**Remarks of**

**June E. O'Neill**
**Director**
**Congressional Budget Office**

**before the Conference on**
**Appraising Fannie Mae and Freddie Mac**
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On several occasions, the Congress has asked the Congressional Budget Office (CBO) to analyze the cost to taxpayers of federal credit assistance, including the implicit credit support provided to government-sponsored enterprises. Two years ago, in response to a statutory request, CBO, along with the General Accounting Office (GAO) and the Departments of the Treasury and Housing and Urban Development (HUD), prepared separate reports on the desirability and feasibility of privatizing Fannie Mae and Freddie Mac. Those studies provide estimates of the size and allocation of federal subsidies received by the enterprises.

In my remarks today, I will make two main points:

1. Government sponsorship reduces the operating costs of Fannie Mae and Freddie Mac by billions of dollars each year. Much of those savings arises from the perception of an implicit federal guarantee of the enterprises' obligations.

2. Fannie Mae and Freddie Mac pass along about two-thirds of their federal subsidies to mortgage borrowers by lowering interest rates, and they retain about one-third for other purposes. The enterprises have broad discretion under the law to decide both the magnitude and the allocation of their subsidies. It is inherently difficult for the government, through regulation, to affect their decisions.

The Congress rechartered Fannie Mae as a government-sponsored enterprise in 1968 and created Freddie Mac in 1971 to deal with recognized shortcomings in the housing finance system. At that time, restrictions on branch and interstate banking isolated local mortgage markets from each other and from the nation's capital markets. Ceilings on deposit rates paid by thrifts and banks limited their ability to attract funds for mortgage lending. Those constraints caused mortgage rates to be unnecessarily high and volatile and to vary significantly by region.

Fannie and Freddie were established to remedy those shortcomings by borrowing funds in the bond markets and making them available to local lenders. The enterprises have specialized in financing mortgages that carry no government insurance or guarantee, referred to as conventional loans. Fannie and Freddie are restricted to buying mortgages that have balances below certain prescribed levels. This year the so-called conforming limit is $227,150 for loans that finance one- to four-unit properties. Over 90 percent of all conventional mortgages, comprising over 80 percent of the dollar volume of such loans, are eligible to be financed by the enterprises. Fannie and Freddie finance the mortgages they buy by issuing and guaranteeing mortgage-backed securities and by selling debt.

Fannie and Freddie also serve as vehicles for delivering federal subsidies to the mortgage market. Even though the Treasury writes no checks to the enterprises, their special relationship with the federal government allows them to borrow more cheaply than other firms and exempts them from state and local income taxation, thereby reducing their operating costs by billions of dollars each year. Whenever the government conveys economic benefits free of charge, it incurs an opportunity cost equal to the market value of the benefits. The benefits received by Fannie and Freddie could otherwise be sold to private investors, and the proceeds could be used to finance other government programs. The cost of subsidizing Fannie and Freddie is as real as the cost that would be incurred if the government gave away, free of charge, permits to harvest timber in national forests or licenses to broadcast on the radio spectrum.

The largest source of federal subsidies to Fannie and Freddie is the perception of investors that the government, if necessary, would act to prevent the enterprises from defaulting on their obligations. That perception of an implicit federal guarantee gives the debt and mortgage-backed securities issued by Fannie and Freddie super-triple-A status and enables them to borrow at lower interest rates than comparable private firms, which lack their special advantage. The implicit backing of the federal government also permits Fannie and Freddie to sell very large quantities of unique financial instruments, including callable debt. It gives the enterprises the singular ability to enter into financial obligations (off the balance sheet) with other parties who regard the transactions as essentially free of default risk. In addition, Fannie and Freddie are exempt from state and local income taxation, the registration requirements of the Securities and Exchange Commission (SEC), and other provisions of law. They are also subject to lower capital requirements than banks and thrifts.

The federal subsidies conveyed by the enterprises' explicit legal exemptions can be estimated in a straightforward manner based on their pretax net income, the tax rates of the relevant governments, and the volume of securities they issue. In 1996, CBO estimated that the exemption from state and local income taxation cost federal taxpayers about $260 million in 1995. GAO has estimated that the exemption from SEC registration is worth more than $100 million annually.

The value of the government's implicit guarantee is more difficult to estimate. The four government studies did so by assessing the level of default risk that Fannie and Freddie pose to the federal government. CBO's report assumed, for example, that the risk posed by each enterprise is comparable to that posed by a wholly private firm with a double-A credit rating. Using market data, the studies compared the yields of debt and mortgage-backed securities issued by Fannie and Freddie with the yields of similar obligations issued by private firms that pose comparable default risk. The subsidies conveyed by the implicit federal guarantee were estimated by multiplying the savings in funding costs by the enterprises' average outstanding obligations. Though reasonable, that approach tends to understate the value of the guarantee because it assumes that wholly private firms can borrow in the same huge volumes as Fannie and Freddie and can issue the same proportion of callable debt.

Using that approach, CBO estimated that the implicit federal guarantee conveyed $6.5 billion in subsidies to Fannie and Freddie in 1995. Using somewhat different assumptions, the Treasury estimated subsidies of $5.3 billion for that year.

What do the enterprises do with their large subsidies? CBO and the Treasury concluded that Fannie and Freddie lower the interest rates on the mortgages they finance by about 35 to 40 basis points (100 basis points equal 1 percentage point). CBO found that in 1995, the enterprises passed through about $4.4 billion of their federal subsidies to home buyers and other mortgage borrowers. At the same time, they kept $2.1 billion, or nearly $1 for every $2 they delivered to the intended beneficiaries—hence, the characterization of the enterprises in CBO's report as "spongy conduits."

It is not surprising that the enterprises retain a portion of their federal subsidies. Fannie and Freddie have shareholders and want to earn profits. The retained portion of their federal subsidies enhances their profits. The enterprises have broad discretion to determine the volume of mortgages they will finance, the prices they will pay for loans, and the mix of debt and mortgage-backed securities they will issue. That discretion gives Fannie and Freddie substantial influence over the size of their federal subsidies. The risk-based capital regulation now being developed by the Office of Federal Housing Enterprise Oversight (OFHEO) will limit that discretion but will not eliminate it. The enterprises' federal charters limit their profitability, however, by constraining their ability to enter new lines of business. If Fannie and Freddie were not allowed to retain some of their federal subsidies, they probably would be pursuing privatization.

The four government reports issued in 1996 noted that Fannie and Freddie had been increasing their use of debt financing since 1992. That trend continued in 1996 and 1997, when the enterprises' outstanding debt increased 29 percent while their outstanding mortgage-backed securities grew by only 9 percent. The enterprises have used much of that new debt to buy back mortgage-backed securities that they had issued in the past. Debt financing does not appear to provide significant benefits to the mortgage market beyond that provided by financing with mortgage-backed securities. Increased debt financing swells the federal subsidies to Fannie and Freddie without providing an equivalent benefit to mortgage borrowers.

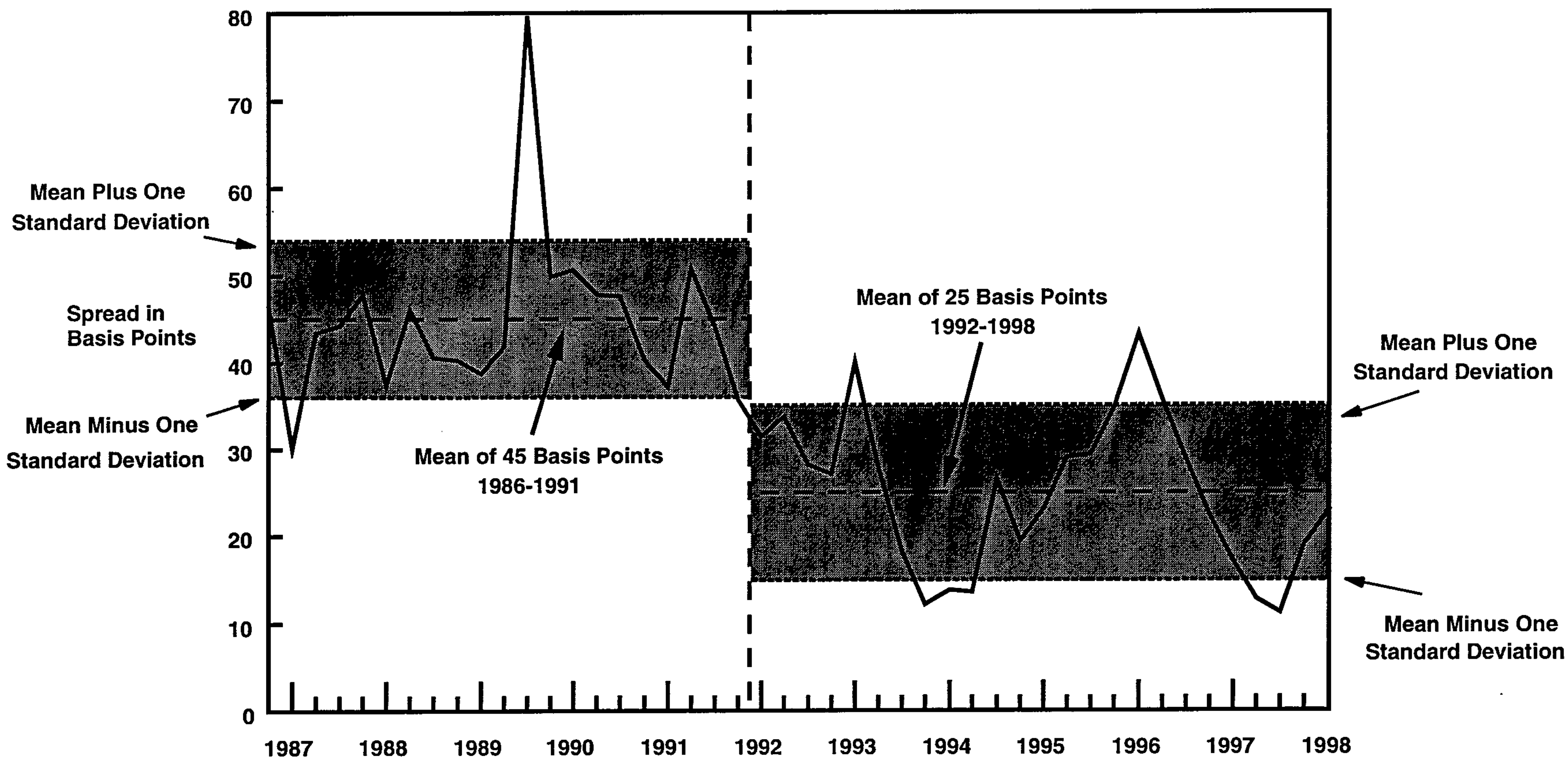
The reports also observed that the nation's mortgage markets have become more efficient in recent years. One implication of the growing efficiency is that Fannie and Freddie do not reduce the interest rates on conforming fixed-rate loans as much as they once did. CBO recently examined the spread between the yields on 30-year, fixed-rate jumbo and conforming mortgages.[1] We found that the spread has

1. CBO examined national survey data collected monthly from April 1986 through March 1998 by HSH Associates, a private publisher of financial data. The HSH data include mortgage rates and points. In calculating the spread between jumbo and conforming yields, CBO assumed that each point adds 0.2 percentage points to the yield.

averaged 25 basis points since 1991, down from an average of 45 basis points from 1986 to 1991 (see attached chart). Thus, the most recent data indicate that the enterprises are less effective vehicles for delivering federal subsidies to the mortgage market than CBO and the Treasury had previously estimated.

A major lesson to be drawn from the 1996 reports is that it is inherently difficult for the government to influence, through regulation, either the magnitude or the allocation of federal subsidies to Fannie and Freddie. In 1992, the Congress required the HUD Secretary to impose affordable housing goals on the enterprises. The goals require them to devote a portion of their mortgage purchases to support low-income and underserved borrowers and areas. Fannie and Freddie have complied with those goals. But the goals are not difficult to achieve, and it is not clear how much they have affected the enterprises' actions. In fact, as noted in the 1996 reports, depository institutions as well as the Federal Housing Administration devote a larger proportion of their mortgage lending to targeted borrowers and areas than do the enterprises. Future research could analyze a range of regulatory mechanisms to address both the size of federal subsidies to Fannie Mae and Freddie Mac and the allocation of those subsidies, including the portion retained.

## Spread Between Yields on 30-Year, Fixed-Rate Jumbo and Conforming Mortgages, Fourth Quarter 1986 to First Quarter 1998




SOURCE: Congressional Budget Office based on data from HSH Associates.