

CRS Report for Congress

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Government-Sponsored Enterprises (GSEs): An Institutional Overview

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Summary

Congress chartered government-sponsored enterprises (GSEs) to improve the workings of credit markets. This report briefly describes the nature of GSEs, their mixed governmental-private nature, the differences between GSEs and government agencies, and concerns about and supporting arguments for GSEs. This report will be updated as events warrant.

Government-Sponsored Enterprises

A number of organizations fall between the categories of private sector and governmental entities.¹ One type of quasi-governmental organization is the “government-sponsored enterprise” (GSE). At present, there are no general standards governing the establishment of a GSE, nor is there a listing of GSEs in the *United States Code*.² Each GSE is created by Congress with its attributes defined in its enabling legislation and charter. The absence of a legal definition of a GSE does not, however, preclude the development of a practical definition. For the purposes of this report, a GSE “is a privately owned, federally chartered financial institution with nationwide scope and spending powers that benefits from an implicit federal guarantee to enhance its ability to borrow money.”³

¹ CRS Report RL30533, *The Quasi Government: Hybrid Organizations with Both Government and Private Sector Legal Characteristics*, by Ronald C. Moe and Kevin R. Kosar.

² The Omnibus Reconciliation Act of 1990 did enumerate the criteria for a GSE, but subsequent budget acts have not done so. See 104 Stat. 1388-607, Sec. 13112.

³ Ronald C. Moe and Thomas H. Stanton, “Government-Sponsored Enterprises as Federal Instrumentalities: Reconciling Private Management with Public Accountability,” *Public Administration Review*, vol. 49 (July/Aug. 1989), p. 321.

Historically, the federal government has been involved in few commercial enterprises on an equity basis. There were some early instances of the federal government participating in otherwise private corporate enterprises on a shared ownership basis, most notably the first and second Banks of the United States.⁴ This practice came into question, however, as a consequence of a Supreme Court ruling in 1819.⁵ From that time to the present, the federal government, with few exceptions, has consciously avoided shared ownership involvement with private entities.

Why Did Congress Create GSEs?

GSEs were not created for the purpose of expanding home ownership by lower- and middle-income members of the public. Rather, Congress established GSEs “to improve the efficiency of capital markets” and to overcome “statutory and other market imperfections which otherwise prevent funds from moving easily from suppliers of funds to areas of high loan demand.”⁶ The economic rationale for GSEs is the belief that, without such government-sponsored institutions, a critical area of necessary debt financing would be underserved or served inefficiently. Government, according to this rationale, should use some of its sovereign powers (e.g., full faith and credit of the U.S. Treasury) to encourage the development of private financial intermediaries to serve selected markets. GSEs are part of a tradition of mercantilist financial institutions. Government assigns them benefits and privileges in their charters that are not available to fully private corporations.⁷ In return, the government limits activities and lines of business of GSEs and requires them to promote selected public policy objectives. As a private entity, a GSE is exempt from federal management and staffing laws, which provides additional operational flexibility.⁸

GSEs are not banks, credit unions, or savings and loans associations. Excepting the Farm Credit Banks, none of the GSEs lends money directly to members of the public. GSEs are for-profit financial entities that provide capital market liquidity. To these ends, GSEs (to varying degrees) issue capital stock and short- and long-term debt instruments,

⁴ Bray Hammond, *Banks and Politics in America From the Revolution to the Civil War* (Princeton, NJ: Princeton University Press, 1957); John T. Holdsworth and David Dewey, *The First and Second Banks of the United States*, S.Doc. 571, 61st Cong., 2nd sess. (Washington: GPO, 1910); Leonard D. White, *The Jacksonians* (New York: Macmillan, 1954), chapter 24.

⁵ *McCulloch v. Maryland* (17 U.S. (4 Wheat.) 315 (1819)). The Supreme Court’s ruling implied that partial federal ownership of a corporation, in this instance the Bank of the United States, assigned the corporation certain attributes normally reserved to the sovereign authority (e.g., non-taxable status in the several states). See also: *Osborn v. Bank of the United States* (17 U.S. (4 Wheat.) 738 (1824)).

⁶ Thomas H. Stanton, *Government Sponsored Enterprises: Their Benefits and Costs As Instruments of Federal Policy* (Washington: Association of Reserve City Bankers, April 1988), p. v.

⁷ Thomas H. Stanton, *Government Sponsored Enterprises: Mercantilist Companies in the Modern World* (Washington: The AEI Press, 2002).

⁸ This flexibility has led to controversies. For example, some have argued that GSEs compensate their executives too generously. Terence O’Hara, “Exit Packages in Dispute at Fannie Mae,” *Washington Post*, Dec. 28, 2004, p. E1.

guarantee mortgage-backed securities (MBS), purchase loans and hold them in their own portfolio, fund related activities, and collect fees for guarantees and other services.⁹ At present, there are seven GSEs. Three of the GSEs — the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Agricultural Mortgage Corporation (Farmer Mac) — are investor owned; the others — the Federal Home Loan Bank System and the Farm Credit System — are owned cooperatively by their borrowers.¹⁰

Differences Between GSEs and Agencies

GSEs are instrumentalities, not agencies, of the United States. This distinction is both legally and administratively important. The federal government's control over an institution differs significantly depending upon whether that institution is an agency or instrumentality. An agency (as defined in Title 5, Part 1 of the *United States Code*) is managed directly through the federal management hierarchy. As a general rule, an agency is subject to all general management laws and regulations provided in the *United States Code* unless it is exempted from such coverage either in its enabling statute, or by virtue of being part of an exempted class of agency. Thus, an agency is subject to federal appointment of its senior officers (often requiring Senate confirmation), to civil service and federal procurement laws, and to the federal budget and other direct federal management controls, unless exempted.

An instrumentality of government, on the other hand, is a privately owned institution not subject to any of the general management laws and regulations unless so indicated in its enabling legislation (charter). An instrumentality may be assigned limited prerogatives in its charter (e.g., immunity from state taxation) normally associated with the government's sovereign authority. In return for this limited assignment of governmental powers, an instrumentality cannot, on its own authority, alter the charter or conduct activities contrary to the intent of the charter. Thus, a GSE is supervised, but not directly managed, by the federal government.

While the details may vary from one instance to the next, GSEs typically have four characteristics:

- private sector ownership;
- limited competition;
- activities limited by congressional charter; and
- chartered privileges that create an inferred federal guarantee of obligations.

⁹ U.S. General Accounting Office, *Financial Services Institutions: Information for Assessing the Government's Potential Financial Exposure*, GAO/GGD-98-125 (Washington: GAO, 1998), p. 3.

¹⁰ The other two GSEs — the Financing Corporation and the Resolution Funding Corporation — are funding shells, not operating companies. They were given GSE status so that their funding would not appear to be federal borrowing for purposes of the federal budget. The Student Loan Marketing Association (Sallie Mae) was not included in the list because it shed its GSE designation and became the entirely private SLM Corporation in 2004.

Today, GSEs primarily act as financial intermediaries to assist borrowers in housing and agriculture. Although they are privately owned, they benefit financially from government sponsorship. Their securities can collateralize public deposits (e.g., Social Security Administration and state and local government deposits) and can be held in unlimited amounts by most banks and thrifts. With one exception (Farmer Mac), they sell securities to the public without registering them with the Securities and Exchange Commission, and their corporate earnings are exempt from state and local income taxes, the latter practice attracting particular controversy.¹¹ All but one (Farm Credit System) have a line of credit with the Treasury. These statute-created benefits create an inferred federal guarantee; that is, investors act as if they believe that the federal government would make good on GSEs' debts and obligations in the event of a failure.

Concerns About GSEs

In terms of meeting their original congressional objective — to provide liquidity to credit markets on a national, rather than regional or state, basis — the GSEs have been remarkably successful. They are widely credited with (1) serving rural agriculture's financial requirements, (2) lowering the cost of home mortgages, and (3) increasing liquidity by forging stronger links with general capital markets. Defenders of the current GSEs also hold that GSEs are generally well managed and financially sound. Moreover, they contend that GSEs continue to provide a valuable public service by assisting low and low-middle income individuals to become homeowners.¹²

However, with these successes have come reservations and questions. These concerns are rooted in investors' inference that the federal government backs GSE obligations, and in the privileges accorded by the federal government to GSEs, as well as in their hybrid nature, size, and subsidization.

Inferred Guarantee and Privileges. Through their charters, GSEs receive a number of privileges not granted to private sector financial firms. These privileges and the public-private (hybrid) nature of GSEs create the perception among investors that the federal government backs GSE obligations. To be clear, there is no explicit guarantee in law for GSE liabilities. In fact, the charter of each GSE requires that it inform investors that its securities are not government-backed. Nevertheless, there is a general

¹¹ Recently, Freddie Mac and Fannie Mae agreed to register voluntarily with the Securities and Exchange Commission (SEC). See CRS Report RS21263, *Fannie Mae, Freddie Mac, and SEC Registration and Disclosures*, by Mark Jickling and Barbara Miles.

¹² Fannie Mae has suggested that its special GSE status lowers the cost of a home loan by “a quarter to a half of a percent,” which means that 400,000 families qualified for mortgages that would not have otherwise. See Fannie Mae advertisement, *Washington Post*, May 11, 1999, p. A5. The Secretary of Housing and Urban Development disagrees. “[N]umerous HUD studies and independent analyses have shown that the GSEs have historically lagged the primary market instead of led it with respect to funding mortgage loans for low-income and minority home buyers.” Statement of Mel Martinez, Secretary of the Department of Housing, and Urban Development before U.S. Congress, Senate Committee on Banking, Housing and Urban Affairs, Oct. 16, 2003, p. 3, available at [http://www.senate.gov/~banking/_files/martinez.pdf], visited Oct. 20, 2003.

presumption to the contrary, which Fannie Mae acknowledged in a letter to the Office of the Comptroller of the Currency:

Fannie Mae standard domestic obligations, like Treasuries, typically receive no rating on an issue-by-issue basis, because investors and rating agencies view the implied government backing of Fannie Mae as sufficient indication of the quality of Fannie Mae obligations.¹³

This impression of federal backing has been encouraged by the federal government's past actions. For example, when the Farm Credit System was in crisis in the late 1980s, the federal government arranged a bailout.¹⁴

Hybrid Nature. GSEs are chartered for a public purpose but are privately owned, for-profit firms. As an instrumentality, the GSE is to serve the public good; yet, the primary accountability of GSE management is not to the federal government or the public, but to owners of GSE stock and securities. As a chief executive officer of Sallie Mae once told a Senate oversight subcommittee, "We are a private corporation and as such, with stockholders and bondholders, we have a fiduciary responsibility to those individuals."¹⁵ Indeed, the recent managerial turnover at Freddie Mac and Fannie Mae was due, in great part, to its use of inaccurate accounting methods to report earnings that are attractive to investors.¹⁶ The for-profit nature of the GSE also means it has incentives to seek profits in product and service markets outside its government charter.¹⁷

Size and Systemic Risk. GSEs, in fact, are among the largest financial institutions in the United States. Investors' inference of federal backing is one factor that has enabled GSEs to grow rapidly; on average, the combined size of Fannie Mae and Freddie Mac has more than doubled every five years since 1968.¹⁸ For example, the combined debt outstanding of Fannie Mae and Freddie Mac is approximately \$1.7 trillion in 2004. The Federal Home Loan Bank System had \$754 billion in consolidated debt

¹³ As quoted in Stanton, *Government Sponsored Enterprises: Mercantilist Companies in the Modern World*, p. 35.

¹⁴ On the rescue of the Farm Credit System, see U.S. General Accounting Office, *Farm Credit System: Repayment of Federal Assistance and Competitive Position*, GAO/GGD-94-39 (Washington: DC 1994).

¹⁵ Statement of Edward A. Fox, President and CEO of Sallie Mae, before U.S. Senate, Committee on Labor and Human Resources, Subcommittee on Education, Arts, and Humanities, *Oversight of Student Loan Marketing Association (Sallie Mae)*, hearings, 102nd Cong., 2nd sess. (Washington: GPO, 1982), p. 135.

¹⁶ See CRS Report RS21567, *Accounting and Management Problems at Freddie Mac*, by Mark Jickling; and CRS Report RS21949, *Accounting Problems at Fannie Mae*, by Mark Jickling.

¹⁷ For example, GSEs used their government privileges to raise funds for nonmortgage investments, a policy that has attracted the attention of GAO. The GSEs took issue with GAO's characterization of their activities. See U.S. General Accounting Office, *Federal Oversight Need in Nonmortgage Investments*, GAO/GGD-98-48 (Washington: GAO, 1998).

¹⁸ Stanton, *Government Sponsored Enterprises: Mercantilist Companies in the Modern World*, p. 8. Not only does the inferred guarantee make GSE securities attractive to investors, it also encourages investors to continue to invest in GSEs even when GSEs take on more debt and more risky debt.

outstanding in 2003.¹⁹ GSE securities are held by both U.S. and foreign banks and financial institutions. Therefore, some observers believe the failure of a GSE has the potential to create worldwide, destructive spillover effects.²⁰ Moreover, the larger a GSE grows, the more difficult it becomes to end its government charter without disruptions to capital markets.

Subsidization. GSEs borrow money at significantly lower interest rates than competitors because of the inferred federal guarantee and the government-bestowed privileges. Collectively, then, the federal government effectively subsidizes GSEs. The Congressional Budget Office estimated this subsidy to be over \$13.5 billion in the year 2000 alone.²¹ This situation generates a number of issues. The first is the equity issue. Specifically, critics question whether it is fair for government to give GSEs an advantage over private banking firms.²²

The second matter is the question of continued government intervention. Again, the goal of each of these GSEs was to overcome barriers to the free flow of credit. Once these barriers have been removed, observers ask if extensive government intervention (in the form of a GSE) in the market is still appropriate. Critics of continued GSE existence argue that GSEs should be graduated into private status (as was done with Sallie Mae).²³

Third, and relatedly, is the question of efficiency. The financial landscape has been dramatically altered by nationwide banking, better access to capital markets by housing and farm interests, and a huge increase in consumer debt financing. Thus, the subsidies conferred on housing and agriculture through GSEs come into question.

Issues for Congress

Are GSEs still needed? Would the GSE subsidies be more efficient in some other form? In the event of a financial crisis at a GSE, would the federal government intervene to stabilize securities markets? These are some of the questions that Congress may wish to consider.²⁴

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¹⁹ Office of Federal Housing Oversight, *2005 Report to Congress* (Washington: OFHEO, June 15, 2005), p. 63; and website of the Federal Home Loan Banks, Office of Finance [http://www.fhlb-of.com/issuance/debt_outstanding.html], visited Dec. 19, 2005.

²⁰ For example, see International Monetary Fund, *Global Financial Stability Report*, September 2003, available at [<http://www.imf.org/external/pubs/ft/GFSR/2003/02/index.htm>], visited Oct. 20, 2003.

²¹ Congressional Budget Office, *Federal Subsidies and the Housing GSEs: Subsidies in 2000* (Washington: CBO, 2001), p. 2.

²² U.S. Congressional Budget Office, *Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac* (Washington: CBO, 1996), p. xii. Private companies further complain that the government-conferred privileges of GSEs inhibit private competition against GSEs.

²³ Peter J. Wallison et al., *Privatizing Fannie Mae, Freddie Mac, and the Federal Home Loan Banks: How and Why* (Washington: The AEI Press, 2004).

²⁴ On legislative proposals in the 109th Congress, see CRS Report RL32795, *Government-Sponsored Enterprises (GSEs): Regulatory Reform Legislation*, by Mark Jickling.