

The Effect on the Mortgage Markets of Privatizing Fannie Mae and Freddie Mac

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About 6 years ago, my colleague Ben Hermalin and I wrote a paper on mortgage market impacts for the Congressionally-mandated study of the privatization of Fannie Mae and Freddie Mac (F&F).¹ Today, I have been asked to provide an update of that paper. Perhaps its pride of authorship, but I think the paper has passed the test of time very well, with one exception. A cornerstone of the earlier paper was the claim that F&F maintained what we called a "tacitly colluding duopoly", representing what was arguably the greatest application of market power in the United States at the time. Well times change, and a new upstart--Microsoft--has taken over the title for concentrated market power. I really must add here, in view of Microsoft's current legal difficulties, that I have no reason to suggest that F&F were or are breaking any laws.

F&F have given up the title for extreme market power, but they retain the title for combining market power with a major subsidy. Analyzing the removal of this combination of subsidy with market power was the focus of our earlier paper. This remains, I believe, the proper focus--perhaps more than ever--for understanding the mortgage market impacts of privatizing F&F.

The required analysis is not standard microeconomics, since it is highly unusual to find market power combined with a government subsidy. For example, in the early days of capitalism, when the English Crown was in the business of granting monopolies, the monopolies subsidized the government, certainly not vice versa. Indeed, the F&F combination of subsidy with market power arose from a very special circumstance in which the US government decided to subsidize a market--the secondary market for conforming mortgages--by providing the subsidy to just 2 firms within that industry. The subsidy then led to market power, since it made it impossible for competitors to enter the secondary market for conforming mortgages.

¹ See Benjamin Hermalin and Dwight Jaffee "The Privatization of Fannie Mae and Freddie Mac: Implications for Mortgage Industry Structure," in Studies on Privatizing Fannie Mae and Freddie Mac, US Department of Housing and Urban Development, May 1996.

Getting Down To Cases

The main question is to determine the expected impact on the secondary market for conforming mortgages were we to remove simultaneously the subsidy and the market power from F&F--for simplicity I will call this *privatization*. As the first case, let us assume that there are neither economies nor diseconomies of scale in the relevant parts of the mortgage market. In this case, the end result after privatization is, by design, a competitive and unsubsidized market. Two main sets of impacts from privatization can then be identified, one relating to *monetary transfers* and the second relating to *resource reallocations*.

Three parties partake in the monetary transfers. First, *US taxpayers* gain, because they no longer guarantee F&F liabilities. Second, F&F stakeholders lose, because they no longer receive the taxpayer subsidies. Third, US mortgage borrowers will lose if mortgage rates rise, or are unaffected if the rates remain unchanged, both of which are possible. We thus have one group gaining, one group losing, and one group in between, with the total effect over all three groups necessarily netting to exactly zero. To understand what this means, notice that for the *representative American*, who participates in a proportionate share of each of the monetary transfers, the net effect must also be exactly zero. Thus, a judgment regarding monetary transfers, either pro or con, must weigh the relative importance of the three stake holding groups. Economists--unlike politicians--are generally unwilling to make such judgments.

The second major set of changes created by privatization relates to resource reallocations. Here economists do take a stand, and in fact two sets of resource reallocations could result from privatization, both of which are favorable. First, the resource costs of raising tax revenues will be saved, since tax revenue will no longer be needed to backstop the F&F guarantee. Second, it may be possible to reduce the resources allocated to conforming mortgage market securitization.

This benefit arises if the current subsidies have resulted in applying too many resources to conforming mortgage market securitization. This case occurs when the subsidies have reduced the mortgage interest rate below the competitive equilibrium, implying that the mortgage rate would rise following privatization. We are saying this would be welfare enhancing.

Can Mortgage Rates Actually Be Too Low

Now it may catch your attention, and it certainly has caught the attention of F&F, that we are claiming that rising mortgage interest rates, and correspondingly falling mortgage flows, may actually be a benefit of privatization. In contrast, of course, F&F were created to do just the opposite, namely to reduce mortgage interest rates and to expand mortgage flows. So what is going on here? It is important to recall that the mortgage agencies were created initially--and here I am going back to the 1930s--to rectify existing and recognized imperfections in the secondary mortgage markets. These imperfections took two basic forms: *illiquidity*, which arose because standardized instruments did not exist; and *asymmetric information*, which made it difficult for investors to evaluate existing mortgage securities.

It is to the great credit of F&F, as well as to GNMA and the private firms in the mortgage security market, that these problems have been solved by technological improvements in the methods for standardizing security design and for evaluating and controlling credit and interest rate risks. These improvements, however, are now in hand and will remain whether or not F&F are privatized. Therefore, the proper conclusion, in my view, is that we only achieve *mortgage market overkill* by continuing to subsidize mortgage market development, given that the basic problem has long been solved. In particular, there is a cost to mortgage market overkill, since too much of one thing, such as mortgage securitization, will necessarily imply too little of something else that is even more valuable, given that the overall quantity of resources is limited.

The Role of Economies of Scale

My discussion so far has been assuming that constant returns to scale apply in the mortgage securitization market. Now I want to consider an important alternative, namely that F&F embody significant economies of scale. Since F&F are an order of magnitude larger than any other participants in the mortgage market, this could represent a major cost advantage and operating efficiency for F&F. This raises the question whether the operating efficiencies created by such increasing returns to scale would be lost in the process of privatization.

My basic answer is that the potential benefits from economies of scale can be maintained under a F&F privatization, and in fact these advantages may expand further if F&F choose to enter the jumbo securitization market. Of course, economies of scale also mean that, F&F, or even other market participants, could retain significant market power following privatization. Such *natural monopolies* are not unique to the mortgage market, however, and the welfare issues they raise should be handled in the same manner as in other industries. In other words, this would be just another case where anti-trust policy must balance the benefits arising from economies of scale against the costs of market power.

Other Points of Debate

Given that Bob Van Order from Freddie Mac will be my discussant here in a few minutes, it is strategic for me to anticipate some of his other likely complaints. The situation reminds me of the old Monetarist-Keynesian debates, at which the participants could completely anticipate each other's positions. Recognizing this, Bob Solow once suggested that we just publish the already established list of comments and rebuttals, and adjourn immediately to the faculty club for drinks. In fact, the HUD volume containing the Hermalin and Jaffee paper also contains F&F comments on the paper and our responses. So we really can adjourn for drinks, when I am done.

Bob Solow had one other great line in his debates with Milton Friedman. He noted that everything seemed to remind Milton of the money supply, whereas for him just about everything reminded him of sex. But he did not feel it necessary to bring sex into his professional writings. I suppose the equivalent here is that just about everything seems to remind Bob Van Order of an unfair advantage that deposit insurance purportedly confers on thrift institutions. He certainly has the privilege of that opinion, but it seems to me to be no more relevant than is sex to discussions of F&F privatization.

A Proposal for Implementing Privatization

Our original paper did not look at the question of the best manner for actually implementing the privatization of F&F, since other papers had been commissioned to discuss exactly that topic. However, having now had the opportunity to review that literature and the subsequent literature as well, I do have comments on a path for implementation that derives directly from the welfare considerations I have just discussed.

As I have tried to point out, the key problem in the current situation is that the F&F subsidy has also become the mechanism for the creation of market power. One solution then, of course, is to eliminate the subsidy, in which case the whole system could return to the optimum of perfect competition. I fully support this view, but I have also come to recognize that Congress may well prefer to retain the subsidies, so that no changes would then actually occur.

It is in this context that I want to suggest an alternative that maintains the subsidies but implements them in a flexible manner that is compatible with perfect competition across the full residential mortgage market. To save time, it is easiest just to give a specific example or two, but what I am really proposing is a general approach.

The key point is to offer the benefits of the federal guarantee to all residential mortgage market institutions and firms, as long as they meet the specified standards for mortgage underwriting and institutional capital requirements. The mortgage securities of each firm meeting these conditions would receive a guarantee against default, to be provided explicitly by the US government. The current distinction between conforming and jumbo mortgages could disappear, since any firm--F&F or otherwise --would be free to enter any part of the market.

The plan creates a level playing field, in which all firms have equal access to the federal mortgage-security guarantee program. Transparency is a second important benefit, since the guarantee would be explicit and complete, and the amount of securities to which it applied could be easily totaled. Of course, in this simple version, the amount of the subsidy would rise, since it would be available to all firms in all mortgage markets, not just F&F in the conforming market. It is an easy matter, however, to fine tune the subsidy, to change its structure, amount, and even its flexibility over time.

For example, to reduce the subsidy, the new federal guarantee could be applied only to those mortgage securities relating to conforming mortgages, and the definition of conforming mortgages could be further limited if desired. The amount of the subsidy could also be reduced in other ways, for example by raising the capital standards, or by charging a partial fee for any qualifying firm to obtain the guarantee.

In summary, it seems to me that this plan provides a fully transparent and very flexible means for tuning the amount of the mortgage subsidy. At the same time it guarantees a fully competitive market place, thus ensuring that economic welfare is maximized..