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Director

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Honorable Richard H. Baker
Chairman
Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

I appreciate the opportunity to respond to the criticism leveled at our report on GSEs. As I stated in a recent letter to Franklin Raines, while there are legitimate points of contention, I believe that the CBO report provides a credible and unbiased answer to the questions that you posed, and that much of the criticism is misleading.

In general, there can be little dispute that the relationship with the federal government enjoyed by the GSEs is valuable. This notion that because there are no direct federal expenditures and therefore there can be no subsidy is simply incorrect. The federal government engages in all sorts of programs and arrangements that subsidize favored activities without any direct expenditures. If the federal imprimatur were not valuable, why all the effort to maintain it?

It is widely recognized that one of the biggest risks to the GSEs' ongoing operations is political risk—the threat that the government might change the nature of the relationship. Indeed, whenever such a risk surfaces, the GSEs' stocks decline and the interest they must pay increases. Clearly, the market perceives a value to the status quo. Therefore, the question is the value, the worth, of the implied federal guarantees.

Despite the fact the GSEs claim our analytical framework is fundamentally “flawed,” it is only the GSEs and their paid consultants who make that assertion. This methodology has been widely reviewed in and out of government, including by participants in “the market,” which the GSEs claim CBO does not understand. It is only by comparing their financial activities with institutions and mortgages that do not enjoy their special status that we can begin to discern what it means to be a housing GSE.

Of course, these comparisons are not precise. It is necessary to make assumptions at various stages in the analysis—assumptions we make very explicit in our study. The GSEs have chosen to question only those assumptions they think diminish their case and not those that help it. More importantly, much of their criticism misses the mark.

Specifically, Fannie Mae’s critique of CBO claims in part that if we had used the “facts” they describe to “correct” our “mistakes,” the results would have been reversed. By selectively altering the analysis, Fannie Mae asserts CBO has overestimated the subsidy to Fannie Mae and Freddie Mac and underestimated the benefits the two stockholder-owned GSEs provide. An equally selective “correction” would result in much higher estimates of the subsidies realized (and retained by the GSEs) and lower benefits to home-buyers.

These selective “corrections” can be usefully ordered by the effect that each has on Fannie Mae’s re-estimate of the subsidy. From largest to smallest, they are:

- Applying the mortgage interest saving to the entire mortgage market (adds \$3.7 billion - \$6.6 billion per year to benefits.)
- Omitting from the total subsidy the 25 bps that accrues to borrowers from GSEs’ guaranteed MBS (lowers GSE subsidy by \$3 billion per year.)
- Using a smaller estimate of the GSE debt funding advantage, by using a lower long-term spread and a higher proportion of short-term debt (lowers GSE subsidy by \$2.4 billion - \$3 billion per year.)
- Subtracting federal taxes (reduces the subsidy by \$300 million per year).

Consider the argument for each of these changes.

Applying Lower Mortgage Rates to the "Entire" Conforming Market

CBO’s method of calculating credit subsidies, accepted by Fannie Mae—at least for purposes of their critique—measures subsidies for new extensions of credit only. That is, the benefits to borrowers are assigned to the year in which mortgages are financed. If Fannie Mae and Freddie Mac increase their holdings of mortgages or MBS outstanding by \$200 billion in a year, the GSEs are credited with passing through a subsidy of 25 bps on all \$200 billion. Fannie Mae argues that they should also be credited with passing through benefits for the increase in mortgages financed by others in the current year. Their argument is incorrect for at least three reasons.

First, no new mortgages in excess of the increase in those purchased or securitized by Fannie Mae and Freddie Mac exist. Fannie Mae and Freddie Mac currently add to their mortgage holdings or MBS outstanding, more fixed-rate, conforming, conventional mortgages (those for which a 25 bps reduction in rates has been estimated) each year than the total increase in such mortgages outstanding in that year. In 1999, for example, Fannie Mae and Freddie Mac increased their outstanding MBS and debt by \$264 billion. However, the total increase in 1- to 4-family, conforming, fixed-rate, conventional mortgages was less than \$245 billion. Thus, all (plus \$20 billion or so) of the increase in mortgages outstanding in 1999 and subject to the 25 basis point reduction is credited to Fannie Mae and Freddie Mac by CBO.

Second, Fannie Mae is able to claim that additional mortgages exist by double (and triple) counting additions to the stock of mortgages from earlier years and for which CBO has already given credit in those earlier years. It does so by comparing its total holdings and MBS to the total of all outstanding mortgages, no matter when they were originated. In the process, Fannie Mae combines estimates based on flows from the CBO report with stock numbers of their own creation. No justification exists for adding old mortgages to new ones to obtain the current year's subsidy pass-through.

Third, even if some benefits accrued to mortgages not intermediated by the GSEs, that would not diminish the fact that some of the subsidy is retained by them—the GSEs are neither financing nor passing through any subsidy to these borrowers. More importantly, there are concomitant costs not borne by the GSEs. For example, as Mr. Howard recently noted: "Do some segments of the credit markets receive less financing, or pay a higher rate for that financing, because of Fannie Mae and Freddie Mac's effectiveness in channeling capital to homeowners? Almost certainly yes, as most economists would attest." An increase of 3 to 4 basis points in the cost of U.S. Treasury debt, for example, would cost taxpayers alone an additional \$1 billion per year.

Ignoring Reduced Yields on MBS

Fannie Mae argues that only a portion of the lower yield on MBS guaranteed by the GSEs should be included in the total subsidy. Their claim is that because Fannie Mae receives only guarantee fees from the sales of MBS, the reduction in interest rates due to the federal backing of the guarantee should not be included in the total subsidy.

CBO includes the reduction in rates on MBS because even though Fannie Mae never "touches" the money that finances the MBS, the lower rate on that funding is a direct effect of the federal backing of the GSE guarantee. Accordingly, CBO

includes the full 30 bps reduction in MBS yield in the total subsidy, credits 25 bps to home buyers, and charges the GSEs with retaining only 5 bps.

To exclude the 25 basis points that accrues to conforming borrowers, as suggested by Fannie Mae, would understate the total subsidy and the portion passed through to conforming borrowers.

While Fannie Mae charges this approach lacks “intellectual rigor,” they nonetheless include the 25 basis points in home-buyer benefits. An honest interpretation of their own “logic” would require them to remove the 25 basis points from both the subsidy and pass-through calculations, leaving the retained subsidy estimate unaffected.

Reducing the Debt Funding Advantage

Fannie Mae claims that CBO overestimated the debt funding advantage by:

- comparing rates on GSE debt to those on securities issued by large financial institutions, most of which were rated A; and
- not applying the lower funding advantage to short-term debt that has been synthetically converted to long-term debt.

Interpreting S&P ratings. Fannie Mae argues that because Fannie and Freddie are rated AA- by S&P, the GSE funding advantage should be calculated by comparing the rates GSEs pay with rates paid by AA-rated fully private borrowers only. S&P’s ratings of GSEs, however, do not indicate the ratings that those firms would receive if they were fully private, nor are the ratings directly comparable with those assigned non-GSEs.

S&P ratings for GSEs are explicitly intended to reflect "risk to the government," the risk that a GSE, while retaining all the privileges of government sponsorship, will require an infusion of cash from the federal government to meet its obligations. Key privileges include the retention of the federal charter which creates a perception that GSE securities are effectively guaranteed by the federal government. This perception is manifest in the designation of their obligations as "agency" securities. S&P explains the significance of this feature of GSE status for the assigned risk to the government rating:

“Their ability to issue debt instruments with ‘agency status’ enables Fannie Mae and Freddie Mac to access the capital markets even in time of financial stress, resulting in a high level of financial flexibility not experienced by fully private corporations.”

Thus, the AA- rating for Fannie Mae and Freddie Mac and the AAA rating for the FHLBs means that in the opinion of S&P, the probability of a specified GSE requiring an infusion of federal funds, even with continued access to capital market financing and other benefits of federal backing, is equal to the probability of a default by a similarly rated fully private firm.

A GSE rating cannot be converted to a fully private, stand-alone rating because it explicitly does not take into account the increased risk and weakened competitive position that would accompany full privatization. This means that the S&P rating may provide an upper bound on the rating that GSE securities would command with privatized status. It gives no indication, however, of how much lower the rating would actually be. Thus, the S&P rating provides no justification for calculating the GSE funding advantage exclusively from AA-rated securities. The comparison firms chosen reflect the typical credit standing of non-GSE financial institutions and as such represent the natural comparison group.

Effective or nominal short-term debt? The GSE funding advantage is lower on short-term debt than on long-term debt. Both Fannie Mae and Freddie Mac issue substantial volumes of short-term debt, much of which is converted into long-term fixed-rate debt through interest rate swaps and other derivatives. In recent years, for example, 40-50 percent of GSE debt has had a stated maturity of less than a year, but most of this has been converted into long-term debt, so that only 10-20 percent remains short-term after synthetic extension.

Fannie Mae argues that the lower funding advantage should be applied to all short-term debt, even if its maturity is extended through derivative transactions. But the GSEs simultaneously issue long-term debt and short-term debt whose maturity is "synthetically extended" using derivatives. Since these two funding sources are equivalent in function, the marginal cost of both must be approximately equal. The funding advantage on synthetic long-term debt, therefore, must be about the same as on long-term debt. If it were not the case, why would the GSEs undertake actions that would be inefficient and less advantageous to them financially?

Netting Federal Taxes from the Retained Subsidy

As is well known to officials at Fannie Mae, both the Office of Management and Budget (OMB) and CBO consistently report subsidies on a pre-tax basis. This is to assure that the cost of subsidies is comparable across beneficiaries, without regard to the recipient's tax status. Thus, no justification exists for reducing the retained subsidy by Fannie and Freddie's federal taxes paid. Further, the comparison made in this study is with firms that also pay federal taxes.

Using the Credit Reform Methodology

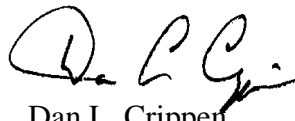
Fannie Mae also argues that using the methodology of "Credit Reform" would result in a much lower subsidy value than CBO's estimate. CBO explicitly did not use this methodology because it is not the intent of Credit Reform to account for the full subsidy provided to a government-backed credit program. For instance, Credit Reform explicitly ignores associated administrative costs, does not recognize opportunity cost, and does not adjust for the market price of risk. The CBO study provides an estimate of the economic cost of the subsidy, which is based primarily on the opportunity cost to the government of providing such a guarantee without compensation rather than on estimates of default losses.

The Effect of Increasing Competition on the Subsidy Pass-Through Rate

Finally, Mr. Chairman, as you requested, I would like to comment on the effect that increasing competition among the GSEs would have on the subsidy pass-through. CBO's analysis attributes the GSEs' ability to retain a portion of the subsidy to the fact that their GSE status limits competition from other financial institutions in the conforming mortgage market. If the number of companies granted a GSE charter was increased, the secondary market would become more competitive, resulting in a larger portion of the subsidy being passed through to borrowers.

Mr. Chairman, there is always uncertainty in our work . . . that's why much of what we produce are called "estimates." Our job is to honestly and objectively (and explicitly) make necessary assumptions in an unbiased manner—we necessarily, but knowingly, err on both sides. It is certainly possible, as the GSEs have done, to make all assumptions on one side of the analysis and dramatically alter the result—counting only the benefits and not the costs or counting only the pass-through but not the subsidy. That might be justified if we had done the opposite. We did not. I believe, if anything, our assumptions on balance helped the case of the GSEs.

Sincerely,



Dan L. Crippen
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