
FINANCIAL SERVICES & E-COMMERCE

FANNIE AND FREDDIE WE'RE STUCK WITH: BUT CAN WE GET RID OF GSEs?

By Alex. J. Pollock

The model of Fannie Mae and Freddie Mac as “GSEs” (government-sponsored enterprises) was a profound mistake. Virtually everybody agrees with that. In retrospect, it was also an *obvious* mistake. Just imagine anybody wanting to hyper-leverage half the mortgage market on the taxpayers’ credit card, so the profits were private and the losses public, create an enormous credit risk concentration in Washington DC, and inevitably curry political favor by increasing risk.

It is already six years ago that Fannie and Freddie collapsed and went from being “the envy of the world,” according to their own PR and their Congressional backers, to being utterly humiliated and made into the wards of the state they still are. But during those six years the political chance to close them down has come and gone. The stars looked aligned, but as it turned out weren’t, and we are still stuck with Fannie and Freddie like a \$5 trillion tar baby.

Fannie and Freddie have recovered financially through lavish subsidies and regulatory advantages given by the government, including support of their mortgage-backed securities by unprecedented Federal Reserve buying; this ups their profits and market share and gives their political clients hope. Too bad, but there it is.

What can we do to avoid a threatened restoration of the GSE ancient regime? Can Fannie and Freddie be addressed before they arise from their near-death as dominating and pernicious as before?

Yes, they can be. The imperative is to eliminate to the maximum extent the special legal and regulatory favors for Fannie and Freddie, so that even though they are still operating, they would cease to function *as GSEs*.

The governing principle of how to do this is simple and straightforward: it is to *treat Fannie and Freddie exactly like every other big bank*. This will put them with no special advantages into competition with at least the seven or eight biggest banks, which is plenty for robust competition. (Some maintain that big banks are a kind of GSE--assuming that for the sake of argument, Fannie and Freddie would not be any more a GSE than every other big bank is.)

What does treating Fannie and Freddie exactly like every other big bank specifically mean? At least six steps:

- *First:* No more hyper-leverage, no more capital requirement lower than anybody else’s, no more capital arbitrage using Fannie and Freddie to make the whole financial sector riskier. Fannie and Freddie must have exactly the same leverage capital minimum requirement as every other big bank:

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equity of at least 5% of total assets. Since at the moment they have zero equity, they have a long way to go.

- *Second:* Fannie and Freddie must be formally designated as Systemically Important Financial Institutions (SIFIs), as they quite obviously are, by the Financial Stability Oversight Council (FSOC), just like every big bank. Fannie has assets of over \$3 trillion, bigger than JPMorgan and Bank of America. Freddie has assets of over \$1.9 trillion, bigger than Citigroup and Well Fargo. Fannie and Freddie are undeniably major generators of systemic risk and need to be treated as such.

- *Third:* Fannie and Freddie must explicitly pay for the indubitable guaranty they enjoy from the government, just like banks have to. Fannie and Freddie should pay the government an “offset fee” assessed on their total liabilities, exactly as banks have to pay the government a “deposit insurance premium” assessed on their total liabilities. I propose a reasonable rate for this offset fee would be 0.17% per year.

- *Fourth:* All consumer protection rules must be applied in full force to loans sold to Fannie and Freddie, instead of giving them exemptions.

- *Fifth:* Every banking regulation which grants special favors to Fannie and Freddie must be eliminated. Congress should instruct the banking regulators to do this, if the regulators don’t do it on their own. Banking regulations must treat Fannie and Freddie exactly as they do any other bank.

- *Sixth:* Fannie and Freddie must be subject to state and local income taxes, just like every other bank, instead of being exempt.

I do not claim these changes would create the ideal housing finance sector, but they are the best combination of correct concepts and political possibility now available.

