

Government-Sponsored Enterprises and Changing Markets: The Need for an Exit Strategy

Thomas H. Stanton

Johns Hopkins University

The major government-sponsored enterprises (GSEs) are beginning to compete with one another, both at the margins and potentially with respect to some core businesses. GSEs also affect the profitability of other financial institutions. Removal of government sponsorship from some GSEs can be an attractive policy option. If transition issues are properly addressed, there will be minimal adverse effects upon ultimate borrowers. Virtually all financial services that GSEs provide today are also available, in some form, from effective competitors. For example, homebuyers and students have access to an increasingly efficient market for private mortgage-backed and asset-backed securities.

I. INTRODUCTION

The government created the major government-sponsored enterprises (GSEs)¹ as instruments of federal policy to overcome perceived market imperfections or market failures. Thus, Fannie Mae began in 1938 as a subsidiary of the Reconstruction Finance Corporation, a wholly owned government corporation. Its public purpose was to provide a secondary market for federally insured mortgages and thereby provide liquidity to mortgage lenders who otherwise would lack the available funds to make mortgage loans.

Similarly, the Federal Home Loan Bank System (FHLBS) was intended to provide liquidity to savings

and loan associations that otherwise could not thrive if their money was tied up in long-term illiquid mortgages. The Farm Credit System was designed to be a form of national bank to serve rural borrowers who had little ready access to commercial lenders that served urban areas. More recently, Sallie Mae was created to provide a secondary market in student loans at a time when commercial lenders considered such loans to be unprofitable. Exhibit 2 lists the federal contingent liabilities represented by GSEs as of September 30, 1994, compared to the somewhat larger contingent liability from federal deposit insurance.

Over time, the financial markets have become much more efficient. Market imperfections included statutory limits that confined potential competitors such as banks and thrifts, and also an absence of easily obtainable information about the credit risk of particular kinds of loans. Changing markets and improved laws (e.g., the repeal of legal limits upon bank branching and the geographic areas that banks and thrift institutions could serve) have alleviated many of the past imperfections. The

¹A government-sponsored enterprise can be defined as a privately owned, federally chartered financial institution with nationwide scope and specialized lending powers that benefits from an implicit federal guarantee to enhance its ability to borrow money. As can be seen from this definition, GSEs have many characteristics in common with banks and thrift institutions. Exhibit 1 summarizes the activities of the GSEs discussed in the paper.

Exhibit 1. Government Sponsored Enterprises

The federal government creates government sponsored enterprises as way to provide credit support for favored public purposes such as housing, agriculture and education. Today's government sponsored enterprises and their major public purposes are as follows:

- **Farm Credit System (1916):** The FCS is organized as a system of borrower cooperatives to make a range of agricultural loans including farm mortgage loans. The FCS has been restructured a number of times, most recently on the basis of laws that were enacted after the system's financial failure in 1985. FCS institutions are currently engaged in a process of consolidation that is prompted largely by the need to reduce overhead costs;
- **Federal Home Loan Bank System (1932):** The FHLBS was originally organized as a system of district banks owned cooperatively by thrift institutions. The banks provided advances (loans to primary lenders), collateralized by home mortgages to thrifts as a way of enhancing their liquidity.

In 1987 and again in 1989 the federal government assessed the FHLBS to pay for the capitalization of two GSE-type entities, known as the Financing Corporation (FICO) and Resolution Funding Corporation (Refcorp) respectively, to help to pay for the savings and loan debacle, and also imposed some long-term obligations upon the FHLBS. In 1989 the FHLBS was authorized to open its membership and provide advances and services to other residential mortgage lenders, including commercial banks and credit unions.

- **Fannie Mae** (originally a wholly owned government corporation; rechartered as a GSE in 1968) and **Freddie Mac** (chartered as a GSE in 1970): These investor-owned corporations purchase home mortgages from primary lenders such as mortgage bankers and savings and loan association (also known as thrift institutions);
- **Sallie Mae (1972):** This investor-owned corporation purchases student loans from primary lenders, usually commercial banks and provides advances collateralized by student loans. In 1993 Sallie Mae requested that the federal government terminate its status as a GSE and permit the company to be rechartered under a general business corporation law;
- **Farmer Mac (1988):** This secondary market lender is owned by investors who are commercial banks, other primary lenders, and FCS institutions. It has attempted to create a market for securities backed by pools of agricultural mortgages, but has not been able to achieve the volume of business needed to assure financial success.

activities of government agencies and of government-sponsored enterprises themselves helped to generate valuable information about the credit quality of particular kinds of loans such as home mortgages, agricultural loans and student loans. The massive market failure of the Great Depression that helped to spawn Fannie Mae and the FHLBS is becoming a faded memory.

With the alleviation of market imperfections, government-sponsored enterprises have lost much of the original basis for their success. Market imperfections meant that government-sponsored enterprises could provide financial services that bridged the imperfection and served creditworthy borrowers that otherwise lacked complete access to credit.

Exhibit 2. Face Value of Federal Contingent Liabilities: GSES and Deposit Insurance Programs September 30, 1994

Contingent Liability	Face Value
Federal Deposit Insurance:	
Banks	1,885
Thrifts	691
Credit Unions	253
Total Deposit Insurance	2,829¹
Government Sponsored Enterprises (GSEs):	
Freddie Mac	567
Fannie Mae	744
Federal Home Loan Banks	197
Sallie Mae	51
Farm Credit System	51
Farmer Mac	2
Total GSEs	1,553³
Funding Corporations:	
Financing Corporation (FICO)	9 ⁴
Resolution Funding Corporation (Refcorp)	31
Total	4,422

Source: *Budget of the United States Government, Analytical Perspectives, FY 1996, p. 152; Sallie Mae, Fourth Quarter Report; Budget of the United States Government, Appendix, FY 1996, pp. 1127-1128.*

¹This number reflects federal deposit insurance up to the statutory limit of \$100,000 per insured deposit account and does not reflect any additional contingent liability that would arise if the government extends its backing to uninsured depositors.

²Outstanding Farmer Mac Securities amount to about \$0.1 billion.

³This total excludes double counting of securities of one GSE that are held by another GSE (especially the FHLBS) for investment purposes.

⁴Repayment of most principal (but not interest) on FICO and Refcorp obligations will be made through the use of Treasury obligations that have been purchased for that purpose and held in segregated accounts.

Now that market imperfections have diminished, those creditworthy borrowers have access to a broad range of financial institutions and services. GSEs can only survive as long as their modest federal subsidy (derived from the implicit federal backing, various tax advantages and other benefits in their particular enabling legislation) gives them a pricing advantage that is attractive to customers. Financial services companies without GSE status may begin to offer attractive bundles of services that GSEs may be precluded from providing because of the limitations in their federal charters. If the pricing is competitive, these new products may attract customers away from some of today's GSEs.

This may not be a tolerable situation for a GSE. As its federal charter begins to confine its activities, the GSE must push at the limits, both in the market and in attempting to expand its permitted activities under the law. A number of the GSEs today are in this position. What is especially interesting is the way that the major GSEs are beginning to compete with one another, both

at the margins and potentially with respect to some of their core businesses. The GSEs are also continuing to affect the profitability of federally insured financial institutions in an increasing number of ways.

Each of the GSEs is evolving somewhat differently in these respects. It cannot be stated with certainty either (1) that interactions among GSEs and between GSEs and other financial institutions will precipitate financial instability or (2) that the government would be incapable of dealing with any such problems.

One can say with greater confidence that the government thus far has not shown any special skill at dealing with financial institutions and contingent liabilities in a preventive manner.² The pressures for the status quo, often backed by powerful political constituencies, can deter the government from acting until it is very late. If there are substantial losses, as occurred with the thrift debacle and the Farm Credit System in the 1980s, then the government tends to look for available deep pockets and to use indirect and hidden ways to generate the money needed to pay off investors who relied upon the government's implicit or explicit assurances.

For a number of reasons, privatization may be an attractive exit strategy to consider for a GSE, preferably before it runs into possible trouble. First, if privatization is planned in advance while a GSE still possesses a charter with positive value, this can be carried out prospectively as a win-win arrangement between the government and the private owners. Second, virtually all of the financial services that government-sponsored enterprises provide today are also available, in some form, from effective competitors. For example, homebuyers and students have access to an increasingly efficient market for private (i.e., non-GSE) mortgage-backed and asset-backed securities.

This means that, so long as transition problems are addressed, the removal of government sponsorship from a GSE will have minimal adverse consequences upon the ultimate borrowers who benefit today from services provided by that GSE. Perhaps the most perceptible change will come in the form of increased borrowing costs that result from removal of the government subsidies that are provided through the statutory language of

²Thus, analysts with a historical perspective note that much of the major financial legislation in the United States has been crisis-oriented:

"[R]eform has frequently been crisis-oriented. Despite an awareness of the structural defects in the financial system or in the monetary authority, little effort is directed toward reform until a crisis has occurred or is about to occur."

Thomas F. Cargill and Gillian G. Garcia, *Financial Reform of the 1980s*, (Stanford: Hoover Institution Press, 1985), p.38.

today's GSE charter. Even that increase is likely to be modest in its impact upon the ultimate borrower.³

A. Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac today demonstrate how dynamic corporate institutions backed by government subsidy can dominate the competition in their markets. These two companies are constrained by law to purchasing or securitizing home mortgages up to a size that is limited by a statutory formula. The current mortgage limit is \$203,150 for the maximum size of a single-family mortgage that is eligible for purchase by the two GSEs.

Fannie Mae and Freddie Mac are secondary market institutions. In other words, their federal charters prohibit them from originating mortgage loans directly; instead, they must purchase mortgages from other lenders such as the primary lenders who actually make the mortgage loans to the individual borrowers. In today's market, the major types of primary mortgage lender are mortgage bankers, commercial banks and thrift institutions.

Fannie Mae and Freddie Mac have grown dramatically. In terms of their combined assets and mortgage-backed securities, on average they have more than doubled in size every five years since 1970. Fannie Mae and Freddie Mac today are two of the world's largest financial institutions. As can be seen in Exhibit 2, on September 30, 1994, Fannie Mae had combined liabilities and mortgage-backed securities outstanding of \$744 billion; for Freddie Mac, the comparable figure was \$567 billion. Together, the two GSEs represent a federal contingent liability of \$1.3 trillion.

Fannie Mae and Freddie Mac today are very profitable, with returns on equity last year of 24 percent and 20 percent, respectively. This return is far superior to the average of commercial banks or other private lenders. In their structure today, Fannie Mae and Freddie Mac

³For example, the residential mortgage market is divided between conforming mortgages, i.e., those eligible for purchase by Fannie Mae and Freddie Mac, and nonconforming mortgages. The spread between conforming and nonconforming mortgages amounts to perhaps three-eighths of a percentage point. That figure is a reasonable approximation of the impact upon borrowers if Fannie Mae and Freddie Mac were completely privatized. By contrast, the federal government includes a mortgage interest deduction in the federal income tax code that provides roughly five or ten times that amount of benefit to eligible homebuyers.

Such analyses have not been prominent in government documents. However, the Congressional Budget Office (CBO) recently presented a policy option to impose a partial user fee upon Fannie Mae and Freddie Mac and calculated that the associated possible increase in mortgage rates would be minuscule. Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*, "Impose a Cost-of-Capital Offset Fee on Fannie Mae and Freddie Mac," pp. 318-319 (February 1995).

resemble investor-owned public utilities that are largely unsupervised by the government with respect to pricing or the scope of their services.⁴

In recent years, Fannie Mae and Freddie Mac have purchased over half of all home mortgages originated in the United States. The other half have consisted largely of three kinds of mortgages: (1) adjustable rate mortgages held largely in the portfolios of thrift institutions and commercial banks, (2) jumbo mortgages, i.e. those larger than \$203,150 and therefore ineligible for purchase by Fannie Mae and Freddie Mac, and (3) mortgages insured by the federal government, especially the Federal Housing Administration (FHA) of the US Department of Housing and Urban Development (HUD). The federally insured mortgages may be securitized by the Government National Mortgage Association (Ginnie Mae), a wholly owned government corporation that is a part of HUD.

Fannie Mae and Freddie Mac conduct their activities under authority conferred by the specific statutory language in their congressional charters. As they expand, the two companies face increasing constraints from the terms of these charters. Fannie Mae and Freddie Mac are pushing hard at these limits on their activities, both by increasing the intensity of service to their legally permitted market segments and by weakening the legal constraints on their activities.

Three recent actions deserve special note because of their implications for other parts of the American financial system. First, Fannie Mae and Freddie Mac are developing large-scale automated underwriting and mortgage application systems that are based upon the most recent forms of information technology.⁵ Sallie Mae similarly used new information technologies to erase the borders between the primary and secondary markets. As was the case with Sallie Mae, Fannie Mae and Freddie Mac are likely to be able to use the new technologies to

push their market power forward from the secondary market into the primary market as well.

This development will permit Fannie Mae and Freddie Mac to reduce the cost structure of the primary mortgage market. Lenders will face the need to reengineer the mortgage origination system of the United States. Also, the new automated systems will prompt change in the real estate settlement system and its myriad of expensive services that could usefully be bundled with the loan origination process.⁶ This development is also likely to hasten the process of consolidation of mortgage lenders in the primary market.

Second, Freddie Mac has brought new information technologies to bear upon the process of credit scoring; Fannie Mae is actively exploring the development of such a capability. Readily retrievable information about the credit history of a huge number of past borrowers can be matched with the characteristics of a loan, a property and the credit profile of a prospective borrower to assess the likelihood that he or she will default on the new mortgage. By placing the new credit scoring systems in the hands of primary lenders, Freddie Mac and Fannie Mae can improve the extent that they serve creditworthy borrowers whose mortgage applications might have been rejected in the past because of nontraditional credit histories. In particular, by focusing upon factors that relate solely to the creditworthiness of a particular borrower, the new credit scoring systems may be able to reduce disparate treatment of racial and other minorities in the mortgage origination process.⁷

The effects of this development will be felt by the Federal Housing Administration in its single-family mortgage insurance program. Today, FHA mortgage insurance helps to facilitate the flow of mortgage credit to lower-income and first-time borrowers — including a disproportionate number of racial and other minorities—who otherwise might not be served by the conventional (i.e., privately insured) mortgage market.⁸

The mortgage borrowers served by FHA are of two types: (1) largely creditworthy borrowers who exhibit some form of nontraditional profile that makes private lenders reluctant to extend credit, but who are good credit risks, and (2) people who are poor credit risks and who are likely to default in disproportionate numbers and thereby cause financial losses to the government program. The FHA program can only remain financially sound if it serves the creditworthy borrowers in sufficient

⁴Oakley Hunter, an early Fannie Mae President, made a similar point some years ago:

“Because of its broad purpose of fostering residential financing, FNMA’s operations in some respects may be compared to those of a public utility, i.e., the public interest involvement justifies some government regulation.”

Oakley Hunter, “The Federal National Mortgage Association: Its Response to Critical Financing Requirements of Housing,” *The George Washington Law Review*, Volume 39, Number 4, May 1971, at p. 831.

A number of the particular forms of regulation cited by Mr. Hunter have been repealed or circumscribed since the time of his writing; HUD’s vestigial authority to approve business activities of Fannie Mae is now the subject of some controversy. See, e.g., Snigdha Prakash, “Fannie Fighting Expansion of Oversight by HUD,” *American Banker*, February 15, 1995, p. 8.

⁵See, e.g., Peter Maselli, “Mortgages in Minutes,” *Mortgage Banking*, October 1994, pp. 102–113.

⁶President’s Commission on Housing, “RESPA Review,” *Report of the President’s Commission on Housing*, pp. 191–193 (1982).

⁷Kenneth R. Harney, “Automated Credit Scoring Screens Loan Applicants,” *Washington Post*, January 15, 1994, p. E-1.

⁸Vanessa Perry, “Who are FHA Borrowers?” *Secondary Mortgage Markets*, Vol. 11, No. 3, Freddie Mac, January 1995, p.13.

numbers to permit payment for the losses from defaulting borrowers. FHA-insured mortgages must carry higher fees than conventional mortgages because of the higher overall default rate on FHA mortgages. The result is a form of cross-subsidization, with the creditworthy borrowers paying higher than market rate fees as a way to help pay for the defaults of the other FHA borrowers who are not creditworthy.

This process is likely to accelerate once Fannie Mae and Freddie Mac implement their new automated underwriting systems. The new systems are likely to identify many new creditworthy FHA-type borrowers who will then be able to receive a conventional mortgage with lower fees than they would have to pay for an FHA-insured mortgage. The new systems will also prompt reductions in closing costs that will increase the affordability of conventional mortgage loans.

The result will be increased pressure upon the financial soundness of the FHA single-family mortgage insurance program. One serious possibility would be an increase in the number of creditworthy borrowers who leave FHA for the conventional mortgage market and a consequent increase in the percentage of FHA mortgages made to less creditworthy homeowners. This could lead FHA to increase its fees to pay for the increased loss rate; the higher fees in turn would accelerate the flight of creditworthy borrowers from the FHA program to the extent that conventional mortgages are available.

The government has only begun to look at the policy implications of this problem and at alternative possibilities for the future of the FHA single family program. It remains to be seen whether the government will decide to privatize the FHA single-family mortgage program along lines recently suggested by the federal Office of Management and Budget (OMB).⁹ If this happens, then there may be an opportunity to offer Fannie Mae and Freddie Mac a package that combines (1) the prospect of substantial new business starting in the short term and (2) a

⁹The Office of Management and Budget, "FY 1996 Passback: Department of Housing and Urban Development," November 21, 1994, pp. 21-22, stated:

"The Administration will propose legislation to change the mechanism for ensuring access to credit by buyers who cannot obtain traditional financing. Under the proposal, FHA will no longer insure individual mortgages. Instead, FHA will provide credit enhancement for pools of high LTV [loan-to-value] and other high-risk mortgages securitized and guaranteed by Fannie Mae, Freddie Mac or other securitizers. The enhancement, in the form of a loss reserve, will ensure that the cash flow to investors is not interrupted by defaults, FHA will continue to charge borrowers a fee to fully fund the loss reserves and cover its administrative costs."

This proposal was not included in the final version of the Administration's FY 1996 budget; however, variations on the idea have been suggested by members of the new congressional majority.

long-term sunset provision in their charters. More about this later.

The third development has been an effort, especially by Fannie Mae, to expand the terms of the law and regulations that govern its permitted business activities. One part of this effort relates to the current activities of the Federal Home Loan Bank System. In 1989, Fannie Mae obtained a statutory change that removed restrictions on its authority to make loans on the security of mortgages. In 1990, Fannie Mae requested that the Secretary of Housing and Urban Development permit Fannie Mae to purchase debt obligations secured by conventional mortgages or securities backed by such mortgages.

Among other possible financial services, this would have permitted Fannie Mae to offer advances to thrift institutions, commercial banks and other mortgage lenders on quite favorable terms compared to those offered by the Federal Home Loan Bank System to its members. In particular, while the FHLBS has based much of its business upon the practice of making advances that are highly overcollateralized (as a way of controlling credit risk), Fannie Mae proposed to reduce the amount of overcollateralization. This change would appear to make the proposed Fannie Mae advances quite attractive compared to those currently offered by the FHLBS.

The Department of Housing and Urban Development refused to approve Fannie Mae's 1990 request. Fannie Mae and Freddie Mac object strongly to the authority of the department to approve or disapprove their new business programs.¹⁰ Especially at a time when Congress is seriously considering proposals to abolish the department, there is a chance that the government will give up its approval authority with respect to Fannie Mae and Freddie Mac new business activities. There is some chance that the FHLBS one day could find that Fannie Mae and Freddie Mac have the potential to offer new forms of advances and other financial services that may be able to take away large and profitable parts of the current FHLBS customer base.

These three developments illustrate how Fannie Mae and Freddie Mac today are dynamic institutions that combine market power with an impressive ability to deploy new technologies to reshape the American mortgage market in ways that few policymakers may perceive. The consequences are beginning to spill over into other parts of the financial markets. As shall be discussed below, this is becoming relevant to the future activities of other government-sponsored enterprises.

¹⁰See U.S. Department of Housing and Urban Development, "Proposed Rule: The Secretary of HUD's Regulation of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac)," *Federal Register*, Vol. 60, No. 32, February 16, 1995, pp. 9154-9247.

The growth of Fannie Mae and Freddie Mac in the marketplace has been accompanied by a growth in their political power. In recent years, Fannie Mae and Freddie Mac have faced a range of challenges in the form of new legislation or regulations with the potential to enhance or impede profitability of the two companies. As with other federally chartered institutions,¹¹ Fannie Mae and Freddie Mac have devoted considerable resources to assuring dominance in the political process. They achieved a major political victory in their efforts to weaken legislation to create a strong financial regulator with discretion to set bank-type capital requirements.¹²

The results of GSE political power have been chronicled in an increasing number of reports from a variety of sources.¹³ As the Secretary of the Treasury has pointed out:

"The principal GSEs are few in number; they have highly qualified staffs; they have strong support for their programs from special interest groups; and they have significant resources with which to influence political outcomes."¹⁴

One of the most attractive consequences of privatization of Fannie Mae and Freddie Mac is the way that this would encourage these huge companies to devote their energies to success in the marketplace rather than dominance in the political process. A fundamental flaw with the institutional structure of the government-sponsored enterprise is the way that the government subsidy creates market dominance by some GSEs and this in turn also creates the potential for political dominance.¹⁵ The result can

¹¹See examples cited in Thomas H. Stanton, "Nonquantifiable Risks and Financial Institutions: The Mercantilist Legal Framework of Banks, Thrifts and Government Sponsored Enterprises," in Charles A. Stone and Anne Zissu, Eds., *Global Risk-Based Capital Regulations*, Vol. 1, Chapter 3, pp.57-97 (1994).

¹²Kenneth H. Bacon, "Privileged Position: Fannie Mae Expected to Escape an Attempt at Tighter Regulation," *Wall Street Journal*, June 19, 1992, p. A1.

¹³See, e.g., Carol Matlack, "Getting Their Way," *National Journal*, October 27, 1990, pp. 2584-2588; Stephen Labaton, "Power of the Mortgage Twins: Fannie And Freddie Guard Autonomy," *New York Times* (November 12, 1991) pp. D1, D8; Jill Zuckman, "The \$50,000 Question," *Congressional Quarterly*, August 3, 1991, p. 2140; and David A. Vise, "The Money Machine: How Fannie Mae Wields Power; Fannie Mae Lobbies Hard to Protect its Tax Break," *Washington Post*, January 16, 1995, pp. A-1, A-14 and A-15.

¹⁴U.S. Department of the Treasury, *1991 Report of the Secretary of the Treasury on Government-Sponsored Enterprises*, p. 8 (1991).

¹⁵The *Washington Post* recently reported on Fannie Mae's use of market power to enlist political support:

"Builders, real estate brokers and bankers across the country rely so heavily on Fannie Mae for mortgage funds that they live in fear of offending the firm and routinely defend it in Washington."

David A. Vise, "The Money Machine: How Fannie Mae Wields Power," January 16, 1995, p. A14.

be a GSE that becomes an institution that cannot be controlled by the government even when such control may be necessary and appropriate.

Fannie Mae and Freddie Mac are so large and powerful today that the government probably lacks the ability to compel them to accept privatization if they believe that their interests would thereby be disadvantaged. An alternative, discussed below, might be to explore the possibility of providing positive incentives for the two GSEs now to accept a sunset provision in their charter legislation that would require privatization in a specified number of years.

B. The Federal Home Loan Bank System

On paper, the Federal Home Loan Bank System looks like a profitable venture. At yearend 1994, the 12 Federal Home Loan Banks had total assets of \$245 billion, net income for the year of \$738 million, and total capital of \$13.3 billion. Despite the thrift debacle and the traditional dependence of the FHLBS on the thrift industry for its membership and customer base, the FHLBS has never lost a dollar on its advances to member institutions. This is a tribute to conservative business practices that include a requirement that advances to members be substantially overcollateralized as protection for the FHLBS against the possibility of default.

In 1989, Congress opened membership in the FHLBS to banks and other mortgage lenders as well as the traditional thrift institution membership. The number of FHLBS members has almost doubled in the past five years, growing from 2,887 members at yearend 1990 to 5,345 members at yearend 1994. Today, the number of commercial banks that are members of the FHLBS significantly outnumbers the number of thrift institution members.

These impressive numbers fail to reveal some significant structural flaws in the design and current operation of the FHLBS. The most serious structural flaw relates to a financial requirement, imposed in 1989 legislation, that the FHLBS provide \$300 million annually for forty years to fund obligations of the Resolution Funding Corporation (Refcorp), an off-budget government corporation. In 1989, Congress also mandated the allocation of \$2.5 billion in FHLBS retained earnings to capitalize Refcorp as a means of helping to fund the closure of failed thrift institutions. The government used the Refcorp money to fund a new government corporation, known as the Resolution Trust Corporation, that supervised the closure of insolvent thrift institutions and disposition of their assets.

Another problem relates to the unusual capital structure of the FHLBS; the U.S. General Accounting Office points out that FHLBS capital today "is not well-suited

for absorbing risk.¹⁶ Instead, it exhibits many of the characteristics of "borrower stock" with a powerful constituency that will argue that it should be protected against losses. This occurred when the Farm Credit System (FCS), also a cooperatively owned GSE, was unable to meet its obligations in the mid-1980s; the federal government ultimately decided to provide federal financing to restructure the FCS while protecting FCS stock from the kind of losses that would be appropriate for equity investors.

The problem with the required annual FHLBS payment to Refcorp is the way that it "introduces some perverse incentives into the FHLB System."¹⁷ The Refcorp payment imposes fixed costs upon the FHLBS, regardless of the profitability or income of the System in a particular year. The fixed \$300 million Refcorp payment has created pressure on the FHLBS to increase its income-producing activities. As an official of the Federal Home Loan Bank of San Francisco, the largest of the Banks points out, "Our business is not to be in arbitrage . . . But that [Refcorp] obligation has made it our business."¹⁸

The FHLBS has increased its purchases of mortgage-backed securities, federal funds and commercial paper, for example, as a way to earn investment income. The Federal Home Loan Banks engage in what the Congressional Budget Office calls "risk-controlled arbitrage." The FHLBS taps the inexpensive federal agency credit market and uses the proceeds to purchase higher yielding assets. The FHLBS attempts to limit its risk from this activity and the Federal Housing Finance Board (FHFB), the regulator of the FHLBS monitors this risk when examining the Banks.

The Congressional Budget Office acknowledges these efforts to limit risk and notes:

"Managing an arbitrage portfolio of MBS investments, however, can be tricky. It requires skilled portfolio managers and sophisticated financial models. Even a well-hedged MBS portfolio can experience losses in some interest rate environments. Thus, these new investments have introduced new management and operations risks into the system."¹⁹

The FHLBS reduces borrowing costs through a variety of techniques. For example, Federal Home Loan Banks

have issued over \$44 billion of a form of derivative security known as a structured note. These derivative securities have high credit quality but are susceptible to interest rate risk and market risk that can be difficult to predict. The bankruptcy of Orange County in California was precipitated by unwise and leveraged investments in structured notes issued largely by the FHLBS and Fannie Mae. The financial officer of the FHLBS explained the issuance of structured notes by observing that "We have a hungry system to feed."²⁰

The fixed Refcorp payments weaken the ability of the FHLBS to deal with the prospect of a few years of insufficient earnings. The Refcorp payment has given the FHLBS an incentive to increase its membership base; in a growing system, the burden of the \$300 million annual payment can be shared among more members. However, the converse is also true: if the annual income of the FHLBS were to decline perceptibly, the new voluntary members could redeem their FHLBS cooperative stock and give up their memberships.

This creates the possibility of a negative spiral, with low earnings precipitating a loss of membership that itself precipitates further loss of members. The result would be an increased burden upon the fraction of FHLBS stock that is held by mandatory members, i.e., federally-chartered thrift institutions. Any losses to the value of FHLBS stock in turn could have significant negative effects upon the balance sheets of thrift institutions.

Under the law, federal bank and thrift regulators do not classify FHLBS stock as an equity investment; this permits banks and thrifts to maintain only a minuscule amount of capital to back their FHLBS stock investments.²¹ A loss in value of FHLBS stock would be felt in the form of impaired capital at a number of the banks and especially thrift institutions that hold that stock.

The FHLBS continues to provide much the same kind of overcollateralized advance to primary lenders that it has provided since its creation over sixty years ago. It is not at all clear that this financial product can be combined with risk-controlled arbitrage in the FHLBS investment portfolio to assure steady earnings until the Refcorp obligation is retired in the year 2030. One possibility,

¹⁶U.S. General Accounting Office, *Federal Home Loan Bank System: Reforms Needed to Promote its Safety, Soundness and Effectiveness*, GAO/ GGD-94-38, pp. 57-59, December 1993.

¹⁷Congressional Budget Office, *The Federal Home Loan Banks in the Housing Finance System*, p. 26, July 1993.

¹⁸Amy Barrett, "Riskier and Riskier at the Home Loan Banks: The federal system's new investment strategy raises eyebrows," *Business Week*, January 30, 1995, p. 78.

¹⁹*The Federal Home Loan Banks in the Housing Finance System*, p. 27, July 1993.

²⁰Randall Smith and John Connor, "Matter of Security: Risky Derivatives are Huge Source of Funds For Federal Agencies," *Wall Street Journal*, pp. A1 and A7, at p. A7, January 20, 1995.

²¹Banks and thrift institutions must keep at least eight percent capital available to back commercial loans that they hold on their books. The Federal Deposit Insurance Corporation (FDIC) and Office of Thrift Supervision include FHLBS stock in the 20 percent risk-weight category. This means that the bank or thrift needs to maintain only twenty percent of that eight percent capital requirement, or 1.6 percent total capital. By contrast to the FDIC, the Office of Comptroller of the Currency requires its supervised banks to maintain eight percent capital to back FHLBS stock that they hold.

noted above, would be that Fannie Mae or Freddie Mac will eventually overcome the opposition of HUD and then will introduce one or more superior financial products with the potential to erode the market for highly overcollateralized FHLBS advances.²²

These risks need to be addressed. The Congressional Budget Office, U.S. General Accounting Office, and U.S. Department of Housing and Urban Development²³ all have made recommendations as to substantial improvements in the law governing the FHLBS.

As with Fannie Mae and Freddie Mac, the political strength of the FHLBS would seem to preclude any unilateral action by the federal government to require privatization. Instead, positive inducements may again be appropriate: in return for transformation of the Refcorp obligation from a fixed \$300 million assessment into a form of federal income tax (i.e., a variable assessment), and other necessary changes to the FHLBS charter, the FHLBS legislation could include a sunset provision that prescribed a transition process and privatization of the system in a specified number of years.

C. The Farm Credit System

The Farm Credit System continues to recover from its failure in the mid-1980s²⁴. The FCS has repaid all of the funds used for the financial rescue and continues to increase its capital.²⁵ The proportion of FCS capital that is "borrower stock" continues to decline as a fraction of

available funds. The FCS now includes a cushion of funds that are available through the new Farm Credit System Insurance Corporation.

The Farm Credit System too has begun to be affected by the activities of the other GSEs. Fannie Mae has inaugurated a new rural housing initiative, and some FCS institutions have become approved Fannie Mae Seller/Servicers for purposes of originating rural home mortgages.

The activities of the FHLBS are of greater potential significance to the Farm Credit System, at least currently. As the FHLBS expands its membership, it is beginning to provide advances to rural commercial banks. These banks are the natural competitors of the Farm Credit Banks.

Traditionally, FCS market share has grown when the commercial banks have faced constraints upon their liquidity (i.e., available loan funds). Also, commercial banks have been limited in their access to longer term money that would permit management of interest rates between their assets and liabilities if they make longer term fixed rate agricultural mortgage loans. Now, however, FHLBS advances to rural commercial banks have the potential of providing longer term funds in ample quantity and preventing such reductions in liquidity. This could begin to affect the long-term market prospects of the FCS, especially if the FHLBS obtains legislation to relax current restrictions upon the availability of advances for commercial banks.

One countervailing factor concerns the mergers and acquisitions of rural commercial banks that are currently taking place. The new larger commercial banks may find more attractive opportunities in serving larger customers or non-farm credit needs and may be less willing to serve smaller and mid-sized farmers. These farm borrowers then might be expected to turn in greater proportions to the FCS. In contrast to a commercial bank, the FCS must continue to serve agricultural credit needs even during periods when other opportunities might promise greater returns.

Another trend relates to the consolidation that is taking place among the farm borrowers themselves. A recent analysis documents the decline in the number of mid-sized farms and points out that these have been the traditional borrowers from the Farm Credit System. The larger agricultural producer cooperatives have access to the international markets and use specialized FCS institutions, the Banks for Cooperatives, as one part of a large array of sources of funds at competitive rates; the smaller farmers tend to have off-farm income and relationships with commercial banks that often displace reliance upon the FCS banks and associations for credit. Two experts, David Freshwater and Charles Riemenschneider, con-

²²Another possibility that could affect the FHLBS customer base would be an amendment to the charter of the FCS to permit Farm Credit System institutions to offer advances to commercial banks that serve rural areas. This was advocated by the American Bankers Association. See, "New Tools for Commercial Banks in Rural America," Report of the American Bankers Association Rural Economic Development Task Force, November 1994.

²³U.S. Department of Housing and Urban Development, Office of Policy Development and Research, *Report to Congress on the Federal Home Loan Bank System*, April 1994 (two volumes).

²⁴The Governor of the Farm Credit Administration announced in 1985 that the FCS could not repay its obligations without an infusion of federal funds. FCS institutions had made systematic mistakes, including poor underwriting, mispriced loans and a serious interest rate mismatch between assets and liabilities; the agricultural downturn in the early 1980s suddenly exposed these mistakes. The FCS was protected neither by a necessary cushion of equity capital nor by an independent and capable financial regulator. Losses of \$4.6 billion in two years reported by the FCS in the mid 1980s set a record for U.S. financial institutions.

See, Kenneth L. Peoples, et al., *Anatomy of an American Agricultural Credit Crisis: Farm Debt in the 1980s*, Farm Credit System Assistance Board, (Lanham, MD: Rowman and Littlefield Publishers, Inc., 1992); and 1990 *Report of the Secretary of the Treasury on Government-Sponsored Enterprises*, Appendix D, pp. D-1 to D-62.

²⁵U.S. Department of Agriculture, Economic Research Service, "Farm Credit System Profits Fall, But Capital Building Continues," *Agricultural Income and Finance: Situation and Outlook Report*, Annual Lender Issue, AIS-56, February 1995, pp. 18-19; see also pp. 20-23.

clude that the Farm Credit System eventually may need to give up its status as a government-sponsored enterprise in return for the greater flexibility of doing business as a lender under state laws.²⁶

For a number of reasons, public policy considerations do not point as strongly to the need to privatize the Farm Credit System, compared to the larger GSEs discussed earlier. First, the Farm Credit System appears to serve useful public purposes, especially with respect to the credit needs of mid-sized farms during all phases of the agricultural credit cycle. Second, the FCS now is supervised by an arms-length regulator with respectable powers, budget and staff resources to help protect against the risk of substantial losses from forms of financial difficulty that the system might face. Third, there is some reassurance in the fact that, even when under financial pressure in the early 1980s, the Farm Credit System resisted the temptation to bet the bank that can prove so expensive when it compounds financial losses.

Taken together, these considerations lead to the following policy judgments: First, the federal government must remain in a position to deal with the contingent liability that arises from the activities of FCS institutions, especially in times of financial adversity. Second, the powerful interests of rural commercial banks seem likely to contain any congressional inclinations injudiciously to expand the legal charter of the Farm Credit System. One approach that builds upon the current enthusiasm for shrinking the size of the federal government might be to transform some current guarantee and direct loan programs of the U.S. Department of Agriculture into grant programs such as for buydowns of interest rates that subsidize the provision of financial services through private lenders including the FCS.

Under these circumstances, if the FCS begins to lose long-term market share, then the government may be in a position to manage the decline in a way that limits financial risks. FCS institutions will need to continue to reduce their high cost structures; those that prevail in the competition with commercial banks (probably including the merged banks for cooperatives) are likely to have found a market niche that potentially can be supervised to assure that there is little risk to the taxpayer.

²⁶Freshwater, David, and Charles H. Riemenschneider, "Is a Revised Mandate for the Farm Credit System Needed?" Staff Paper, Department of Agricultural Economics, University of Kentucky, February 1994. The authors note the increased efficiency of the bank and nonbank competitors of the Farm Credit System:

"In general these trends serve to lower the costs of raising funds for the competitors of the FCS, further depreciating the value of GSE status" (at p. 6).

D. Farmer Mac

Farmer Mac was designed to be an institution that issued guarantees of securities backed by pools of agricultural mortgages. However, with the exception of a small loan pool that Farmer Mac securitized in 1994, the company's loan securitization has been dormant since 1992. Farmer Mac's other line of business is to provide a secondary market for loans guaranteed by the U.S. Department of Agriculture. This business has grown, but not by enough to offset the lack of volume in the company's securitization business. The company is eating into its capital and is unlikely to survive under its current charter.

Farmer Mac's effort to find a partner for its rural housing program was thwarted in 1994 when Fannie Mae announced a new rural housing initiative. As a result of the Fannie Mae initiative, the Farm Credit Bank of Columbia dropped its plans to begin a Farmer Mac program for pooling rural housing mortgages.²⁷

Farmer Mac is seeking legislation to alleviate some of the features of its charter that are considered to make securitization unprofitable. Features of special concern to Farmer Mac have been the requirements (1) that Farmer Mac use an outside entity to pool loans for securitization, (2) that Farmer Mac securities be based upon creation of a 10 percent subordinated interest in each pool and that the private party that holds the subordinated interest be subject to first losses, and (3) that statutory capital requirements be phased in completely by 1996.

Such changes would permit Farmer Mac to offer borrowers an opportunity to arbitrage across federal capital requirements. The Farmer Mac capital standards would be much lower than those required both for the FCS and for commercial banks, its competitors. Lower capital requirements may permit Farmer Mac to offer more attractive prices for its loans than these competitors.

It is not clear whether even such capital forbearance and other statutory changes would be sufficient to turn Farmer Mac into a profitable government-sponsored enterprise. The securitization of loans must be a high-volume business to pay for the high transactions costs and to keep down the spreads on the securities. Given the strong presence of agricultural portfolio lenders with excess loanable funds, it is not apparent that Farmer Mac today serves a profitable market niche.

Unless Farmer Mac is willing to accept serious capital standards (comparable at least to those that currently apply to its competitors), the government would be well advised to work with Farmer Mac to develop a prompt privatization strategy or simply to wind up the affairs of

²⁷"Is Farmer Mac at a Crossroads?" *Agricultural Income and Finance*, February 1995, pp. 30-31.

the company and pay out the remaining net worth to shareholders. Farmer Mac is a specialized lender that serves an agricultural sector whose financial cycles can be quite volatile.²⁸ The federal government saw in the thrift debacle that it can be risky to relax capital requirements for financially weak specialized lending institutions, and especially for those that are investor-owned with consequent incentives to compound their risk-taking if weakness begins to look like failure.

E. Sallie Mae

Sallie Mae is a government-sponsored enterprise that wants to give up its GSE status and become a corporation chartered under the general purpose laws of a state.²⁹ Sallie Mae has told its shareholders that:

"Most of our diversification opportunities . . . go beyond the parameters of our current charter as a government-sponsored enterprise (GSE). . . . It is our belief that rechartering represents the best means of enhancing the future performance of the corporation. We also believe that our core competencies can be applied to new value-creating endeavors beyond those permitted in our GSE charter."³⁰

Sallie Mae's current activities as a government-sponsored enterprise could conceivably be replaced by increased securitization of student loans, expansion of existing large portfolio lenders and secondary market institutions, the new federal direct student loan program and by the possibility of continuing activity from Sallie Mae after its transition to a general purpose non-GSE company.

Yet, Sallie Mae appears to face some obstacles in achieving privatization. The company's circumstances highlight the problems of changing the status of a large financial institution in an orderly manner without obtaining a consensus beforehand.

Some of the issues relating to privatization may arise from the larger political controversy over the future form of the federal student loan program. Opponents of a large federal direct student loan program may want to keep Sallie Mae as a GSE that provides a secondary market for billions of dollars of guaranteed student loans.³¹ Possibly more serious politically, there have been reports that commercial banks oppose Sallie Mae's plan to privatize

because of fear of increased Sallie Mae competition in the primary market.³²

The Clinton Administration has indicated its tentative support for privatization of Sallie Mae and reportedly has considered the question of an "exit fee," i.e., a payment by Sallie Mae to the government as a part of the privatization transaction. The position of Congress is not yet known.

F. The Financing Corporation and the Resolution Funding Corporation

The Financing Corporation (FICO) and the Resolution Funding Corporation (Refcorp) are government corporations that were designed to have the attributes of government-sponsored enterprises. They are owned in essence and controlled in fact by the federal government rather than by private parties.³³ Their formal status as GSEs permitted much of the financing of the closure of insolvent thrift institutions to be done by the federal government without recording the outlays in the federal budget.

One consequence of this subterfuge, in terms of the long-term impact of the \$300 million annual Refcorp payment on the stability of the Federal Home Loan Bank System, has been described above. A second consequence relates to the problems that arise when private parties fear that the government will act unilaterally to upset what they consider to be the agreed rules of the game. Because the government twice legislated to take retained earnings from the FHLBS, the Federal Home Loan Banks now resist retaining further earnings as a cushion of capital in the system.³⁴

The third consequence relates to the impact of the Financing Corporation on the future of the thrift industry. The FICO legislation requires assessments to be levied annually upon thrift institutions to pay for deposit insurance through the Savings Association Insurance Fund of the FDIC and for the FDIC to set the premiums while taking account of the level needed to pay for the FICO obligations.

If FDIC sets the thrift insurance premiums at a level sufficient to pay for FICO obligations, then a thrift

²⁸U.S. Department of the Treasury, *1990 Report of the Secretary of the Treasury on Government-Sponsored Enterprises*, May 1990, pp. E-1 to E-21.

²⁹Sallie Mae, *1993 Annual Report*, p. 8 (1994). See also, Sallie Mae, *Restructuring Sallie Mae*, September 1994.

³⁰Sallie Mae, *1994 Annual Report*, p.10 (1995).

³¹Jim Zook, "Sallie Mae Eyes Expansion Beyond Its Charter: Political concerns over student loans may frustrate the corporation's plans," *The Chronicle of Higher Education*, March 3, 1995, pp. A26-A27.

³²"[T]he banking industry is vowing privately to fight any such move to fully privatize Sallie. Bankers claim an unleashed Sallie Mae would threaten their margins on student loans." Jim McTague, "The Perils of Sallie Mae: Student loan agency squares off against Bill Clinton's pet project," *Barron's*, April 4, 1994.

³³Thomas H. Stanton, "Government Sponsored Enterprises: Another View," *Public Budgeting and Finance*, Volume 9, Autumn 1989, pp. 81-86.

³⁴*Federal Home Loan Bank System: Reforms Needed to Promote its Safety, Soundness, and Effectiveness*, p. 66. It should be noted that there is some legal precedent that would seem to support the government's actions in taking the retained earnings from the FHLBS. See *Fahy v. O'Melveny & Myers*, 200 F2d 446 (9th Cir., 1952).

institution charter will become much more expensive than a comparable commercial bank charter. This will occur in the context of a steady shrinkage in the deposit base at thrift institutions. The result could be what the Congressional Budget Office calls a "death spiral,"³⁵ with declining thrift deposits requiring higher FICO assessments upon the remaining thrift deposits and with this in turn increasing the pressure for shrinkage of the insured deposit base.³⁶

Another complication is posed by the advances that thrifts and commercial banks receive from the FHLBS. Thrift institutions and banks may be able to increase their use of FHLBS advances (for which they pay no federal insurance premium despite the implicit government backing of the FHLBS) and thereby reduce their use of insured deposits that are subject to the insurance premium.³⁷

The conclusion is inescapable: the federal government uses two major forms of backing for obligations of financial institutions, deposit insurance and GSE status, and these two forms of backing are beginning to run into one another. The federally backed portions of the financial markets are beginning to interact in ways that the government does not completely anticipate beforehand.

Worse, legislative opportunities present themselves as narrow issues that individual congressional committees deal with in isolated fashion, without considering the unintended consequences that later materialize. No one in government appears to have the larger financial picture entirely in view.

II. ISSUES TO BE ADDRESSED IN PRIVATIZING GOVERNMENT SPONSORED ENTERPRISES

A. Practical Aspects of Privatization

Because government-sponsored enterprises are privately owned, the term "privatization" needs to be explained. For GSEs, privatization can be defined as the removal of federal sponsorship from the activities of a financial institution so that it can participate in the markets as a completely private firm without the benefits

and limitations that attach uniquely to today's GSE charter.³⁸

The privatization of a GSE is complicated by the fact that ownership of the enterprise is already in private hands. The process of privatization of a state-owned enterprise requires sale of assets or of a going concern to one or more private entities that pay the government for the value of the acquisition. By contrast, the privatization of a GSE involves a form of corporate reorganization that is combined with systematic retirement of the outstanding obligations and mortgage-backed securities that trade with the government's implicit backing.

As with the process of creation of a GSE, termination of a GSE is feasible and practical, but only if the numerous technical details are properly addressed.³⁹ The federal government has studied issues relating to the process of privatizing the largest GSEs, Fannie Mae and Freddie Mac.⁴⁰ Sallie Mae has prepared a variety of documents in connection with its desire to privatize.⁴¹

One interesting practical issue involves the divergence of interests between GSE managers and their private shareholders. As a matter of law, the directors and officers of an investor-owned corporation have a responsibility to maximize value to the shareholders.⁴² However, managers of U.S. corporations have tended to confuse their personal interests in perpetuating the status quo with the interests of shareholders in maximizing value, possibly by dissolving the particular firm.⁴³ This inertia is compounded by operation of the income tax laws that tend to reward retention of earnings rather than corporate distributions to shareholders.⁴⁴

³⁸Thus, Congress has used the term "privatization" in 1992 legislation to describe the studies that the government is currently conducting with respect to the desirability and feasibility of removing GSE status from Fannie Mae and Freddie Mac. Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Pub.L. 102-550, Section 1355, "Studies of Effects of Privatization of FNMA and FHLMC."

³⁹Some of these technical issues are described in Thomas H. Stanton, "Restructuring Fannie Mae and Freddie Mac: Framework and Policy Options," report prepared for the Congressional Budget Office, October 18, 1994.

⁴⁰Four agencies, the U.S. Treasury Department, the U.S. Department of Housing and Urban Development, the Congressional Budget Office and the U.S. General Accounting Office are preparing reports to Congress pursuant to the 1992 law that requires studies of the feasibility and desirability of privatizing Fannie Mae and Freddie Mac.

⁴¹See, e.g., *Restructuring Sallie Mae*, September 1994.

⁴²This is well-settled law. See, e.g., *Dodge et al. v. Ford Motor Co. et al.*, 170 N.W. 668 (Mich., 1919).

⁴³Michael C. Jensen, "The Modern Industrial Revolution, Exit and the Failure of Internal Control Systems," *The Journal of Finance*, Vol. 48, No. 3, pp. 831-880 (July 1993).

⁴⁴Milton Friedman, *Capitalism and Freedom*, University of Chicago Press, 1962, page 130.

³⁵Congressional Budget Office, "Adequacy of the Savings Association Insurance Fund Premiums," memorandum to House Banking Committee staff, October 14, 1994, p. 3.

³⁶U.S. General Accounting Office, *Deposit Insurance Funds: Analysis of Insurance Premium Disparity Between Banks and Thrifts*, GAO/AIMD-95-84, March 1995.

³⁷The Federal Deposit Insurance Corporation has begun to look at the more general question whether the calculation of the assessment base should be expanded to include a number of items such as secured borrowings, but has not focused directly upon FHLBS advances. See, Federal Deposit Insurance Corporation, "Advanced Notice of Proposed Rulemaking: Assessments," *Federal Register*, Vol. 59, No. 192, October 5, 1994, pp. 50710-50717.

In one celebrated case, that is relevant to privatization because of the way that the government created a more competitive structure, managers failed to assess the true benefits of operating in a competitive market. This was the breakup of the Standard Oil Company in 1911, pursuant to court order in an antitrust case. Shares of stock of the successor companies were distributed to shareholders of the Standard Oil Company.

The new companies were much more adroit than the old monopoly and were able to exploit new technologies (notably the thermal cracking process) that had been stifled by the rigid bureaucracy of the parent company. Within a year of the restructuring the value of the stock of the successor companies had doubled. Yet, the Standard Oil Company had fought the government for years to prevent the breakup.⁴⁵

Fear of a more competitive environment is likely to beset managers of some of today's GSEs. Perhaps the most acute case is that of the Federal Home Loan Banks. The managers of the Federal Home Loan Banks take virtually no credit risk in their transactions. This could make it difficult for them to contemplate survival in a market that might require them to underwrite loans before they extend credit.⁴⁶

New competition becomes a factor because of the tradeoff that privatization brings to a GSE: The institution gains freedom to engage in a broad range of activities, unconfined by the constraints of the current GSE charter, in return for giving up the special benefits (the implicit federal guarantee, tax breaks, etc.) that the government provides through the charter. The GSEs would lose some of their ability to compete in current lines of business in return for the opportunity to engage in new activities without the peculiar risks and limitations that are associated with a federal charter.

One problem with competition involves the transition period and the possible inability of today's GSEs to take prompt advantage of any new freedom to engage in new activities. GSEs are specialized lenders that lack experience making tradeoffs among multiple kinds of financial services for diverse customers in various lines of business. Commercial banks and other lenders tend to have such experience. The larger private financial services companies use sophisticated systems and internal rate of return calculations based upon marginal costs and revenues to decide how to allocate resources among alternative lines of business that are consistent with the overall corporate strategy; GSEs, confined currently to more narrow market niches, may have little experience making such deci-

sions in a competitive and volatile market-based environment.

The result may be that some GSE managers fear the consequences of privatization for themselves and their institutions. Such fears would be especially pronounced among those senior GSE executives whose skills relate more to political dominance than to the market-related abilities that will be more valued by the companies after privatization.

B. Approaches to Privatization

Some general approaches suggest themselves as ways to deal with these issues. First, the sunset date for privatizing and terminating the old GSE charter would be set far enough in advance that the parties would have time to prepare themselves. When a prospective sunset date is set a number of years in advance, the GSEs and their managers, customers and competitors can use the time to adjust to the changes caused by privatization. The transition period also provides an opportunity for the GSEs to set aside some resources to capitalize non-GSE affiliates. Managers can use these affiliates to build experience competing as non-GSEs in preparation for the time when the entire company gives up its GSE status.

Second, there must be some sort of transfer payment, from the government to GSE shareholders or vice versa, to reflect the relative value of the GSE charter and the new privatized one. The issue of transfer payments is important because it rewards GSEs for planning in advance at a time when their charters still have value. Thus, for GSEs that today use their federal backing to reap supernormal profits, the government might try to create positive incentives to the shareholders for any loss of shareholder value that might be occasioned by transformation to a privatized company without the advantages and limitations of GSE status.⁴⁷

Using these principles, the government might offer a package to Fannie Mae and Freddie Mac that would include:

- (1) a positive inducement for Fannie Mae and Freddie Mac, such as the apparent congressional inclination to make changes to the current FHA single-

⁴⁵Daniel Yergin, *The Prize: The Epic Quest for Oil, Money and Power*, (New York, NY: Simon & Schuster, 1991), pp. 106-113.

⁴⁶*The Federal Home Loan Banks in the Housing Finance System*, pp. 55-57, July 1993.

⁴⁷Given the budget constraints upon the U.S. government today, it is difficult to envision a direct cash outlay from the government to pay GSE shareholders to give up a GSE charter that is profitable at the moment. That is why this paper adopts the approach of using the current movement to privatize government programs as an opportunity for transferring positive value to such GSEs. The shareholders could receive immediate benefits, in the form of new business activities, in return for a sunset on GSE activities in the future. The relative dates could be set so that the immediate value of the new business opportunity reasonably matches the present value of the future cost of the sunset.

family mortgage insurance program to channel much of that business through Fannie Mae and Freddie Mac. This would represent an expansion of Fannie Mae's and Freddie Mac's current business by perhaps 20 percent;

- (2) addition of a sunset provision to the Fannie Mae and Freddie Mac charters that would provide for privatization in 10 years; and
- (3) opportunity for the two GSEs to present a privatization plan that includes a transition period of several years so that the companies could explore and develop experience in new lines of business likely to be profitable once they gave up their GSE charters.

By contrast, for a GSE such as Farmer Mac whose charter seems to have little value compared to alternatives, the process of privatization will resemble a corporate reorganization or dissolution. Other GSEs such as Sallie Mae might be persuaded to pay some form of exit fee in return for the right to give up the constraints that are imposed by the GSE charter.⁴⁸ This would be an especially attractive possibility in today's context of efforts to reduce the size of the federal budget and deficit. To win agreement of competitors, the transition might be phased, for example, to preclude Sallie Mae from originating student loans for a specified number of years.

It should be possible to resolve technical issues relating to such a concept; it will be equally important to resolve the political issues so that there is general commitment to privatization on the part of all parties once the transition period begins. Otherwise the transition period would create two kinds of risk: If the non-GSE affiliates run into difficulty, GSE managers will attempt to run back to the protection of government backing. By contrast, if the affiliates appear too successful, then their competitors may try to force the GSE back into the constraints of its original charter. Once agreement to privatize is reached, then there must be commitment by the government to see it through.

III. CONCLUSION

The federal government has created a contingent liability of some \$1.5 trillion to back the activities of GSEs. The government lacks the capacity to monitor the activities of the GSEs and their interactions with one another and with the banks and thrifts and other institutions that are backed by federal deposit insurance.

⁴⁸For example, Congress has legislated a loose form of exit fee to be assessed with respect to institutions of the Farm Credit System before they are permitted to their status as System institutions. 12 U.S.C. Sec. 2279d, "Termination of System institution status," added by the Agricultural Credit Act of 1987, Public Law No. 100-233.

The activities of the various GSEs with one another and with the federal deposit insurance system are beginning to collide in complicated ways. This makes it important for the government to take steps such as the following:

- *Create a central office with the responsibility and capacity to monitor federal contingent liabilities.*

As a modest step, the government would be well-advised to create a small staff with the capacity and responsibility for analyzing the activities of all institutions backed by federal contingent liabilities, including analyses of the interactions among these institutions and future trends.

To protect against the type of "capture" that the Treasury warned about in its 1991 report on GSEs, the office should be located in the Treasury or Federal Reserve Board. Preferably the office should submit its reports directly to a strong congressional committee such as House Ways and Means that is capable of protecting the free flow of high quality information. It should have the mandate and authority to obtain information and publish reports. However, to avoid the prospect of confrontation over regulatory matters, the office should not have regulatory responsibilities.

- *Begin to disentangle some of the interrelationships of GSEs and federally insured financial institutions.*

It is time to begin disentangling some of the interlocks among federal contingent liabilities. One interlock with significant safety and soundness implications is the ability of federally insured banks and thrifts to own stock of GSEs without reserving appropriate capital. This contrasts to the outright prohibition that usually applies to bank holdings of private equity securities.

Again, the Federal Home Loan Bank System presents this issue in its most pressing form. The Congressional Budget Office points out that any loss of value of FHLBS stock could have serious effects upon the capital of the institutions, and especially the thrift institutions, that hold it. This is because of the anomaly in the federal risk-based capital requirements, discussed above, that permits thrift institutions and many banks to hold only a minuscule amount of capital (1.6 percent) to back the value of their investment in FHLBS stock.⁴⁹

The capital rules are only slightly better with respect to the amount of capital (eight percent) required to back bank and thrift investments in equity securities of the other GSEs. These rules too should be changed so that GSE stock is treated on a parity with its actual risk

⁴⁹*The Federal Home Loan Banks in the Housing Finance System*, pp. 39-44, July 1993.

qualities. Again the reason is safety and soundness: Unlike GSE obligations, stock of a GSE does not benefit from legal attributes that imply federal backing. Such stock is potentially as risky as any other stock issued by a private company of comparable financial strength.

It is important to change these rules. Otherwise the structural infirmities of the FHLBS, were they ever to precipitate losses or weaknesses in stock value of any other GSE, could spill over into the thrift and banking industry. The rules should be changed prospectively, with a transition period of perhaps several years, to permit the markets and institutions to adjust to the new rules.

It would also be useful to repeal the special laws that permit banks, thrifts and Federal Home Loan Banks to invest in the stock of GSEs without regard to the investment limits that otherwise apply to their holdings of equity securities of private companies. Again, such change should apply prospectively after a transition period. The purpose of this change is to reduce the concentration of risk that can arise if a federally-backed institution invests too heavily in equity securities of any particular privately-owned company.

- *Begin negotiations with all GSEs (except possibly the Farm Credit System) with respect to privatization.*

It is time now to begin negotiations with the GSEs about their future relationship with the federal government. The case deserving the most prompt attention is that of the Federal Home Loan Bank System. The current structure is not stable, and it is important that the structural infirmities not merely be patched up to postpone unforeseen difficulties to another day. Virtually any negotiations with the FHLBS should include addition of a sunset provision that would prescribe a transition to non-GSE status in a specified number of years.

The other immediate case is that of Farmer Mac. It is time to ease the company's transition out of GSE status rather than trying to tinker with a charter to create a new statutory niche in an agricultural market that is well served by other federally backed lenders.

Negotiations with Sallie Mae are already underway. It is to be hoped that these discussions can be concluded with a form of privatization that represents a "win-win" outcome for all parties.

The government is currently studying the desirability and feasibility of privatizing Fannie Mae and Freddie Mac. The two GSEs do not appear to welcome the prospects of any privatization legislation. Even if the government attempts to sweeten the deal along the lines suggested above, it is not clear that the GSEs would accept privatization at this point in their life cycles. The GSEs wield awesome power, to paraphrase the Treasury, to influence political outcomes. The government must

remember this lesson before it contemplates creation of any new GSEs.

The government assignment of FHLBS and thrift industry resources to help pay for FICO and Refcorp once seemed to be an expedient way to get money for the savings and loan bailout. It turns out that here too, the GSE model does not provide a free lunch. The distortions caused by the ongoing FICO and Refcorp obligations need to be addressed. Perhaps some form of variable user fee on GSEs, plus transformation of the FHLBS obligation into a responsibility to pay federal income taxes, can deal with these long-term contingent liabilities.

Finally, the Farm Credit System, having gone through the wringer once, seems in fairly good shape to try to withstand the next downward phase of the agricultural credit cycle. Experts have already forecast that FCS institutions may run up against their charter limits and need to give up GSE status. Some forward planning now might facilitate that transition. Again, the message needs to be stressed that the options can be made more attractive if institutions try to privatize before rather than after their current charter has lost value.

- *Undertake careful financial and market analysis before creating any new GSEs; place a sunset provision in charters of any new GSEs; create an office in the Treasury Department to supervise all new GSEs.*

Fannie Mae was made a government-sponsored enterprise because of the need of the Johnson Administration for budget savings.⁵⁰ Today's budget pressures are likely to create opportunities for special interests to suggest creation of a variety of GSEs as a way to put federal functions off-budget. Indeed, as in the case of a proposed GSE to serve small business investment companies, they are likely to call such a GSE a "privatization" of a government function;⁵¹ this has the potential to confuse any perception of the continuing government involvement that a GSE represents.

The financial failure of the Farm Credit System in the mid-1980s, followed by the need for massive federal funding to pay for the savings and loan debacle, has convinced responsible policymakers of the need to assure that any new GSEs will be financially sound. This research indicates an additional concern: in creating a GSE, the government must avoid the extremes repre-

⁵⁰Richard W. Bartke, "Fannie Mae and the Secondary Mortgage Market," *Northwestern University Law Review*, Vol. 66, No. 1 (March-April 1971), pp. 1-78, at pp. 31-32.

⁵¹National Association of Small Business Investment Companies, Memorandum from Peter McNeish to Philip Lader, Administrator of the Small Business Administration, February 6, 1995. The new GSE would be known as the Venture Capital Marketing Association, or "Vickie Mae."

sented by the failure of Farmer Mac on the one hand and by the untrammelled financial dominance of Fannie Mae and Freddie Mac on the other. In today's volatile financial markets, it is difficult to legislate to create a statutory niche for a new GSE that escapes both of these extremes.

If the government does decide to create one or more new GSEs, it should create a single office in the Treasury Department that is equipped with the powers and mandate of a bank-type regulator to supervise safety and soundness, regardless of the types of financial services offered by the new GSEs or the particular kinds of borrowers they may serve. This office would be similar to the offices already within the Treasury that oversee national banks and thrift institutions. The Treasury Department is one of the few agencies of government with the skills to oversee safety and soundness properly and the political strength to make regulatory capture difficult.⁵²

Finally, if the government creates any new GSEs, it needs to prepare now for the prospect of privatization. Legislation to create a new GSE should provide for sunset in a prescribed number of years (probably 10 or 15) and for an orderly transition away from GSE status. Only this way can the government protect against creation of new federally-backed institutions whose public purposes are rendered irrelevant by the rapid developments that take place in today's efficient financial markets.

ACKNOWLEDGEMENT

The author would like to thank the Institute for Policy Innovation of Lewisville, Texas, for financial assistance in preparing a monograph based upon an earlier version of this research. The views expressed in this paper are solely those of the author.

REFERENCES

- American Bankers Association, "New Tools for Commercial Banks in Rural America," Report of the American Bankers Association Rural Economic Development Task Force; November 1994.
- Bacon, Kenneth H., "Privileged Position: Fannie Mae expected to escape an attempt at tighter regulations." *Wall Street Journal* (June 19, 1992), pp. A1, A4.
- Barrett, Amy, "Riskier and Riskier at the Home Loan Banks: The federal system's new investment strategy raises eyebrows," *Business Week*, January 30, 1995, p. 78.
- Bartke, Richard W., "Fannie Mae and the Secondary Mortgage Market," *Northwestern University Law Review*, Vol. 66, No. 1 (March-April 1971), pp. 1-78.

⁵²It would be dangerous to create a new regulator to supervise each new GSE that the government may decide to create. As the U.S. General Accounting Office has pointed out, it is hard for regulators to maintain their independence if they are responsible for regulating only a single GSE. U.S. General Accounting Office, *Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks*, GAO/GGD-91-90, May 1991, p. 45.

- Cargill, Thomas F., and Gillian G. Garcia, *Financial Reform of the 1980s*, (Stanford: Hoover Institution Press, 1985).
- Congressional Budget Office, "Adequacy of the Savings Association Insurance Fund Premiums," memorandum to House Banking Committee staff, October 14, 1994.
- Congressional Budget Office, *Controlling the Risks of Government-Sponsored Enterprises*, Washington, D.C.: April 1991.
- Congressional Budget Office, *The Federal Home Loan Banks in the Housing Finance System*, Washington, D.C.: July 1993.
- Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*, "Impose a Cost-of-Capital Offset Fee on Fannie Mae and Freddie Mac," pp. 318-319, Washington, D.C.: February 1995.
- Freshwater, David, and Charles H. Riemenschneider, "Is a Revised Mandate for the Farm Credit System Needed?" Staff Paper, Department of Agricultural Economics, University of Kentucky, February 1994.
- Friedman, Milton, *Capitalism and Freedom*, (Chicago, IL: University of Chicago, 1962).
- Harney, Kenneth R., "Automated Credit Scoring Screens Loan Applicants," *Washington Post*, January 15, 1994, p. E-1.
- Hunter, Oakley, "The Federal National Mortgage Association: Its Response to Critical Financing Requirements of Housing," *The George Washington Law Review*, Vol. 39, No. 4, May 1971, pp. 818-834.
- Jensen, Michael C., "The Modern Industrial Revolution, Exit and the Failure of Internal Control Systems," *The Journal of Finance*, Vol. 48, No. 3, pp.831-880 (July 1993).
- Labaton, Stephen, "Power of the Mortgage Twins: Fannie And Freddie Guard Autonomy," *New York Times* (November 12, 1991) pp. D1, D8.
- Maselli, Peter, "Mortgages in Minutes," *Mortgage Banking*, October 1994, pp. 102-113.
- Matlack, Carol, "Getting Their Way," *National Journal*, October 27, 1990, pp. 2584-2588.
- McTague, Jim, "The Perils of Sallie Mae: Student loan agency squares off against Bill Clinton's pet project," *Barron's*, April 4, 1994.
- National Association of Small Business Investment Companies, Memorandum from Peter McNeish to Philip Lader, Administrator of the Small Business Administration, February 6, 1995.
- Office of Management and Budget, "FY1996 Passback: Department of Housing and Urban Development," November 21, 1994.
- Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1996*, "Appendix," and "Analytical Perspectives," (Washington, D.C.: U.S. Government Printing Office, 1995).
- Perry, Vanessa, "Who are FHA Borrowers?" *Secondary Mortgage Markets*, Vol. 11, No. 3 (Reston, VA: Freddie Mac, January 1995), p. 13.
- Kenneth L. Peoples, David Freshwater, Gregory D. Hanson, Paul T. Prentice, and Eric P. Thor, *Anatomy of an American Agricultural Credit Crisis: Farm Debt in the 1980s*, Farm Credit System Assistance Board, (Lanham, MD: Rowman and Littlefield Publishers, Inc., 1992).
- Prakash, Snigdha, "Fannie Fighting Expansion of Oversight by HUD," *American Banker*, February 15, 1995, p. 8.
- President's Commission on Housing, *Report of the President's Commission on Housing*, (Washington, D.C.: 1982).
- Sallie Mae, *1994 Annual Report*, p.10 (Washington, D.C.: 1995).
- Sallie Mae, *1993 Annual Report*, (Washington, D.C.: 1994).
- Sallie Mae, *Restructuring Sallie Mae*, (Washington, D.C.: September 1994).
- Smith, Randall, and John Connor, "Matter of Security: Risky Derivatives are Huge Source of Funds For Federal Agencies," *Wall Street Journal*, pp. A1 and A7, January 20, 1995.
- Stanton, Thomas H., "Government Sponsored Enterprises: Another

- View," *Public Budgeting and Finance*, Vol. 9, Autumn 1989, pp. 81-86.
- Stanton, Thomas H., "Nonquantifiable Risks and Financial Institutions: The Mercantilist Legal Framework of Banks, Thrifts, and Government Sponsored Enterprises," in Charles Stone and Anne Zissu, eds., *Global Risk-Based Capital Regulations*, Vol. 1 Homewood, IL: Irwin Professional, 1994.
- Stanton, Thomas H., "Restructuring Fannie Mae and Freddie Mac: Framework and Policy Options," report prepared for the Congressional Budget Office, October 18, 1994.
- U.S. Department of Agriculture, Economic Research Service, *Agricultural Income and Finance: Situation and Outlook Report*, Annual Lender Issue, AIS-56 (Washington, D.C.: February 1995).
- U.S. Department of Housing and Urban Development, Office of Policy Development and Research, *Report to Congress on the Federal Home Loan Bank System*, two volumes (Washington, D.C.: April 1994).
- U.S. Department of the Treasury, *1990 Report of the Secretary of the Treasury on Government-Sponsored Enterprises*, (Washington, D.C.: May 1990).
- U.S. Department of the Treasury, *1991 Report of the Secretary of the Treasury on Government-Sponsored Enterprises*, (Washington, D.C.: April 1991).
- U.S. General Accounting Office, *Deposit Insurance Funds: Analysis of Insurance Premium Disparity Between Banks and Thrifts*, GAO/AIMD-95-84 (Washington, D.C.: March 1995).
- U.S. General Accounting Office, *Government Sponsored Enterprises: Framework for Limiting the Government's Exposure to Risks*, GAO/GGD-91-90 (Washington, D.C.: May 1991).
- U.S. General Accounting Office, *Federal Home Loan Bank System: Reforms Needed to Promote its Safety, Soundness and Effectiveness*, GAO/GGD-94-38 (Washington, D.C.: December 1993).
- Vise, David A., "The Money Machine: How Fannie Mae Wields Power; Fannie Mae Lobbies Hard to Protect its Tax Break," *Washington Post*, January 16, 1995, pp. A-1, A-14 and A-15.
- Yergin, Daniel, *The Prize: The Epic Quest for Oil, Money and Power*, (New York, NY: Simon & Schuster, 1991).

- Zook, Jim, "Sallie Mae Eyes Expansion Beyond Its Charter: Political concerns over student loans may frustrate the corporation's plans," *The Chronicle of Higher Education*, March 3, 1995, pp. A26-A27.
- Zuckman, Jill, "The \$50,000 Question," *Congressional Quarterly*, August 3, 1991, p. 2140.

LEGAL CITATIONS

- Agricultural Credit Act of 1987, Public Law No. 100-233, I "Termination of System institution status," codified at 12 U.S.C. Sec. 2279d.
- Dodge et al. v. Ford Motor Co. et al.*, 170 N.W. 668 (Mich., 1919).
- Fahy v. O'Melveny & Myers*, 200 F.2d 446 (9th Cir., 1952).
- Federal Deposit Insurance Corporation, "Advanced Notice of Proposed Rulemaking: Assessments," *Federal Register*, Vol. 59, No. 192, October 5, 1994, pp. 50710-50717.
- Federal Housing Enterprise Financial Safety and Soundness Act of 1992, P.L. 102-550, approved October 28, 1992.
- U.S. Department of Housing and Urban Development, "Proposed Rule: The Secretary of HUD's Regulation of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac)," *Federal Register*, Vol. 60, No. 32, February 16, 1995, pp. 9154-9247.

THOMAS H. STANTON is a Washington, D.C. attorney who specializes in the design and administration of federal credit programs and government corporations. He is a fellow of the Center for the Study of American Government at the Johns Hopkins University, where he teaches on the law of public institutions. Mr. Stanton helps to teach the annual seminar on government enterprises conducted by the National Academy of Public Administration. His writings on government involvement in the credit markets include a book on government-sponsored enterprises, *A State of Risk* (HarperCollins, 1991), and many articles. Mr. Stanton has his B.A. from the University of California (Davis), M.A. from Yale University and J.D. degree from the Harvard Law School.