie Mae and Freddie Mac did not occur in a vacuum. They were, and continue to be, only one part of a much larger mosaic of governmental policies, at all levels of government, to encourage the construction and consumption of housing. These policies include: income tax deductions and exemptions for home owners; subsidies for renters; tax breaks for housing construction; explicit subsidies for mortgage finance, through the Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), and the Government National Mortgage Association (Ginnie Mae), as well as through some states' mortgage finance subsidy programs; implicit subsidies through the GSEs; specialized charters for depository institutions (thrifts) that are expected to focus on residential mortgage finance; and direct provision of rental housing ("public housing").

"Too much is never enough" is a not unreasonable characterization of U.S. housing policy.

The encouragement for home ownership has at least four underlying motivations: First, it is simply seen as part of "The American Dream". Second, since housing prices in most parts of the U.S. had tended (over most time periods) to trend upward since the 1940s, housing investment was seen as a good way of building household wealth (and on a leveraged basis, as well, since a 20% down payment meant that the house purchase was leveraged five-to-one). Third, it is a way to internalize the agent-principal problems that

[1] Critics of the two companies and their hybrid structure feared that their thin capital levels were inadequate to withstand the interest rate risks that were embedded in their large mortgage portfolios. In the end, however, it was credit risk that overwhelmed their thin capital levels.

otherwise arise between landlords and tenants. And it is a means of exploiting the positive social spillover effects or externalities that appear to accompany home ownership.

On this last point, the theory that argued that there should be positive social externalities from home ownership -- that a homeowner is more likely to care about his/her community than is a renter, more likely to participate in community activities, etc. -- has been around for decades. But only since the middle 1990s has a small but growing body of empirical studies provided support for this notion.

An important caveat should immediately be added to these positive motivations for home ownership: Home ownership is not for everyone. A house is a large, illiquid asset, which can impede labor mobility across geographic regions. Home ownership requires a relatively steady income stream and requires disciplined budgeting. And, as millions of households (and their lenders) have discovered to their regret over the past three years, housing prices do not always increase.[2]

Further, a sensible and efficient approach to addressing the social externality would be to have a modest and focused program that is aimed at the likely margin for action: modest subsidies (e.g., for down payments and/or monthly payments) for low- and moderate-income households so as to encourage them to become first-time homeowners. Unfortunately, with only minor exceptions,[3] housing encouragement instead is broadbrush in scope. The most extensive subsidy, for example, is the income tax deduction for mortgage interest and the capital gains exclusion of the gain on sale of a household's principal residence.

[2] Also, of course, rental subsidies run counter to the goal of encouraging households to become homeowners.
[3] One exception is the American Dream Downpayment Assistance Act of 2003, which instructs the Department of Housing and Urban Development (HUD) to provide down payment assistance to low- and moderate-income families. However, the appropriations for HUD's administration of this program have been relatively modest.

Such broadbrush subsidies tend to encourage households who would be homeowners anyway simply to purchase larger and better appointed houses on larger lots. Further, the main beneficiaries are higher-income households who would be more likely to itemize their deductions (and thus be able to take advantage of the interest deduction) and who would tend to have larger capital gains to shield. The implicit subsidy on mortgage interest provided through Fannie Mae and Freddie Mac operates through the same broadbrush path (and also subsidizes the purchase of second homes and rental housing), with the same broad encouragement of larger amounts of housing on larger lots.[4] It is hard to see the social benefit that accrues from encouraging upper-income households, who would likely purchase homes anyway, to buy larger quantities of housing on larger lots and/or to buy second homes.

Indeed, the research of the past quarter century indicates that U.S. housing policies have distorted consumption and investment choices, causing an inefficiently large fraction of U.S. investment to be devoted to housing (and correspondingly less devoted to other productive physical capital, as well as to human capital).

B. The debacle.

Although Fannie Mae and Freddie Mac were not at the center of the subprime debacle, their portfolios and MBS did become more risky in the middle of this decade, as they expanded into "Alt-A" (between prime and subprime) mortgages. Further, as housing prices fell steeply in some areas like Las Vegas, parts of California, Arizona, and south Florida, even some "prime" mortgages (i.e., those where the borrower made a 20% down

[4] Also, even before the sharp increase that was legislated in early 2008 in the conforming loan limit for mortgages that could be bought or securitized by Fannie Mae and Freddie Mac, the conforming loan limits were substantially above the median house price in most parts of the U.S.; as a consequence, Fannie Mae and Freddie Mac were not especially well focused on encouraging home ownership by low- and moderate-income households.

payment, had an adequate income, and had a good credit score) yielded borrower defaults and losses. Other apparently good mortgages, where private mortgage insurance was covering the shortfalls in borrowers' down payments, came into doubt because of rising questions about the solvency of the mortgage insurers and thus their ability to make good on their obligations. And Fannie Mae and Freddie Mac were also burned on investments (intended to help satisfy their distributional requirements) in supposedly safe tranches of mortgage-based securities that had lower-quality mortgages as their underlying collateral.

At the end of the day, however, it was inadequate capital for the overall risks in their investment portfolios and in their MBS that caused their downfall. Recognizing their inadequate capital, the FHFA placed both companies in conservatorships on September 6, 2008.[5] As was mentioned above, in February 2009 the U.S. Treasury stated that it was setting aside $200 billion for each company to cover their potential losses.

The free lunch has turned out to be a costly meal indeed.

C. Future Status.

In the current shaky financial environment, Fannie Mae and Freddie Mac should remain as wards of the federal government. But the hybrid model is clearly too fraught with problems. Efforts to harness the private sector to subsidize housing consumption, through implicit rather than explicit subsidies, simply create too many strains and temptations. The hybrid model should not again be a tool of long-term housing policy.

After the financial markets have stabilized, the two companies should be fully and truly privatized, with no remaining special ties to the federal government[6] -- but also no

[5] A discussion of FHFA's conservatorship actions, as well as much other recent information about Fannie Mae and Freddie Mac, can be found in FHFA's Report to Congress 2008 (May 18, 2009).

[6] However, at the time of the privatization, all of the existing debt of the two companies should carry an explicit government guarantee (since they have been GSEs); but from that point forward, all new debt of

special burdens or restrictions on their activities, except for those that would be part of any special prudential regulatory regime that is likely to be established by the federal government to deal with large financial companies that pose systemic risks.[7] The federal government will have to fill the large negative net worth "holes" of the two companies before privatizing them; but those "hole-filling" expenditures will be necessary regardless of what happens to the two companies, since the federal government is highly unlikely to "stiff" the creditors of the two companies.

To replace their implicit broadbrush effects on housing markets, targeted programs that provide explicit on-budget subsidies to encourage low- and moderate-income households to become first-time home buyers should be expanded. Recall that there are strong arguments and good evidence for encouraging households to become home owners (although, again, home ownership is not for everyone). These arguments point to the need for focused (rather than broadbrush) programs that are targeted on households that are on the cusp of whether (or not) to buy a home. Low- and moderate-income households would appear to be the best targets for these subsidies, which should take the form of down payment assistance and monthly mortgage payment assistance (as well as extensive counseling on the pluses and minuses of home ownership).

As was noted above, the American Dream Downpayment Assistance Act of 2003 provides a model for such targeted subsidies, although it has been only modestly funded. Its funding should be expanded, and the program should be broadened to include monthly payment subsidies as well. The $8,000 "first-time home buyer tax credit" provision in the American Recovery and Reinvestment Act of 2009 is another potential avenue. As it is

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the two privatized companies should cease having any explicit or implicit government guarantee.

[7] The privatization of the Federal Home Loan Bank System should similarly occur, for similar reasons

currently constituted, however, the tax credit is more targeted on providing short-term assistance to the slumping U.S. housing markets than in providing sustained assistance to low- and moderate-income households. For example, the tax credit expires at the end of 2009, and it applies to households with incomes that are substantially higher than "low" and "moderate".[8] An extension of the tax credit, with much lower income ceilings, would be a worthwhile modification.

In sum, long-term housing policy should involve the complete privatization of Fannie Mae and Freddie Mac and a program of targeted assistance to low- and moderate-income households to encourage them to become homeowners. That assistance should be focused, explicit, and on-budget, not broadbrush, implicit, and off-budget. We have paid far too high a price in pursuing the chimera of a "free lunch" in housing policy. "Never again" should be the operative phrase.

Recent Relevant Writings by Lawrence J. White

"Comments on 'The Privatization of Fannie Mae and Freddie Mac,'" in U.S. Department of Housing and Urban Development, Studies on Privatizing Fannie Mae and Freddie Mac, 1996.

"Focusing on Fannie and Freddie: The Dilemmas of Reforming Housing Finance," Journal of Financial Services Research, February 2003.

"Regulating Housing GSEs: Thoughts on Institutional Structure and Authorities," Economic Review, Federal Reserve Bank of Atlanta, First Quarter 2004 (with W.S. Frame).

"Emerging Competition and Risk-Taking Incentives at Fannie Mae and Freddie Mac," in Federal Reserve Bank of Chicago, How Do Banks Compete? Strategy, Regulation, and Technology, 40th Annual Conference on Bank Structure and Competition, 2004 (with W.S. Frame).

[8] The tax credit applies to married couples earning up to $150,000 (and then phases out for higher incomes, reaching zero at an income of $170,000); by contrast, median household income in the U.S. in 2007 was $50,233.

“The Trouble with Fannie and Freddie,” SternBusiness, Fall 2004.

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“Fannie Mae, Freddie Mac, and Housing Finance: Why True Privatization is Good Public Policy,” Policy Analysis, No. 528, Cato Institute, October 7, 2004.

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“Charter Value, Risk-Taking Incentives, and Emerging Competition at Fannie Mae and Freddie Mac,” Journal of Money, Credit and Banking, February 2007 (with W.S. Frame).

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BIOGRAPHICAL SUMMARY

Lawrence J. White

Lawrence J. White is Arthur E. Imperatore Professor of Economics at New York University's Stern School of Business and Deputy Chair of the Economics Department at Stern. During 1986-1989 he was on leave to serve as Board Member, Federal Home Loan Bank Board, and during 1982-1983 he was on leave to serve as Director of the Economic Policy Office, Antitrust Division, U.S. Department of Justice. He is currently the General Editor of The Review of Industrial Organization and Secretary-Treasurer of the Western Economic Association International.

Prof. White received the B.A. from Harvard University (1964), the M.Sc. from the London School of Economics (1965), and the Ph.D. from Harvard University (1969). He is the author of The Automobile Industry Since 1945 (1971); Industrial Concentration and Economic Power in Pakistan (1974); Reforming Regulation: Processes and Problems (1981); The Regulation of Air Pollutant Emissions from Motor Vehicles (1982); The Public Library in the 1980s: The Problems of Choice (1983); International Trade in Ocean Shipping Services: The U.S. and the World (1988); The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation (1991); and articles in leading economics and law journals.

He is editor or coeditor of eleven volumes: Deregulation of the Banking and Securities Industries (1979); Mergers and Acquisitions: Current Problems in Perspective (1982); Technology and the Regulation of Financial Markets: Securities, Futures, and Banking (1986); Private Antitrust Litigation: New Evidence, New Learning (1988); The Antitrust Revolution (1989); Bank Management and Regulation (1992); Structural Change in Banking (1993); The Antitrust Revolution: The Role of Economics, 2nd edn. (1994); The Antitrust Revolution: Economics, Competition, and Policy, 3rd edn. (1999); The Antitrust Revolution: Economics, Competition, and Policy, 4th edn. (2004); and The Antitrust Revolution: Economics, Competition, and Policy, 5th edn. (2009). He was the North American Editor of The Journal of Industrial Economics, 1984-1987 and 1990-1995.

Prof. White served on the Senior Staff of the President's Council of Economic Advisers during 1978-1979, and he was Chairman of the Stern School's Department of Economics, 1990-1995.

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