

Comments on the paper by Lawrence White:

“On Truly Privatizing Fannie Mae and Freddie Mac:
Why It's Important, and How to Do It”

by

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1. Wherein I Fully Agree

Larry White has created a highly useful paper that clearly lays out the reasons to privatize Fannie Mae and Freddie Mac (F&F) and offers a roadmap for doing so. I agree fully with the goal and his reasons for it, although below I will indicate I have a different perspective on how best to “do it”. To begin, I would like to emphasize further some of Larry White’s key points:

- *Important historical contributions.* F&F have served an important function by integrating the US mortgage market across geographic regions and by creating standards that helped create the market for residential mortgage backed securities (MBS).
- *An ineffective mechanism to encourage low-income housing.* F&F have not focused on encouraging homeownership for low- and moderate-income families. As an example, their limit for conforming loans far exceeds the median price of new homes.
- *Freely prepayable mortgage.* F&F generally securitize only mortgages without prepayment penalties, even though the cost of the prepayment option is then embedded in the mortgage rate. This feature raises the net cost to lower- and moderate-income families, without providing commensurate benefits.
- *Systemic risks.* As a result of their large size, high leverage, and imperfect hedging of interest rate risk, F&F present a major risk to the US financial system.
- *Full privatization is the first-best solution.* Full privatization would end the misdirected subsidies and systemic risks created by F&F, while allowing the firms to compete—and I think prosper—on a level field with the rest of the US mortgage market.

2. Wherein I Disagree

Larry White concludes his paper:

“The case for a true privatization of Fannie Mae and Freddie Mac is overwhelming. The method is straightforward. The time is now. Just do it.”

While I fully agree with the goal, I do not believe an adversarial privatization—one opposed by F&F—is feasible. My belief was formed as a participant, along with Larry, in the Congressionally mandated study of privatizing F&F that was completed in 1996.¹ Events since then have reinforced my view. The key issues are the legal difficulties of an adversarial privatization and the demonstrated reluctance of Congress to confront the firms.

But all is not lost. My strategy has two steps:

- 1) *Sharply limit the mortgage portfolios retained by F&F.* This will eliminate most of the systemic risk created by the firms, while maintaining the mortgage market benefits of their MBS underwriting business.²
- 2) *Negotiate a voluntary privatization with Fannie Mae and Freddie Mac.* A majority of F&F profits derive from their retained portfolios; without this benefit, it is likely that F&F will be prepared to negotiate the conditions of a voluntary privatization.

Michael Lea’s excellent paper, “Privatizing a Government Sponsored Enterprise: Lessons from the Sallie Mae Experience” was also written for this conference. From it, you can see a similar two-step process lead to the privatization of Sallie Mae; hopefully the same will apply to F&F.

¹ See Studies on Privatizing Fannie Mae and Freddie Mac, US Department of Housing and Urban Development, May 1996.

² The details are in my recent working paper, which Jack Guttentag has kindly agreed to include here with other conference materials. See Dwight Jaffee, “On Limiting the Retained Mortgage Portfolios of Fannie Mae and Freddie Mac,” also available at: <http://faculty.haas.berkeley.edu/jaffee/research.htm>. Other mechanisms might achieve the same end, such as reducing the conforming loan limit (which I know Larry White would strongly endorse) or by requiring a user fee, paid by F&F to the US Treasury for their issues of Agency debt.