Fannie & Freddie Vs. Wall Street? That's Wishful Spin

By Mark Calabria

President Obama recently made headlines when he said it was time to "wind down" Fannie Mae and Freddie Mac. He is right. The existence of Fannie and Freddie has only exasperated the increased leverage and concentration among America's banks that were direct contributors to the latest financial crisis.

It is broadly agreed across the political spectrum that our nation's largest banks were too leveraged going into the crisis. That is, they held far too much debt relative to equity, leaving many banks unable to absorb losses without falling into insolvency. While there are a variety of reasons for such high levels of debt to equity, including the favorable treatment of debt under our tax code, a less recognized contributor is the presence of Fannie Mae and Freddie Mac.

In the years leading up to the crisis, and continuing today, a typical mortgage transaction would involve Bank A originating say 1,000 mortgages, selling those 1,000 mortgages to Fannie Mae and then buying back the mortgage-backed securities (MBS) holding those 1,000 mortgages. At the end of this roundabout, those 1,000 mortgages would still reside on the balance sheet of Bank A. Why go to all that trouble you ask? Simple, the bank could cut its required capital in half by doing so.

For simplicity, let's assume that the average size of those 1,000 mortgages is \$200,000, leaving the value of the MBS at \$200 million. If Bank A held those mortgages as whole loans, it would have to set aside \$10 million minimum in capital. Holding those mortgages as Fannie Mae MBS drops the bank's capital requirements to only \$4 million, a 60 percent reduction.

Fannie Mae apologists would rightly respond that Fannie Mae itself is required to hold capital against the credit guarantee behind that MBS. Correct, but Fannie Mae was required, by statute, to hold only 0.45 percent capital for its guarantee business. In our present example of $200 million in MBS, that translates to $900,000. If you combined the required capital for both Fannie Mae and Bank A, the financial system is still holding less than half as much capital than if mortgages were held whole on bank balance sheets.

Had all single-family mortgages been held whole on bank balance sheets in 2006, our financial system would have held over $210 billion in additional capital, not far off from the $205 billion obligated under TARP's bank capital purchase program.

The primary function of Fannie Mae and Freddie Mac has long been to allow banks an avenue for transferring the credit risk of their mortgages to the taxpayer. Fannie Mae defenders claim that attempts to eliminate Fannie and Freddie would benefit the big banks. Such a claim is absurd, as the big banks could already eliminate Fannie and Freddie if they wanted. Fannie and Freddie cannot directly purchase mortgages from the public, they can only work via the banks. If the big banks wanted to end Fannie and Freddie, a simple boycott would achieve such. There would be no need for legislation.

The growth of Fannie Mae and Freddie Mac has also occurred alongside growing concentration in the banking industry. In 1984, when only around 20 percent of all mortgages were securitized, banks with over $10 billion in assets controlled just over 40 percent of total industry assets, today banks over $10 billion control over 80 percent of industry assets. The same trend has held for the number of large banks. In the mid-1980's, before the dominance of Fannie and Freddie, there were only 18 banks with over $20 billion in assets; today there are close to 50. On an annual basis, the growth in Fannie and Freddie activity has been positively correlated with measures of bank concentration.

The growth in concentration is also borne out in the business relationships of Fannie Mae and Freddie Mac. At the peak of the housing boom, only 10 lenders made up two-thirds of Fannie Mae's business and 10 lenders made up over three-fourths of Freddie Mac's business.

None of this should come as a surprise. The comparative advantage of small, community banks is in local knowledge: The knowledge of which employers are expanding; the knowledge of which neighborhoods are stable. Fannie and Freddie led the standardization of our mortgage market. But that standardization relied heavily on mathematical models of risk. It turned mortgages into a volume, cookie-cutter business. Doing so undercut the advantage of the local knowledge possessed by small local financial institutions and drove consolidation in the banking industry. Fannie Mae and Freddie Mac also played a major role in driving the growth of private label MBS, becoming the largest single investors in that market.

The usual spin about Fannie Mae versus Wall Street is just that: spin. The fact is that Fannie Mae and Freddie Mac have been the some of the biggest partners of Wall Street. If we did not have Fannie Mae and Freddie Mac what would we have instead? A less leveraged and concentrated banking system for starters.

Mark A. Calabria is director of financial regulation studies at the Cato Institute in Washington DC.