

**“Measuring the Benefits of Fannie Mae and Freddie Mac to Consumers: Between De Minimus and Small?”**  
**Comments on Professor Anthony Sanders’ Paper**

By Thomas H. Stanton\*

It is a pleasure to be able to comment on this paper presented by Professor Anthony B. Sanders on behalf of himself and Professor Brent Ambrose. However, in the fashion of a practicing lawyer, I would like so say a few words before I begin to speak. Those are words of thanks to Jack Guttentag for hosting this conference and for assembling such knowledgeable participants who have been able to contribute insights from a range of perspectives.

The Ambrose-Sanders paper is one of the thought provoking and useful contributions to this conference. The following comments refer both to the second draft of the paper and to those aspects of the first draft that Tony referenced in his presentation at the conference.

The presentation by Tony Sanders relies on earlier work by Ambrose, LaCour-Little, and Sanders, that estimates that the two GSEs lower mortgage rates in the conforming market by 28 basis points or, when adjusted for house-price volatility, 24 basis points.<sup>1</sup> To reach this result the three researchers made impressive efforts to try to resolve some of the methodological issues relating to this measurement.

Professor Sanders’ current presentation is not intended to provide the methodological rigor of the earlier work. He takes the 28 basis point estimate as his starting point and multiplies it by the volume of mortgages that Freddie Mac has

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<sup>1</sup> Brent W. Ambrose, Michael LaCour Little, and Anthony B. Sanders, “The Effect of Conforming Loan Status on Mortgage Yield Spreads: A Loan Level Analysis,” *Journal of Real Estate Economics*, vol. 32, no. 4, 2004, pp. 541-569. Consistent with previous research, the paper estimates the funding advantage Fannie Mae and Freddie Mac enjoy in the agency credit market by comparing the yields of their debt to the yields of “AA” or “A” rated paper issued by non-GSE financial firms. That is an apples-to-oranges comparison, since the GSEs’ risk-to-the-government ratings assume their funding costs will remain low and their liquidity high (due to the perception of an implied government guarantee) even if they suffer large losses, whereas the credit ratings of non-GSEs make no such assumption. Such a comparison biases estimates of the GSEs’ funding cost advantage downward by unknown amounts. See Ron Feldman, “Estimating and Managing the Federal Subsidy of Fannie Mae and Freddie Mac: Is Either Task Possible?” *Journal of Public Budgeting, Accounting, and Financial Management*, vol. 11, no. 1, Spring 1999, pp. 81-116. An imperfect, speculative solution would be to compare the yields on the GSEs’ paper to private debt with lower ratings, say, “BBB”.

outstanding. This means that Freddie Mac alone passes through about \$ 3.1 billion of its subsidy benefits to consumers. He also states that the Fannie Mae and Freddie Mac automated underwriting systems have been determined to lower borrower costs by a considerable if unspecified amount.

Professor Sanders also argues that the jumbo mortgage rate offered by commercial banks must be adjusted by the amount of subsidy that commercial banks receive from the FDIC. Without citing sources, he states that this subsidy is about 15-25 basis points. He then combines the 28 basis point estimate of GSE benefits with the high end of his estimate of FDIC subsidies to banks and concludes that Fannie Mae and Freddie Mac provide benefits of lowering conforming mortgage rates by approximately 50 basis points, when one considers the subsidy that he alleges goes to banks. (These calculations are presented in the first draft of the paper and were referenced in the presentation).

The estimate that deposit insurance provides a 22 basis point subsidy for mortgages funded by banks requires more than mere assertion. It is not clear that the FDIC subsidy to banks, to the extent there is one, accrues to lowering jumbo mortgage rates rather than to other bank activities. The addition of this number to show a GSE benefit for the conforming mortgage market is of doubtful value.

In addition, the number itself is questionable. Other authors, Peek and Wilcox, for example, in their chapter on banking safety net subsidies,<sup>2</sup> suggest much lower estimates than 22 basis points, as well as some serious methodological issues that need to be addressed to quantify any FDIC subsidy, much less to try to allocate it to the mortgage market.

From a public policy perspective, it is also worth noting that the 24 or 28 basis point benefit that Fannie Mae and Freddie Mac convey is very small. Conforming mortgage rates can vary significantly over the time that a homeowner is in the home. For example, rates went from 10.4 percent in 1990 to 8.2 percent in 1995 and 5.9 percent in 2003. In the context of these variations, 28 basis points does not seem to be a large benefit. (See Figure 1 of the Sanders paper).

That is true even if Professor Sanders applies this benefit to some three trillion dollars of mortgages funded by both GSEs, for a total benefit of perhaps \$ 6-8 billion annually. The federal government provides much greater homeownership subsidies than this through the tax code. Three of the largest subsidies in the income tax code for are the deductibility of mortgage interest (worth \$ 61 billion in FY 2004), the capital gains exclusion on home sales (\$ 30 billion) and the deductibility of property taxes on homes (\$ 20 billion). This does not count the exclusion of rental income on owner-occupied homes (worth \$ 24.5 billion).

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<sup>2</sup> Joe Peek and James A. Wilcox, "The Fall and Rise of Banking Safety New Subsidies," chapter in Benton Gup, *Too-Big-To-Fail: Policies and Practices*, manuscript dated November 11, 2002.

In other words, the benefit of the GSEs in lowering mortgage rates is an order of magnitude smaller than the tax benefits. While the tax subsidies for homeownership are accountable in the federal budget, the GSE subsidies are not. Moreover, tax subsidies do not create the systemic risks that are created by providing subsidies to the GSEs.

The benefits of the GSE automated underwriting systems, which Professor Sanders would like to explore, raise another set of methodological problems. Not the least of these would be the need to try to show that systems administered by today's government-sponsored duopoly would have superior market benefits compared to the automated underwriting systems that could exist in a competitive secondary mortgage market without GSEs. That is especially true given the GSEs' traditional focus on capturing monopoly rents and achieving unusually high returns on equity,

Any further study of GSE automated underwriting systems also needs to consider the extent that these systems exclude borrowers that would be served in a more competitive market. In its recent affordable housing rulemaking, for example, HUD found that just over 4 percent of Fannie Mae and Freddie Mac's loans went to African-American and Hispanic first time homebuyers, compared to 9 percent of the conforming market accounted for by these loans. One suspects that the benefits to borrowers, including minorities, would be much greater from competition than from the automated underwriting systems supplied by two huge firms that dominate the secondary mortgage market.

Finally, while the question of how much the GSEs use their government subsidies to reduce mortgage rates is interesting, it is not completely relevant to today's policy debate, which involves quite different issues. Chairman Alan Greenspan sees future systemic difficulties as "likely" if the GSEs are permitted to continue the untrammelled growth of their portfolios.

We are now treated to the spectacle of Freddie Mac's current Chairman Richard Syron arguing that an unlimited portfolio is an essential part of the company's business. This is an effort to counter both Chairman Greenspan and the testimony of Mr. Syron's predecessor Leland Brendsel some years ago that Freddie Mac could serve the housing market quite well through securitization and without a large portfolio.<sup>3</sup> The issue of how far the GSE portfolios can be limited without affecting the housing markets deserves dispassionate analysis by Professor Sanders and his colleagues.

Alex Pollock raised a second issue last night: is federal housing policy well served by creating a government-sponsored duopoly in the secondary mortgage market? In other words, in his analysis, Professor Sanders needs to take account of the substantial costs as well as the benefits of the current duopoly structure of the GSEs.

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<sup>3</sup> Mr. Brendsel's testimony, before the Oversight Subcommittee of the House Ways and Means Committee on September 28, 1989, is recounted in Thomas H. Stanton, *Government-Sponsored Enterprises: Mercantilist Companies in the Modern World*, (AEI Press, 2002), at pp. 83-84.

One of the costs of government-sponsored duopoly concerns economic retaliation. In an informal discussion after dinner last night, participants in this conference raised three different examples of economic pressure that a GSE applied to organizations because they did not like the policy views presented by a member of that organization. One of those examples concerned a vendor to the mortgage market, another a consulting practice, and a third a low-income housing advocacy group.<sup>4</sup> If there were a competitive market rather than a duopoly with market power, such economic pressure would have much less consequence because the GSE (or both GSEs, as the case may be) would not be able to exclude the offending organizations from providing their services to the mortgage market. The talent would simply migrate to serve other competitors.

Let's put the issue of GSE benefits another way. If the most important benefit of GSEs is to lower the cost of home mortgages by an average of 24 or 28 basis points, then we don't need GSEs. Even arguing that a government guarantee, implicit or otherwise, of mortgage-backed securities might be helpful to the private market, what types of institution should deliver that guarantee?

What is needed is a focus on each of the purported benefits of the GSEs and whether a government-sponsored duopoly is the best way to provide those benefits. The answer is likely to be a resounding "no." Then the question becomes the best way to provide benefits that we believe may be indispensable to a stable and flexible mortgage market. That question must be answered. The GSE as we know it has outlived its usefulness. We look forward to further work by Professors Sanders and Ambrose as the nation addresses those issues. Thank you.

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<sup>4</sup> Just after I presented these comments a person came to me with yet a fourth example of retaliation, against a major consulting practice.