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An Economist's Case for GSE Reform

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An *optimal mechanism* is one that not only produces some gross benefits (as virtually all mechanisms do), but produces the most net benefits among conceivable alternatives—a mechanism that achieves bona fide objectives at least cost. Are the government-sponsored enterprises that have come to dominate the mortgage market—specifically Fannie Mae and Freddie Mac—optimal mechanisms for accomplishing legitimate policy objectives? Is their mixing of private interests and public purposes—that is, the combining of government subsidies and the conferring of monopoly status on a privately owned duopoly[1]—the best way to achieve some set of desirable outcomes?

In this essay I address that question and point to some logical problems in the positions advocated by the mortgage GSEs. One cannot reasonably argue that these GSEs are useful mechanisms in the current environment. The perspective of the 1930s that considered Fannie and Freddie as beneficial no longer holds. I begin by reviewing the economic arguments for and against the GSEs and finish by considering various options for reform.

Criteria for Appraising Privileges and Subsidies

The possible economic advantages or disadvantages produced by any financial institution created for the public interest divide into five categories: (1) subsidizing or taxing an activity that society regards as undervalued or overvalued in the market; (2) improving or worsening static productive efficiency through economies or diseconomies of scale or scope; (3) speeding or retarding productivity growth by

influencing technological change; (4) reorganizing market transactions in a way that produces more or less liquidity, perhaps by encouraging or discouraging product homogeneity or by standing ready to make markets in certain assets; and (5) altering the political economy that underlies public finance for the better or worse.

Advocates and opponents of the special chartering of private financial corporations have argued the merits of such special privileges on one or more of those five grounds. The debate began with the chartering of monopolistic banks under the European empires of the seventeenth century and was revisited in the United States during the struggles over the chartering of the First and Second Banks of the United States and in the hundreds of state-level conflicts over the special chartering of state banks in the antebellum period. In the postbellum era the chartering of the Federal Reserve Banks and the creation of the GSEs saw similar debates. In that sense the current disagreement over the GSEs is nothing new. Historically, financial institutions have often been chartered and granted special privileges due to some combination of expected social gains and the political influence of their founders; such entities have sometimes been abolished when their missions became outdated or the relative political influence of their owners waned.

In judging the merits of continuing special privileges and subsidies to a GSE, by any of the five criteria, one must focus on net benefits. In economics *net benefits* are not defined simply as the difference between gross benefits and realized accounting costs, but rather the difference between gross benefits and the full range of economic costs, including opportunity costs. An *optimal mechanism* maximizes the potential difference between realized benefits and realized costs, and only the optimal mechanism has a positive net benefit when costs are defined inclusive of opportunity costs, which take account of all forgone means to realizing gross benefits.

Subsidizing Mortgages. On behalf of Fannie Mae, Adolfo Marzol (1999) has argued against the view that the GSEs' redeeming social value was rooted in overcoming market failures. He described as a snipe hunt the search for market failures (inefficiencies) to justify GSE activities. In his view the central issue is the extent to which the GSEs subsidize mortgages and thereby make homeownership more possible and more affordable. It is often argued in this connection (see Weicher 1999) that homeownership benefits more than the homeowner alone: because homeowners, some believe, are better citizens, gov-

ernment should subsidize homeownership. In the jargon of economics homeownership creates positive externalities.

Demonstrating that the subsidization of homeownership is a bona fide objective worthy of subsidy (and for present purposes I concur) is not enough; rather, advocates of the GSEs must argue that the best mechanism for subsidizing homeownership is the granting of privileges and subsidies to the GSEs. How much do the GSEs receive from the government, and how does that government subsidy to the GSEs ultimately affect the homeownership decisions of American families? Is there a more powerful and less costly way to encourage homeownership?

The Congressional Budget Office has estimated that Fannie Mae and Freddie Mac receive more than $6 billion per year in off–balance-sheet taxpayer subsidies from the implicit protection that their debt receives by the government (see chapter 2 in this volume).[2] Robert Van Order (chapter 3 in this volume) of Freddie Mac contested the size of that subsidy but not the basic logic that CBO and others use to argue that a large subsidy exists.[3] The size and importance of the GSEs and the role of the government in GSE governance and in a credit line at the Treasury account for the extraordinarily low interest that these entities pay on their debt. The CBO estimates that roughly one-third of that $6 billion is transferred as profit to the stockholders of the GSEs, while two-thirds is passed on to mortgage sellers in the form of higher prices (lower interest rates) in the secondary mortgage market. The higher prices paid by subsidized GSEs in the secondary mortgage market are passed on to homeowners as interest rate savings in the competitive primary mortgage market.

But is the most effective means of promoting homeownership a GSE mechanism that operates through lower mortgage interest rates and suffers a one-third leakage when transferring taxpayer-financed subsidies to homebuyers? Can't the government find a better method to transfer subsidies in support of homeownership?

The easiest approach to those questions is to consider a tangible alternative mechanism, namely, the use of down payment subsidies administered by the government. Would that mechanism be a better vehicle for mortgage subsidization? Would it likely be more or less costly to administer? An answer to the first question requires an in-depth analysis of how current interest rate subsidies are channeled. How different an effect would a down payment subsidy have? An answer to the second question calls for determining whether the transaction costs of administering a down payment assistance

program would exceed one-third of the subsidies transferred (the leakage from GSE subsidies).

In a determination of the more powerful vehicle for producing benefits, down payment assistance would be much more effective in accomplishing the central social objective of increasing homeownership. GSE subsidies are too small and too spread out to affect homeownership affordability; they do not target enough assistance to those for whom it would matter the most, that is, low-income individuals without sufficient accumulated wealth to qualify for a mortgage.

Under the current GSE mechanism, all qualifying homeowners enjoy a small interest rate reduction (which in the aggregate they as taxpayers repay 150 percent to the government). In the aggregate, therefore, the GSEs tax rather than subsidize the public. Middle-class homeowners are the recipients of the largest gross transfers from government support for the GSEs and possibly the largest net transfer. Upper-income taxpayers do not often qualify for GSE-purchased mortgages (because of limits on the size of qualifying mortgages), and lower-income taxpayers are often renters (sometimes because they lack sufficient accumulated wealth to meet the requisite down payment on a home). For a low-income taxpayer, ten or fifteen basis points less in annual interest cost translates to a $50 or $75 reduction in the annual cost of debt service (assuming a $50,000 mortgage), which probably does not matter much in the decision to buy a home.

Fannie Mae and Freddie Mac often contend that they make special efforts to assist low-income households to become eligible for mortgages. Although the GSEs like to advertise their special programs for lower-income homebuyers, in fact they do not channel significant subsidies to the low-income. Channeling such subsidies would mean absorbing a significant share of their credit risk at below-market cost. Evidence suggests that Fannie Mae and Freddie Mac limit their exposure to credit risk on low-income mortgages either by requiring high down payments (Bunce and Scheessele 1996) or by relying on external credit enhancements.[4] Fannie Mae and Freddie Mac tend to avoid areas with significant credit risk (especially in multifamily mortgages, where Fannie Mae is the sole lender at risk for only 11 percent of its portfolio) (Fannie Mae 1999, 28). The GSEs lay off risk partly because of statutory limits on their powers (which require private mortgage insurance for mortgages with loan-to-value ratios exceeding 80 percent) and partly because of their profit-maximizing choices in risk management. Laying off credit risk

is rewarded with lower regulatory requirements regarding capital and thus a higher return on equity.

Both Fannie Mae and Freddie Mac have rapidly increased their use of external credit enhancement. In 1998 nearly one-third of all mortgage-backed securities issued by Fannie Mae involved some form of third-party credit enhancement (Fannie Mae 1999, 38), and 40 percent of Freddie Mac's mortgage purchases were credit enhanced (Freddie Mac 1999, 47). Credit-enhanced mortgages accounted for 15 percent of all outstanding Fannie Mae mortgages held or securitized at year-end 1998 (p. 58). For Freddie Mac, 27 percent of its outstanding mortgage portfolio at year-end 1998 had some form of external credit enhancement (Freddie Mac 1999, 27).

To a first approximation, the GSE subsidies are best thought of not as a means of promoting homeownership, but rather as a way to transfer a small amount of income (per household) from the rich primarily to the middle class.[5] If the implicit tax and transfer of income were the sole objective of the GSEs, then the tax system could accomplish it more effectively and at much lower cost (that is, without the one-third leakage to GSE stockholders).

Consider how much greater an effect on homeownership a down payment assistance program would have. Suppose the government made available up to $10,000 in matching down payment subsidies to all homebuyers. Specifically, individuals could receive (once in a lifetime) up to 50 percent of their down payments (up to a maximum of $10,000) from the federal government, limited for use in purchasing homes that cost less than a given amount (say, $150,000). The transfer of the funds to the homebuyer, once made, would be irrevocable.[6]

If this program could be administered at neglible cost, the current off–balance sheet cost to the government of more than $6 billion would permit more than 600,000 low- and middle-income families per year to qualify for substantial assistance toward buying a home. Many poorer families who cannot take advantage of current GSE subsidies because of minimum wealth constraints would become homebuyers because of the larger up-front subsidization of down payments.[7]

A means-tested system of matching funds for down payments offers another important advantage: in contrast to interest rate subsidies from the GSEs, the impact on the value of homes would not undermine the program's effectiveness. By reducing the effective discount rate for the flow of nonpecuniary benefits of homeownership, interest rate subsidies from GSEs raise home prices in a way

that eliminates much or all benefit of the reduced interest rate on the mortgage. Thus the effective net tax rate on homeowner-taxpayers from GSE subsidies may be 250 percent rather than 150 percent of the interest rate subsidy (as the homeowner-taxpayer must pay for the subsidy twice: once as a homeowner and once as a taxpayer). Down payment assistance would raise home prices somewhat, but because it would relax the constraints of minimum wealth on homeownership, the program's net effect on recipients' welfare would be unambiguously positive—the higher price of the home would be more than offset by the effect of the relaxation of the wealth constraint.

Furthermore, targeting assistance to low-income individuals would generate additional positive externalities. By boosting homeownership and home values in predominantly low-income areas, means-tested down payment assistance would contribute to the renewal of America's cities in ways that existing GSE subsidies do not.

What about the costs of administering this program? Even if the down payment assistance program suffered administrative expenses equal to the enormous GSE leakage rate of one-third, it would still permit more than 400,000 low- and middle-income families per year to qualify. But the administrative costs of the proposed assistance program should be close to zero. No government discretion would be needed to determine who qualifies for assistance. Qualifying for assistance would be easy to verify. The only information needed—the identity of the applicant and the price of the house—would be easy-to-observe facts that could be warranted by the mortgage originator.

If the objective of GSE subsidies is to promote homeownership by eliminating the financial barriers faced by low- and middle-income families, then down payment assistance would be a much more powerful and cost-effective means to that end. The subsidization of the GSEs cannot be reasonably justified on the basis of the objective of promoting homeownership.

Static Efficiency. Another dimension of possible social gain from subsidizing the GSEs is the promotion of static efficiency in mortgage intermediation. To avoid confusion, three arguments must be clearly distinguished: (1) the argument in defense of federal chartering of nationwide mortgage intermediaries (without government guarantees or monopoly rights); (2) the argument supporting the chartering of monopolistic nationwide mortgage intermediaries; and (3) the argument for government subsidization of those intermedi-

aries. None of these arguments—for chartering GSEs, for granting them a monopoly, or for subsidizing their cost of funds—can be justified in the U.S. mortgage market today.

For the first type of argument—federal chartering of mortgage banks—it once was possible to contend that because of branching restrictions on banks and no practical means for securitizing mortgage portfolios, the chartering of national mortgage intermediaries in the 1930s offered large potential efficiency gains from economies of scale. Economies of scale of such intermediaries relative to small, geographically isolated banks result from the ability to spread fixed costs over a larger portfolio and to achieve superior portfolio diversification by holding a national mortgage portfolio.

That historical argument, though reasonable, cannot justify perpetuating the current GSEs. First, such reasoning does not imply any benefit from a limited number of monopolistic GSEs, that is, the current Fannie-Freddie duopoly; on the contrary, the argument actually supports chartering competitive nationwide banks—to avoid the costs of limits on branching—and applies to all areas of banking, not just mortgages. Second, the chartering argument suggests no need for subsidizing such nationwide mortgage banks because their economies of scale would be realized without government help. Third, the historical argument holds little practical relevance to the U.S. mortgage market today. Branching restrictions on banks have been removed, and private commercial banks can operate competitive, nationwide networks. Furthermore, the revolution in mortgage securitization (and more generally the securitization of virtually all bank loan products) now allows originating institutions with limited capital to participate in the creation of enormous portfolios of assets (tranches of those are sold to a variety of international investors in the marketplace). Any need for a concentration of capital in the area of origination to permit the creation of large portfolios of mortgages has greatly diminished.

A second type of argument defends the creation of a monopolistic mortgage bank on the grounds of efficiency. Limits to competition among GSEs may have promoted greater standardization of mortgages, which may have facilitated the development of a national mortgage market. That argument, though somewhat plausible, is also a historical one with scant relevance to today's marketplace or to the debate over eliminating the current GSE duopoly.

Economies of standardization involve the creation of focal points that help standards to develop. If those standards are beneficial—

and possibly even if they are not —they will be self-reinforcing; any need to limit the creation of competitive standards no longer exists. Furthermore, limiting markets to a single standard incurs costs—we return to that issue in the discussion of technological progress and efficient pricing.

Securities markets provide interesting examples of the creation and perpetuation of benchmarks and product standards in the absence of monopoly rights. The freedom to adopt a standard or to differentiate one's product produces an interesting mix of imitation and innovation. For example, the Standard & Poor's 500 remains a powerful focal point of portfolio evaluation because of economies of standardization. At the same time new benchmarks with particular purposes—to track small stocks or Internet stocks, for example—have developed as new needs arise. Reaping the gains of product standardization does not require the creation of institutional monopolies.

The third class of argument supports the subsidization of mortgage intermediaries on the grounds of static efficiency. Robert Van Order (1999) has put forth the only such argument applied to the GSEs. He contends that the GSEs are more efficient mortgage portfolio creators than banks (due to purported economies of scale and superior technology) and therefore allocative efficiency requires that the GSEs (rather than banks) manage mortgage portfolios. Van Order argues that government subsidies to banks—typically thought to include underpriced deposit insurance and access to the discount window and Fedwire—may artificially reduce banks' costs of funds and thus permit banks to outbid the GSEs for mortgages. He charges that by subsidizing the GSEs, the government can reduce the deadweight loss from permitting inefficient banks to displace GSEs as mortgage intermediaries.

Though a clever argument for subsidizing the GSEs, it is not a convincing one for four reasons. First, as already stated, the notion of significant technological superiority of the GSEs as mortgage portfolio managers is no longer plausible in the current era of large-scale nationwide banking and private securitization of mortgages.

Second, empirical studies of banks do not support Van Order's claim that banks receive large net safety net subsidies (through deposit insurance or access to the discount window) that allegedly reduce their cost of funds. That situation may have been true of banks in the 1980s, but much has changed since then. Those changes include reforms to thrift capital standards in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), rules for

enforcing capital requirements for financial institutions and limits placed on the too-big-to-fail doctrine in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), additional reforms enacted in 1991 that limited Fed lending to distressed banks, depositor preference legislation in 1993 that reduced FDIC liabilities for failed banks, and the high capital ratios of banks in recent years. Empirical studies estimating the implicit safety net subsidy received by commercial banks indicate little or no existing average subsidy; for many banks the safety net rules entail a net tax (Hovakimian and Kane 1999).[8]

Third, even if banks were being granted a safety net subsidy that allowed them to compete inefficiently in the mortgage market, surely creating new GSE subsidies to counteract the bank safety net subsidy would not remedy the problem. If banks receive a distortionary safety net subsidy, then bank capital standards, prudential regulation, deposit insurance pricing, and access to the discount window should be further reformed. Indeed, even though banks enjoy little or no current average safety net subsidy, I have advocated several further reforms to bank regulation that would provide additional safeguards against such abuse (Calomiris 1994, 1997, 1999; SFRC 1999).

Fourth, Van Order bases his welfare analysis on an incomplete partial-equilibrium model of bank lending that focuses only on the mortgage market. But suppose that a bank enjoys a safety net subsidy that permits inefficient entry into any lending market. Even if a countervailing GSE subsidy blocks that bank from entering the mortgage market, the institution can still enter other markets: those for consumer loans, credit card receivables, and commercial loans and leases. Contrary to Van Order's analysis, preventing the subsidized bank from entering the mortgage market by subsidizing the GSEs worsens welfare from a general-equilibrium perspective. The GSE subsidy does not prevent the bank from inefficiently accessing other loan markets. The GSE subsidy in general equilibrium adds a new distortion and inefficiency to an already distorted financial system.

Technological Progress. According to another argument sometimes made for preserving the mortgage GSE duopoly—though not an argument for subsidizing that duopoly—the GSEs can perhaps better capture the benefits of technological improvements, and that situation might spur them to be more innovative than competing private banks. That highly controversial argument has questionable relevance in today's mortgage market.

In a general theoretical and empirical context, countervailing arguments and evidence (beyond the scope of this chapter to review) suggest that monopolies might be less innovative than competitive systems. Some observers of the computer industry, for example, fault Microsoft (which manages the dominant operating system for personal computer users) for slowing technological progress by gobbling up new software products and either keeping them off the market or delivering them within its operating system in an undesirable way. Other arguments suggest that the social costs of monopoly may outweigh the benefits of promoting greater technological progress.

In any case, singling out financial innovation as an area where technological progress requires a monopoly is strange. The revolution in financial engineering, derivatives, and securitization has proceeded apace in all financial markets, and many observers argue that competition has spurred those developments (Calomiris 1998).

Scant evidence in the mortgage market of recent years points to GSE technological superiority. Indeed Fannie Mae and Freddie Mac have significantly lagged behind in some of the most important new mortgage product areas. For example, the move toward credit scoring in the pricing of mortgages and the related development of the new high-loan-to-value and subprime mortgage markets occurred because of private initiatives and initially relied entirely on private financing sources (Calomiris and Mason 1998). The pioneers in the field were new finance companies that, unlike the GSEs and insured commercial banks, lacked any access to government safety nets.

Arguably the GSEs' policy of pooling mortgage risks (that is, purchasing mortgages in the secondary market as pools rather than on the basis of their estimated individual credit risk and prepayment risk) has slowed the development of credit risk and prepayment risk-pricing models. Even though the GSEs are only secondary market purchasers, if they eschew the efficient pricing of individual credit and prepayment risk, then originators have little incentive to adopt risk-pricing models in the primary market given the GSEs' dominant position in that market. Credit-risk models based on Fair Isaac Co. (FICO) scores have been used for pricing so-called nonconforming market products (high-loan-to-value and subprime mortgages), precisely the market niches where the GSEs have been least dominant.

The GSEs do sort mortgages according to their risks to some extent, as indicated by the varying credit-enhancement requirements

for different mortgages, and use credit scoring as part of their internal risk-management process, but they still pool risks to a significant degree in their purchases of mortgages. Originators would face stronger incentives to track and report individual characteristics related to prepayment and default risk if individual mortgage prices reflected all observable individual risks, as would be the case in a competitive secondary market.[9]

Inefficient risk pooling may have partially spurred the recent entry into the secondary market by the new Mortgage Partnership Finance (MPF) program, pioneered by the Federal Home Loan Bank (FHLB) of Chicago. In essence the MPF program allows banks to retain the credit risk associated with the mortgages that they originate, while passing on the market risk to the participating FHLB. Splitting credit risk from market risks allows originating banks to benefit directly from measuring, controlling, and retaining default risk and may encourage better pricing of risk in the primary mortgage market.[10]

Furthermore, the potential gains to competing financial firms from investing in financial innovation may be even higher in the future. Recent legal precedents encouraging the patenting of financial products—which will ease protecting the rights of inventive financial engineers—point toward an increasing ability of competing private market participants to capture the gains of their inventions (White and Case 1999).

In summary there seems to be no legitimate basis to argue for GSE monopolization of the mortgage market as a means to spurring technological progress. Competitive firms have managed to innovate successfully—particularly in financial markets including the mortgage market—and will continue to do so.

Liquidity. In August 1998 the Russian debt default and its spillover effects buffeted mortgage security markets and other markets for publicly traded debt. Those spillover effects reflected the behavior of financial institutions and other investors in the wake of large declines in asset values. The declines reduced the capital of investing institutions and forced them to curtail overall asset risk to limit the rising default risk on their own debts. The sudden sales of risky assets generated an abnormal spike in risk and liquidity premiums (the yield spreads on illiquid, risky securities) as investors scrambled for low-risk securities and cash.

Fannie Mae and Freddie Mac like to point to the accelerated growth of their portfolios during the August 1998 crisis as evidence

of their important role as providers of liquidity during financial crises. Freddie Mac (1999, p.10) boasts that "when . . . spreads widened, we seized the opportunity to grow our retained portfolio by a record $91 billion, more than three times the growth we generated in 1997." Fannie Mae (1999, p. 10) also took advantage of the crisis: "During the height of the turmoil in financial markets, Fannie Mae purchased nearly $50 billion of mortgages." Access to implicit government support and a credit line at the Treasury underlay the willingness of the GSEs to continue absorbing risk while other institutions were scrambling for liquidity.

The liquidity argument for the GSE subsidies merits serious consideration. As with the other arguments reviewed, the liquidity argument is incomplete; it emphasizes gross advantages, not net gains, and does not consider alternative, possibly superior means for achieving the same ends. That the GSEs are the best means of achieving net gains from liquidity protection in the mortgage market is far from obvious.

First, the willingness of Fannie Mae and Freddie Mac to absorb risk may be viewed negatively (as symptomatic of inefficient subsidization of risk) as well as positively (as symptomatic of greater access to liquidity protection). The willingness of thrifts, GSEs, and large money-center banks to absorb interest rate risk and default risk in real estate markets and debt markets in the 1980s resulted in enormous losses, which in large part have been attributed to the incentives that they faced as protected institutions (Barth and Bartholomew 1992; Boyd and Gertler 1994; Brewer 1995; Stanton 1991). Not only did those excessive risk-loving decisions lead to large losses for taxpayers, they also distorted resource allocations and wasted funds that could have been used productively elsewhere. Furthermore, by making the financial system more vulnerable, that risk-taking binge set the stage for the capital crunch of the late 1980s and early 1990s and the protracted recession that accompanied it. The willingness to absorb risk does not always contribute to the financial system.

A desirable mechanism for liquidity protection combats moments of liquidity crisis (generally measured in days or weeks as in June–July 1970, October 1987, and August–September 1998) without promoting a long-run tendency to undertake excessive risks. Fortunately such a mechanism exists: the Federal Reserve System's discount window.

The Fed's mission is to provide liquidity to the financial system. Most of the time that purpose means targeting the overall sup-

ply of money or credit in the economy to be consistent with stable, noninflationary growth. But sometimes the Fed's role as a central bank involves targeting specific markets or intermediaries for assistance. The discount window is the appropriate tool for that purpose (Calomiris 1994). For example, the Fed made it clear to banks that it was concerned about the upheaval in the commercial paper market in June 1970 and about the liquidity needs of the securities and futures markets in 1987. The Federal Reserve did not offer to protect banks from the credit risks of lending to commercial paper issuers or securities houses, but it did make it clear that banks could access the discount window (where borrowing rates are lower than in the private market) without fear of the implicit nonpecuniary regulatory penalties that normally accompany large borrowings from that subsidized source.

The Fed's policy regarding the discount window provides a state-contingent source of protection against temporary squeezes in particular markets. If banks (or reformed GSEs without access to government subsidies but with access to the discount window) became the primary holders and securitizers of mortgages, then the Fed could assume the role of protecting the mortgage market against sudden disruptions to liquidity, much as it has done in other markets. And the Federal Reserve would do so with minimal moral-hazard costs from encouraging long-run excessive risk taking. Thus a more effective, less costly means for providing liquidity protection for the mortgage market than the current GSE subsidies exists.

Political Economy. The first Bank of the United States was an effective fiscal agent for the federal government and was widely viewed as a uniquely valuable payments intermediary for the nascent nation. Yet its recognized efficiencies did not prevent opponents from blocking the renewal of its charter in 1811. President Andrew Jackson's veto of the rechartering of the second Bank of the United States in 1832 also ended a quite efficient intermediary. The second bank seems to have played a unique role as the only interstate bank during the 1820s to serve as a conduit for interstate trade finance (through the intermediation of bankers' acceptances) and as a disciplinarian that prevented other banks from issuing excessive amounts of liabilities by monitoring bank note issues and channeling excessive amounts back to the banks that issued them (Temin 1969; Calomiris 1993).

Those decisions—which many economists and historians (including myself) have criticized—still are not generally regarded as

entirely unwarranted.[11] Jefferson opposed the first Bank of the United States and Jackson opposed the second bank primarily because they saw in them a great risk to the political economy of the republic. Too great a concentration of political power, they believed, threatened the democratic process. Some critics have portrayed opponents of these banks as unsophisticated, and surely some of them were. But such concerns cannot be so easily dismissed. In a republic legislators enact policy, and their initiatives and votes reflect the political power of existing constituencies. Creating new institutions reallocates economic and therefore political power. Institutions that may produce net benefits in some static sense may have unforeseen and undesirable consequences.

The political economy case against the GSEs is even stronger than the case opposing the first and second Banks of the United States. Observers of the current GSEs often note that they spend an enormous amount of resources, time, and effort lobbying the federal government to influence economic policy. Fannie Mae and Freddie Mac's senior executives often seem to be hired more for their political connections than for their knowledge of the mortgage market (Ullmann 1999). Their reach is broad and their power is great. They exert more control over the markets in which they participate economically and politically than any other financial institution in U.S. history.

Although an economist has difficulty in quantifying the political costs to society of creating such entities, economic research into how government reaches its decisions suggests that the creation of concentrated vested interests in general entails significant costs borne by average citizens that should be considered (Olson 1965; Stigler 1988). Political economy considerations reinforce the conclusion of the previous analysis that no sustainable economic argument exists for net social gains from maintaining the GSEs as a subsidized duopoly.

Implications for Reforming the GSEs

Institutions have a way of perpetuating themselves partly because of the political influence that they maintain and partly because of the difficulty of orderly dissolution that logic suggests would be desirable. With the GSEs, however, fortuitous circumstances make the way out relatively easy.

The Office of Federal Housing Enterprise Oversight has established prudential standards for Fannie Mae and Freddie Mac (see HUD 1999). Because the amount (per dollar of debt) that these GSEs collect

as a government subsidy is proportional to the riskiness of their debt, establishing credible risk-based capital requirements that target low default risk for their debt could rein in their subsidy. Although OFHEO's task may seem rather prosaic, in fact the proper measurement of risk and the maintenance of adequate capital commensurate with that risk could save the U.S. taxpayers billions of dollars annually. Congress should also establish a carefully crafted subordinated debt requirement for the GSEs to provide additional market discipline to supplement regulatory discipline.[12]

Even if capital guidelines could be established and enforced adequately by some combination of market and regulatory discipline, limiting the GSEs' subsidy is not enough; the power that Fannie Mae and Freddie Mac wield in markets and in politics must be reduced. Because Fannie Mae and Freddie Mac both specialize in mortgage intermediation, that structural homogeneity makes it easier by simple division to create several competing entities out of the two.

The following five steps offer a fruitful approach to reforming the GSEs and substituting in their place a better means of encouraging homeownership.

- **Step 1.** Congress and the administration should decide how much the federal government spends on supporting homeownership. That amount should be placed in the budget and should be targeted to homeowners through a down payment assistance program like the one summarized above.[13]
- **Step 2.** During the transition to full privatization of the GSEs, OFHEO should continue to develop risk-based capital standards for them that account for the full range of risks undertaken and that effectively target a nearly zero default rate on GSE debt. The required capital maintained by the GSEs should include a mandatory minimum subordinated debt requirement, as described by Shadow Financial Regulatory Committee (1999). Removing OFHEO from HUD and establishing its true independence by insulating its operating budget from annual congressional review would help. Both the Office of the Comptroller of the Currency and the Federal Reserve are insulated from the annual budgetary process. OFHEO should be granted that same independence.
- **Step 3.** Fannie Mae and Freddie Mac either should be phased out entirely (the preferable course) or should be divided into

several new entities that would not be too big or too politically influential to be protected from failure by the U.S. government. Such new entities should either be subject to the strict capital guidelines described in step 2 or should be invited to apply for bank charters.

- **Step 4.** None of the new entities should have access to credit from the Treasury or should have government-appointed directors. Nor should they receive any other special tax treatment. If the new entities are not reconstituted as banks, they should still be given access to the Fed's discount window on the same terms as member banks.
- **Step 5**. Once Fannie and Freddie have been truly privatized, the Federal Home Loan Banks should be either privatized or closed. The only possibly legitimate rationale for maintaining the FHLBs in their current subsidized and concentrated form is to provide some competition for Fannie Mae and Freddie Mac (to reduce the one-third leakage of their taxpayer-financed subsidy, which currently flows to their stockholders). Once the special privileges of the other mortgage GSEs have been eliminated, the argument for retaining the FHLBs in their current form disappears.[14]

Conclusion

This chapter has considered possible justifications for perpetuating the monopoly rights and government subsidies enjoyed by Fannie Mae and Freddie Mac. None of the arguments suggests that the mortgage GSEs (Fannie Mae, Freddie Mac, and the Federal Home Loan Banks) meet the economic criterion of an optimal mechanism. Indeed it is more plausible to argue that these institutions do significant harm by burdening taxpayers, raising housing prices, discouraging homeownership, and retarding technological progress and competition in the mortgage market.

The promotion of homeownership, static efficiency in the mortgage market, technological progress in mortgage products and pricing, and mortgage market liquidity could be achieved best by abolishing the subsidies and the economic and political power enjoyed by the GSEs and by pursuing alternative, superior means to the legitimate ends described above.

Doing so not only would improve the efficiency of the financial system and make homeownership more achievable for millions of

Americans, it would also improve the quality of our political institutions by removing from the political arena a powerful voice for special interests at public expense.

Notes

1. The characterization of Fannie Mae and Freddie Mac as a duopoly is apt. They often coordinate their actions and do not compete away the value of the subsidy that each receives from the government. To meet their revenue projections, they must have purchased (as soon as the year 2000) 100 percent of all eligible U.S. mortgages originated (all mortgages with face value less than $240,000), and in subsequent years they must purchase all new eligible mortgages as well as a growing proportion of preexisting mortgages held by others. For growth projections, see Wallison and Ely 1999.

2. The Congressional Budget Office estimates a subsidy to the GSEs of $6.5 billion. In 1995 the U.S. Treasury estimated the subsidy at $4.6–6.9 billion (Smalhout 1999).

3. Van Order (this volume, chap. 3) also argues that the existence of a gross subsidy to the GSEs does not necessarily imply an undesirable distortion from that subsidy. We return to that question in the section on static efficiency.

4. Canner, Passmore, and Surette (1996) show that Fannie Mae and Freddie Mac bear little of the total credit risk from loans to low-income borrowers in the United States. For 1995 Fannie Mae and Freddie Mac extended 14 percent of all lower-income, FHA-eligible mortgages (in dollar terms) but absorbed only 4 percent of the risk in the market for FHA-eligible, low-income mortgages (p. 1089). The GSEs are required to obtain private mortgage insurance from outsider providers on low–down payment mortgages and thus cannot subsidize credit risk in that way. But even where they could subsidize credit risk, for example, to high-risk, low-income homeowners, they often appear to choose to raise down payment requirements or obtain credit enhancement from originators or third parties. While the details of that risk sharing are not laid out in detail in the annual reports of Fannie Mae (1999) and Freddie Mac (1999), their discussion of risk sharing in those reports indicates that they obtain credit enhancements from outside investors on loans with high credit risk. Thus while the GSEs as profit-maximizing firms intent on earning high returns on equity could in principle target assistance to high-risk, low-income mortgages by absorbing credit risk of those mortgages at below market interest costs, they choose not to do so to any significant extent.

5. Under the current GSE system, the poorest families (say, those with annual income less than $20,000) receive small positive net transfers from the GSEs since the amount that they receive is small (often zero) and their share of federal tax burden (other than payroll tax) is essentially zero. Middle-income families (say, those earning roughly $20,000–50,000) probably receive the biggest net transfers from the GSEs. Those citizens can qualify for homeownership on the basis of their income and wealth and thus can gain access to the GSE subsidy but pay little federal income tax (other than payroll tax) to finance the GSEs. Middle-upper-income families (say, those with incomes of $50,000–100,000) receive and pay for the GSE subsidies, and for them the net transfers (as a fraction of their income) are smaller. The wealthiest families receive little or no GSE benefits (because their mortgages typically exceed the $240,000 size limit for GSE purchases), and as taxpayers they pay a significant fraction of the cost of financing the GSE subsidies. Another complicating factor in calculating the net subsidies received by households is the effect of the GSE subsidies on the prices of houses purchased. Reduced mortgage rates—by reducing the effective discount rate on housing services—lead to the bidding up of the value of homes, and thus new home purchasers may receive little or no gross benefit from subsidized mortgage rates.

6. From an incentive standpoint, down payments are useful for ensuring that homeowners have a vested interest in their homes. Making the transfer from the government to the homeowner irrevocable (rather than a loan), preserves that incentive benefit.

7. For a discussion of the economics behind credit constraints based on minimum borrower wealth, see Stiglitz and Weiss 1981 and Calomiris and Hubbard 1990.

8. Kwast and Passmore (1997) argue that commercial banks continue to enjoy a safety net subsidy. Their evidence is that commercial banks have lower capital ratios than most other financial institutions. Calomiris and Mason (1999) show, however, that risk-adjusted capital ratios (which vary according to the riskiness of the assets of an intermediary) are similar across intermediaries; banks' lower capital ratios reflect the lower risk of their assets. For additional criticisms of the view that banks enjoy a large safety net subsidy, see Ely 1999.

9. The pooling of risks in the pricing of mortgages is inefficient because it entails a cross-subsidy from low-risk individuals to high-risk individuals. Those cross-subsidies are not only inefficient in a static sense, they also fail to reward good behavior (that can produce a high credit rating), which can raise overall risk in the market. Nevertheless, it is possible to argue that pooling serves a socially desirable outcome since it provides some insur-

ance to individuals against random occurrences that affect credit and prepayment risks. For that reason pooling could be preferred (from the standpoint of aggregate welfare) to sorting. In any case many alternative means exist other than the GSEs to achieving pooling, including regulations requiring the uniform pricing of conventional mortgages by originators.

10. It is not yet clear whether the FHLBs will be successful in their challenge to the Fannie-Freddie duopoly. The FHLBs themselves are GSEs and can thus compete with Fannie Mae and Freddie Mac in ways that private intermediaries cannot. Some observers—notably Alex Pollock (1998), president of the Chicago FHLB—have argued that the MPF program would add competition to the mortgage market and thus might reduce the rents that Fannie and Freddie can extract. That may be, but this sort of competition presents a danger. Increased competition among protected entities (whose subsidies rise with the amount of risk they undertake) can encourage greater risk taking at taxpayers' expense. For that reason the creation of new subsidized GSEs or enhanced competition among GSEs is not a substitute for eliminating GSE subsidies.

11. A better solution—one that would have retained the social gains from having these institutions but also would have addressed concerns about their excessive power—would have been the free chartering of banks with nationwide branching power (the feature that made the first and second Banks of the United States so valuable).

12. For a detailed explanation of the advantages of such a requirement and the pitfalls to be avoided when constructing a credible tranche of junior, risky debt offerings by protected financial institutions, see Calomiris 1997, 1999 and Shadow Financial Regulatory Committee 1999.

13. More generally it would improve government use of resources if annual budget calculations included all off–balance-sheet items with all implicit or explicit government guarantees. Doing so would discourage the perpetuation of inferior policy mechanisms (like GSEs) simply because they facilitate politically convenient, but dishonest, budgetary accounting.

14. The survival and expansion of the Federal Home Loan Banks exemplify the difficulty in eliminating existing institutions in an environment where political entrepreneurship offers high returns. The FHLBs were threatened with extinction in 1989 as the thrift industry suffered a collapse and the functions of thrifts became largely absorbed within the commercial banking sector. The FHLBs were retained initially in 1989 largely to help fund the S&L bailout, for which they were given some explicit liability. To avoid extinction, the Federal Home Loan Banks pursued a two-pronged "regulatory arbitrage" strategy for survival aimed at attracting a new constituency of members to defend them in Congress: commercial banks. The two prongs

of the strategy were (1) offering subsidized credit to mitigate the costs of CRA compliance by banks and (2) offering a new inexpensive general funding source (advances) to substitute for the curtailment of bank access to the discount window. That strategy boosted FHLB membership from less than 3,000 at year-end 1990 to roughly 6,500 by 1998. The Federal Home Loan Bank's subsidized loans (advances) became particularly attractive to small weak banks in the early 1990s. Those banks were finding it harder to access the Fed's discount window because of new restrictions on discount window lending enacted in 1991 in the wake of congressional criticism of Fed lending to insolvent banks during the 1980s. For a discussion of Fed lending policies to insolvent banks, see Gilbert 1994, 1995. For a discussion of Fed discount window policy changes, see those articles and Calomiris 1994.

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