



United States Government Accountability Office
Washington, DC 20548

November 15, 2010

Congressional Committees

Subject: *The Cooperative Model as a Potential Component of Structural Reform Options for Fannie Mae and Freddie Mac*

On September 6, 2008, the Federal Housing Finance Agency (FHFA) placed the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) into conservatorships. FHFA took this step after concern developed that the deteriorating financial condition of the two government-sponsored enterprises (GSE), which had about \$5.4 trillion in combined financial obligations, threatened the stability of financial markets. Since then, the Department of the Treasury (Treasury) has provided financial support to Fannie Mae and Freddie Mac (the enterprises) to help stabilize their financial condition and help ensure their ability to continue to support housing finance. As of September 2010, Treasury had provided about \$150 billion in capital contributions to support the enterprises, and the Congressional Budget Office has estimated that the total cost to taxpayers could be nearly \$400 billion over a 10-year period. In recent months, Congress and the administration have been considering a variety of proposals to reform the enterprises in order to help ensure their safety and soundness and the effectiveness of the U.S. housing finance system.

One structural reform option for the enterprises that has generated some interest in Congress and among housing finance participants and observers is known as the cooperative model. Congress chartered Fannie Mae and Freddie Mac to be for-profit corporations owned by shareholders. Their primary mission over the years has been to establish a liquid, secondary market for what are known as conventional conforming mortgages by purchasing such mortgages from lenders, which can use the proceeds to originate additional mortgages.¹ The enterprises' critics argue that their structures and federal sponsorship, which allowed for the issuance of debt at advantageous rates, have undermined market discipline and encouraged them to engage in profitable but potentially risky activities with inadequate capital levels. Under the cooperative model, the enterprises would be converted from shareholder-owned corporations to cooperatives owned by the lenders that sell mortgages to them. Proponents of the cooperative model believe it would promote safer and sounder

¹Conventional conforming mortgages are those mortgages that are not insured or guaranteed by the Federal Housing Administration, the Department of Veterans Affairs, or the Department of Agriculture and meet the enterprises' underwriting standards.

mortgage underwriting practices because lenders could potentially lose some or all of their capital investments in a cooperative if it suffered significant losses.

We issued a report under the Comptroller General's authority on structural reform options for the enterprises in September 2009 and, on the basis of subsequent congressional interest, we conducted this work as a follow-up effort, also under the Comptroller General's authority.² This letter summarizes briefings that we provided to the staffs of the Senate Committee on Banking, Housing, and Urban Affairs and the House Financial Services Committee (see enc. I for the briefing slides). Our objectives were to (1) identify the key characteristics of the cooperative model, (2) discuss the cooperative model's potential role as part of any long-term structural reform option for the enterprises, (3) discuss some likely advantages and disadvantages of the cooperative model as a potential reform option for the enterprises, and (4) identify some of the key decisions that Congress and the administration would have to make to initiate overall structural reform for the enterprises and design an effective transition process.

To address our objectives, we reviewed and analyzed reports, studies, and other information on the cooperative model and the characteristics of its structure. We also interviewed officials from FHFA; the Federal Home Loan Bank System (FHLBank System), another government-sponsored housing enterprise that is a cooperative; and the Farm Credit Administration (FCA), which regulates another government-sponsored enterprise that also has a cooperative structure, the Farm Credit System (FCS).³ We also reviewed and analyzed prior GAO and other reports and studies on varying structural reform options for the enterprises to determine how, if at all, the cooperative model could apply. Finally, we interviewed select industry groups, market participants, and experts to get their views on the potential advantages and disadvantages of structuring Fannie Mae and Freddie Mac as cooperatives and on transition issues.

We conducted our work from January 2010 through September 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

²GAO, *Fannie Mae and Freddie Mac: Analysis of Options for Revising the Housing Enterprises' Long-term Structures*, GAO-09-782 (Washington, D.C.: Sept. 10, 2009). In addition to fulfilling congressional mandates and requests, GAO also conducts work initiated under the Comptroller General's authority on current or emerging issues that may affect the nation's future or that are of broad interest to Congress.

³The 12 FHLBanks that compose the FHLBank System are owned by member financial institutions located in each FHLBank's respective district. The cooperative structure, among other benefits, gives members access to low-cost loans (advances) and other financial services. Each FHLBank is privately capitalized and governed by a board of directors. The FHLBanks are jointly and severally liable for the consolidated financial obligations of other FHLBanks. FCS, which is composed of 93 banks and associations, is a cooperative owned by its borrowers and affiliated associations. The banks and associations each have their own boards of directors and are also jointly and severally liable for obligations issued by other FCS banks, including payments of interest or principal on consolidated systemwide obligations. In addition, each is required to maintain a permanent capital level of at least 7 percent of risk-adjusted assets.

Background

Congress established Fannie Mae and Freddie Mac in 1968 and 1989, respectively, as for-profit, shareholder-owned corporations.⁴ Their primary mission has been to help provide a secondary mortgage market for conventional conforming loans and thereby to enhance liquidity in housing finance. To do so, they issue debt in financial markets and use the proceeds to purchase mortgages that meet their underwriting standards from primary mortgage lenders that can use the proceeds to originate additional mortgages. The enterprises either hold the mortgages in their portfolios or package them into mortgage-backed securities (MBS) that are sold to investors. In exchange for a fee (the guarantee fee), the enterprises guarantee the timely payment of interest and principal on MBS that they have issued.

While the enterprises operated profitably for many years, their structures have long been in question. For example, some commentators have stated that the federal government's sponsorship conveyed certain financial and other advantages to the enterprises that encouraged them to engage in riskier activities than otherwise would have been the case. In particular, even though the enterprises' statutory charters explicitly state that the federal government does not guarantee their debt and MBS and the enterprises are not included in the federal budget, there was an assumption in financial markets of an "implied" federal guarantee, which enabled the enterprises to borrow at lower rates than other for-profit corporations. Critics argued that this implicit government guarantee and access to less costly credit created a moral hazard. That is, it encouraged the enterprises to assume greater risks and hold less capital than would have been the case in the absence of such a guarantee. At the same time, we and others have previously said that the fragmented financial regulatory system that was in place for many years was not designed to adequately oversee such large and complex financial institutions.⁵

Over the years, the enterprises engaged in potentially profitable but risky activities that were complex to manage and, in some cases, resulted in significant financial losses. Beginning in the 1990s, both Fannie Mae and Freddie Mac rapidly increased the size of their retained mortgage portfolios. While potentially more profitable than their MBS guarantee business, large retained mortgage portfolios exposed the enterprises to potential losses if interest rates fluctuated. When the enterprises issued MBS, however, investors assumed the risks associated with fluctuations in interest rates. Further, in 2004, the enterprises began to rapidly increase their purchases of mortgages and mortgage assets with questionable underwriting standards. For example, the enterprises increasingly purchased Alt-A mortgages that typically did not have documentation of key items such as borrowers' incomes, and packaged these mortgages into MBS for sale to investors. In addition, the enterprises increased their purchases of private-label MBS (i.e., MBS collateralized by subprime mortgages) and retained an increasing number of these securities in their mortgage

⁴Congress initially chartered Fannie Mae in 1938 but did not establish it as a shareholder-owned corporation until 1968. Congress initially established Freddie Mac in 1970 as an entity within the FHLBank System and reestablished it as a shareholder-owned corporation in 1989.

⁵See GAO, *Housing Government Sponsored Enterprises: A New Oversight Structure Is Needed*, [GAO-05-576T](#) (Washington, D.C.: Apr. 21, 2005).

portfolios.⁶ By the end of 2007, the enterprises collectively held more than \$313 billion in private-label MBS, of which \$94.8 billion was held by Fannie Mae and \$218.9 billion by Freddie Mac. When the housing market began to decline sharply in 2007 and 2008, the enterprises lost billions of dollars on their guarantees to investors in MBS collateralized by Alt-A loans. In addition, significant losses were also incurred on their investments in private-label MBS.

In July 2008, Congress passed and the President signed the Housing and Economic Recovery Act of 2008 (HERA), which, among other things, established the FHFA, and charged it with the supervisory and regulatory oversight of Fannie Mae and Freddie Mac.⁷ In response to growing concerns that the enterprises' deteriorating financial condition would destabilize the financial markets, in September 2008, FHFA placed the enterprises in conservatorships. As provided in HERA, Treasury also entered into agreements with Fannie Mae and Freddie Mac to maintain the enterprises' net worth by purchasing their preferred shares on a quarterly basis. As of September 2010, Treasury had purchased about \$150 billion of their preferred shares. In November 2008, the Federal Reserve implemented a program to purchase up to \$1.25 trillion in the MBS and debt of the enterprises to help stabilize the housing finance system.

While the conservatorships can remain in place indefinitely as efforts are undertaken to stabilize the enterprises and restore confidence in financial markets, FHFA has said that the conservatorships were not intended to be permanent. Over the long term, Congress and the administration will face difficult decisions on how to restructure the enterprises and promote housing opportunities while limiting risks to taxpayers and the stability of financial markets. In September 2009, we issued a report that identified several proposed long-term structural reform options for the enterprises.⁸ These options generally fall along a continuum, with some overlap in key areas:

- *Establish the enterprises as government corporations or agencies.* Under this option, the government corporation or agency would focus on purchasing qualifying mortgages and issuing MBS but would not have mortgage portfolios.
- *Reconstitute the enterprises as for-profit corporations with government sponsorship and additional restrictions.* While restoring the enterprises to their previous status, this option would add controls to minimize risk. For example, it would eliminate or reduce mortgage portfolios and establish executive compensation limits.
- *Privatize or terminate them.* This option would abolish the enterprises in their current form and disperse mortgage lending and risk management throughout the private sector. Some proposals involve the establishment of a federal mortgage insurer to help protect mortgage lenders against catastrophic mortgage losses.

⁶ Subprime lending generally involves the origination of mortgages to borrowers who may represent greater default risks than prime borrowers—for example, borrowers with lower credit scores—on terms that may increase the potential for default. A common subprime mortgage product would be an adjustable rate mortgage with an initially low interest rate that increases substantially after a certain period. In the years leading up to the financial crisis, many such subprime mortgages were pooled and sold to investors as private-label MBS.

⁷ Pub. L. No. 110-289, Div. A, Title I, 122 Stat. 2654, 2658 (2008).

⁸ See [GAO-09-782](#).

In our September 2009 report, we also analyzed these three options in terms of their potential capacity to achieve key housing mission and safety and soundness objectives, and identified trade-offs among the various options. For example, a government corporation or agency may mitigate the safety and soundness and systemic risk concerns of the traditional GSE structure. That is, it would eliminate the concern that profit-maximizing corporations would be able to operate with relatively low levels of capital and take excessive risks because of an implied federal guarantee that undermined market discipline. And if a government corporation or agency were to focus on MBS issuances and not retain a mortgage portfolio, then it would be less complex and potentially less risky than the GSEs were. Nevertheless, a government corporation or agency may find successfully managing a large conventional mortgage purchase and MBS issuance business to be challenging. As described in our previous work on the Federal Housing Administration, which insures mortgages meeting its underwriting criteria, government entities may lack the financial resources to attract highly skilled employees and obtain information technology to manage complex business activities.⁹ The failure to adequately manage the associated risks also could result in significant losses for taxpayers.

Subsequently, Congress and the administration have initiated debate and analysis of the various reform options for the enterprises and the housing finance system. For example, congressional committees have held a number of hearings on the topic of government-sponsored enterprises and housing finance system reform. In April 2010, Treasury and the Department of Housing and Urban Development issued a set of questions for public comment on the future of the housing finance system that received more than 300 responses from a broad cross section of consumer groups, industry groups, market participants, the general public, think tanks, and others. It is likely that Congress and the administration will further consider proposals to reform the enterprises' long-term structures during 2011.¹⁰

Summary

A cooperative is generally defined as an entity that is jointly owned and controlled by the members that use its services. The members—such as businesses—finance and operate the cooperative for their mutual benefit and, by working together, can potentially reach an objective that would be unattainable if acting alone. Cooperatives often involve participants in a single industry that have common economic interests and goals and that undertake joint activities such as marketing, purchasing supplies and equipment, and providing certain services. Typically, cooperatives are governed by a board of directors that is elected by the members. Cooperatives may acquire capital through membership fees or members' stock purchases, withholdings from members' net earnings, assessments on the members' sales or purchases, or a combination of these. Therefore, procedures have to be established to determine the role of members in cooperatives' corporate governance and their required

⁹See GAO, *Federal Housing Administration: Modernization Proposals Would Have Program and Budget Implications and Require Continued Improvement in Risk Management*, [GAO-07-708](#) (Washington, D.C.: June 29, 2007), and *Information Technology: HUD Needs to Strengthen Its Capacity to Manage and Modernize Its IT Environment*, [GAO-09-675](#) (Washington, D.C.: July 31, 2009).

¹⁰Section 104 of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires Treasury to study and submit a report and recommendations to Congress on the government's role in the housing finance system, among other things, by January 31, 2011. Pub. L. No. 111-203, § 1074, 124 Stat. 2067 (2008).

capital contributions in the cooperatives. Two government-sponsored enterprises have a cooperative structure—the FHLBank System and FCS.

As indicated in our September 2009 report, the cooperative model is generally viewed as a component of the three larger reform options (government corporation or agency, reconstituted GSE, or privatization or termination) rather than an option by itself. While the cooperative model could conceivably fall under any of the options, it is generally seen as most closely associated with the reconstituted GSE option. Under this option, the enterprises could be established as privately owned entities that would generally focus on purchasing qualifying mortgages from lenders and issuing MBS, which would benefit from explicit federal financial guarantees. These private entities could be structured as cooperatives owned by mortgage lenders, shareholder-owned corporations as is the case today, or possibly as nonprofits. In contrast, the cooperative model is generally not viewed as integral to establishing a government corporation or agency to replace the enterprises. As a public entity, a government corporation or agency would not likely be capitalized by lenders, nor would they likely have a role in its governance or operations. And while lenders may choose to form cooperatives if the enterprises are privatized or terminated, this decision would likely depend on whether they decide that doing so is in their economic interests.

One potential benefit of the cooperative model, as cited by proponents, is that it would encourage safer and sounder mortgage underwriting practices. For example, as the owners of the cooperatives, lenders might have financial incentives to help ensure that the mortgages sold to the cooperatives were properly underwritten in order to minimize potential losses that would adversely affect their capital investments. However, a cooperative model does not necessarily guarantee safe and sound operations. In recent years, several FHLBanks have experienced significant losses on their investments in nontraditional mortgage assets such as private-label MBS, and FCS suffered significant losses during the 1980s because of poor lending practices, and the federal government ultimately authorized financial support for the system. Another potential advantage of the cooperative model is that a limited number of such entities could promote mortgage underwriting standardization and consistency if members use common forms, rules, and procedures. But some observers have noted that a potential disadvantage of the cooperative model is that the time that could be needed for members to reach consensus on key business decisions could result in delays in their implementation. Consequently, these observers question whether the cooperative model would be well suited to meeting the requirements of complex and dynamic secondary mortgage market functions. Moreover, consistent with the discussion in our September 2009 report regarding proposals to establish multiple GSEs to replace the enterprises, multiple cooperatives could lead to fragmentation in mortgage and housing finance.

Reforming the enterprises' long-term structure requires Congress and the administration to make key decisions on the appropriate reform option, the mission of the entity or entities, and the oversight framework. If the new structure includes the cooperative model, a number of decisions would also have to be made on the number of cooperatives that would be formed and their membership requirements, governance and capital structures, and permitted business activities. Key transition issues would also include

- ensuring that the entity or entities replacing the enterprises have sufficient resources, staffing, and technology to carry out their responsibilities and

- if applicable, determining the best means and time frames for lenders to establish cooperatives.

Moreover, regulators would need the authority, expertise, and resources to manage a potentially lengthy transition process while minimizing the risk to housing markets.

Agency Comments and Our Evaluation

We provided a draft of this correspondence to FHFA for its review and comment. FHFA provided technical comments that we incorporated as appropriate. Further, we requested comments on selected excerpts of this draft correspondence from FCA and an industry observer whom we interviewed and whose remarks we cited. Generally, both FCA and the industry observer indicated their agreement with the excerpts of the draft correspondence and FCA provided other technical comments that we incorporated as appropriate.

We are sending copies of this correspondence to interested Members of Congress and the Acting Director of FHFA. In addition, this report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (202) 512-8678 or shearw@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Major contributors to this report were Wesley Phillips, Assistant Director; Michelle Bowsky; Emily Chalmers; Shamiah Kerney; and Paul Thompson.



William B. Shear
Director, Financial Markets and
Community Investment

Enclosure

List of Committees

The Honorable Christopher J. Dodd
Chairman
The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Joseph I. Lieberman
Chairman
The Honorable Susan M. Collins
Ranking Member
Committee on Homeland Security and Governmental Affairs
United States Senate

The Honorable Tim Johnson
Chairman
The Honorable Mike Crapo
Ranking Member
Subcommittee on Financial Institutions
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Robert Menendez
Chairman
The Honorable David Vitter
Ranking Member
Subcommittee on Housing, Transportation and Community Development
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Barney Frank
Chairman
The Honorable Spencer Bachus
Ranking Member
Committee on Financial Services
House of Representatives

The Honorable Edolphus Towns
Chairman
The Honorable Darrell Issa
Ranking Member
Committee on Oversight and Government Reform
House of Representatives

The Honorable Paul E. Kanjorski
Chairman
The Honorable Scott Garrett
Ranking Member
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Committee on Financial Services
House of Representatives

The Honorable Luis V. Gutierrez
Chairman

The Honorable Jeb Hensarling
Ranking Member

Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
House of Representatives

The Honorable Maxine Waters
Chairwoman

The Honorable Shelley Moore Capito
Ranking Member

Subcommittee on Housing and Community Opportunity
Committee on Financial Services
House of Representatives



The Cooperative Model as a Potential Component of Structural Reform Options for Fannie Mae and Freddie Mac

Briefing to Congressional Committees

Introduction

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- The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (the enterprises) are two housing government-sponsored enterprises (GSE). That is, as described in this briefing, the enterprises are private corporations owned by shareholders that derive certain benefits from their federal sponsorship such as advantageous borrowing costs.
 - The enterprises support housing finance by establishing secondary mortgage markets for what are known as conventional conforming loans. They do so by issuing debt and purchasing mortgages and related instruments that meet their underwriting criteria from lenders that can use the proceeds to make additional loans. The enterprises either package the mortgages to create mortgage-backed securities (MBS) that are sold to investors or hold these mortgages, or the MBS, in their retained portfolios.
 - Because of the enterprises' mounting losses on subprime mortgage assets, in September 2008, the Federal Housing Finance Agency (FHFA) placed them into conservatorships out of concern, among other things, that their deteriorating financial condition could potentially destabilize financial markets.

Introduction

- The Department of the Treasury (Treasury) has pledged to provide the enterprises with substantial assistance to stabilize their financial condition and, as of September 2010, had purchased about \$150 billion of their preferred shares. The Congressional Budget Office estimates that the conservatorships could cost taxpayers nearly \$400 billion over 10 years.
- While the conservatorships are in place to help stabilize Fannie Mae and Freddie Mac and restore confidence in financial markets, they are not intended to be permanent.
- Industry participants and others agree that Congress and the administration need to reevaluate the enterprises' roles, structures, and performance and consider options to facilitate mortgage finance while mitigating concerns about safety and soundness and systemic risk.

Introduction

- A September 2009 GAO report analyzed the long-term structural reform options for the enterprises.¹ These options included (1) establishing a government agency or corporation; (2) reestablishing the enterprises as GSEs, but with additional restrictions on their activities; and (3) privatizing or terminating them.
- Subsequently, Congress and the administration have initiated debate and analysis of various reform options for the enterprises as well as for the housing finance system generally.
- One proposal that has generated some interest among industry participants, Congress, and others is referred to as the cooperative model. Under this model, the enterprises would be converted from their current structure as shareholder-owned corporations with government sponsorship into cooperative entities owned by mortgage lenders.

¹GAO, *Fannie Mae and Freddie Mac: Analysis of Options for Revising the Housing Enterprises' Long-term Structures*, GAO-09-782 (Washington, D.C.: Sept. 10, 2009).

Objectives

- This review is a follow-up to our September 2009 report on enterprise reform options. We conducted this performance audit under the Comptroller General's authority. Our objectives for this review are to
 - identify the key characteristics of the cooperative model,
 - discuss the cooperative model's potential role as part of any long-term structural reform option for the enterprises,
 - discuss some likely advantages and disadvantages of the cooperative model as a potential reform option for the enterprises, and
 - identify some of the key decisions that Congress and the administration would have to make to initiate overall structural reform for the enterprises and design an effective transition process.

Summary

- A cooperative is an entity that is owned, capitalized, and operated by its members, usually participants in a particular industry, such as banks, for their mutual benefit. Examples of other cooperatives that are also GSEs include the Federal Home Loan Bank (FHLBank) System and the Farm Credit System (FCS).
- As indicated in our September 2009 report, the cooperative model is generally viewed as a component of the three overall structural reform options for the enterprises (government corporation or agency, reconstituted GSEs, and privatization or termination), rather than an option by itself. While the cooperative model could conceivably fall under any of the three overall options, it is generally seen as most closely associated with the option of reconstituting them as GSEs. Under this option, the entity or entities that replace the enterprises would be privately owned and conduct secondary mortgage market operations with explicit financial support from the federal government. Such private entities could be owned by lenders under the cooperative model, through shareholders, as is the case with the enterprises today, or on a nonprofit basis.

Summary

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- One potential benefit of the cooperative model, as cited by proponents, is that it would encourage safer and sounder mortgage underwriting practices as lenders could potentially lose some or all of their capital investments in a cooperative to which they sell mortgages. However, a cooperative model does not necessarily guarantee safe and sound operations. In recent years, several FHLBanks have experienced significant losses on nontraditional mortgage assets, and FCS suffered significant losses during the 1980s because of poor lending practices. A potential disadvantage of the cooperative model, as cited by some observers, is that, because of the time that may be needed to reach consensus among its members, it may not be well suited to meeting the requirements of the dynamic secondary mortgage market.
 - Congress and the administration would need to make key decisions on the appropriate overall structural reform option, the mission of the entity or entities, and the oversight framework. If the new structure includes the cooperative model, a number of decisions would also have to be made on the number of cooperatives that would be formed and their membership requirements, governance and capital structures, and permitted business activities. Moreover, regulators would need the authority, expertise, and resources to manage a potentially lengthy transition process while minimizing the risk to housing markets.

Background

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- Fannie Mae was originally established in 1938 as a government entity, and later chartered as a for-profit, shareholder-owned corporation in 1968. Similarly, Freddie Mac was established in 1970 as an entity within the FHLBank System and reestablished as a shareholder-owned corporation in 1989.
 - The enterprises' primary mission has been to create secondary markets for conventional conforming mortgages (i.e., mortgages not insured or guaranteed by other federal agencies such as the Federal Housing Administration or the Department of Veterans Affairs). They do so by issuing debt and purchasing mortgages that meet their underwriting criteria from primary lenders, such as banks, which can use the proceeds to make additional loans. The enterprises either package the mortgages to create mortgage-backed securities (MBS) that are sold to investors or hold the mortgages or MBS in their retained portfolios.
 - Pursuant to their charters and legislation, the enterprises are required to serve the mortgage needs of targeted groups, such as low-income borrowers, and expected to support mortgage finance during both good and bad economic periods.

Background

- Fannie Mae and Freddie Mac operated profitably for many years, but observers have noted that federal sponsorship came with financial and other advantages that undermined market discipline and encouraged risky activities.
- In particular, despite the explicit statement in their statutory charters that the enterprises did not have a federal guarantee on their debt and MBS, financial markets have long viewed them as benefiting from an implied federal guarantee. The implied guarantee allowed the enterprises to borrow funds at relatively low interest rates and to operate with lower capital levels than commercial banks. Further, they had incentives to engage in potentially profitable but risky activities that were not necessarily consistent with their housing missions.
- For example, the enterprises' large mortgage portfolios exposed them to interest rate risk and were complex to manage.
- GAO and others have also stated that the fragmented regulatory structure overseeing the enterprises for many years was inadequate, given their size and complexity.

Background

- In the 2000s, the enterprises began losing market share as subprime and Alt-A (i.e., nontraditional mortgages) lending increased, along with the market for private-label MBS that were generally backed by pools of nontraditional mortgages.
- In response, the enterprises increased their purchases of Alt-A mortgages, which they packaged into MBS with guaranteed principal and interest payments, as well as private-label MBS for their own portfolios.
- When the housing market began to decline sharply in 2007 and 2008, the enterprises began losing billions of dollars on these investments. And as home prices declined, their exposure on their guarantees of prime mortgage assets increased.

Background

- In response to growing concerns about the financial condition of the enterprises, in July 2008, Congress passed and the President signed the Housing and Economic Recovery Act of 2008 (HERA), which, among other things, established FHFA, and charged it with the supervisory and regulatory oversight of Fannie Mae and Freddie Mac. In September 2008, FHFA appointed itself as their conservator.²
- Under authority provided in HERA, Treasury entered into agreements with the enterprises to maintain the enterprises' net worth through purchases of their preferred shares on a quarterly basis.
- Treasury initially set a \$100 billion cap on the amount of preferred shares it would purchase from each enterprise. Treasury later raised the cap to \$200 billion per enterprise in February 2009 and substantially raised the cap in December 2009. Under the agreement, Treasury can continue to purchase preferred shares indefinitely.
- In November, 2008, the Federal Reserve announced a program to purchase up to \$500 billion in the MBS guaranteed by the enterprises, and increased this amount in March 2009 up to a total of \$1.25 trillion. It may also purchase up to \$100 billion in direct obligations.

²Among its recent actions, in June 2010, FHFA delisted the enterprises' stock from all national securities exchanges.

Scope and Methodology

To help address our objectives, we took the following actions:

- We reviewed and analyzed reports, studies, and other information on the cooperative model and characteristics of its structure, including the organization, governance and capitalization. We interviewed Farm Credit Administration and FHFA officials on characteristics of certain cooperatives, such as FCS and the FHLBank System, and the potential relevance of these characteristics to the enterprises.
- We reviewed and analyzed reports, studies, and other information on the structural reform options for the enterprises to determine how, if at all, the cooperative model could fit into these options.
- We reviewed previous work we reported in September 2009 and interviewed select industry groups, market participants, and experts on their views regarding the potential advantages and disadvantages of structuring Fannie Mae and Freddie Mac as cooperatives.
- We assessed the cooperative model against objectives identified in the September 2009 report, particularly safety and soundness objectives.

Scope and Methodology

- We built upon previous work and collected other information on the decisions that policymakers will have to make regarding overall structural reform for the enterprises and designing a transition process to a new enterprise structure.
- We conducted our work from January 2010 through September 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.



Objective 1 Cooperatives Are Intended to Operate for Members' Mutual Benefit

- In general, a cooperative is an enterprise that is jointly owned and controlled by the members who use its services. The members capitalize and operate the cooperative for their mutual benefit, and work together to reach an objective, such as access to financing, which may be difficult if acting alone.
- Cooperatives often involve participants in a single industry that have common economic interests and goals. Members of cooperatives may undertake joint activities such as marketing, purchasing supplies and equipment, and providing certain services.³
- Cooperatives in the United States date back to the mid-1700s starting in the insurance industry. From about 1890 to 1920, cooperatives flourished in the farming industry, and have more recently expanded to the financial services and housing industries.⁴

³Henehan, Brian M. and Bruce L. Anderson, *Considering Cooperation: A Guide for New Cooperative Development*, February 2001.

⁴United States Department of Agriculture, *Coops 101: An Introduction to Cooperatives*, June 1997.

Characteristics of Cooperatives

- Cooperatives are characterized by their organization, governance, and methods of capitalization.
 1. Cooperatives are owned and managed by the entities they serve, which benefit from their participation.
 2. Like many corporations, cooperatives are governed by a board of directors. Members generally elect the board and may vote on major organizational issues.
 3. Cooperatives may acquire capital through membership fees or members' stock purchases, withholdings from members' net earnings, assessments on the members' sales or purchases, or a combination of these.
 4. Cooperative members' ownership shares in the cooperative are nontransferable.
- The FHLBank system and FCS are cooperatives that are also GSEs (see slides 16 and 17). One difference between the FHLBank System and FCS and other cooperatives is that they were created and organized through federal legislation and subsequent regulations. Other cooperatives may have been formed independently by members of a particular industry.

Example of Cooperative Model—The Federal Home Loan Bank System

Mission	Organization	Governance	Capitalization
<p>The mission of the FHLBank System is to support residential mortgage lending and related community investment and extend credit through member financial institutions.</p>	<p>The 12 FHLBanks that compose the FHLBank System issue debt on a consolidated basis via their Office of Finance. Each FHLBank is jointly and severally liable for the FHLBanks' consolidated financial obligations in the event of a default.</p> <p>Each FHLBank is owned by member financial institutions in its district. The members are typically insured depositories such as banks and thrifts. Benefits of FHLBank membership include access to low-cost loans (known as advances) and payment of dividends.</p>	<p>The 12 FHLBanks are each separate legal entities governed by boards of directors that are elected by the membership. The board includes independent directors that are not associated with the FHLBank. Laws and regulations pertaining to FHLBank directors are designed to help ensure that large members do not dominate the board (e.g., board representation is not based on volume of business with the FHLBank).</p>	<p>The 12 FHLBanks are privately capitalized. Eligible financial institutions invest stock in their FHLBank to become members. The stock is not publicly traded, and is valued at par. Two classes of stock are allowed, each subject to various restrictions on capital redemption. The stocks generally cannot be redeemed for a period of 6 months or 5 years for Class A and Class B stock, respectively.</p>

Source: GAO.



Example of Cooperative Model—The Farm Credit System

Mission	Organization	Governance	Capitalization
<p>The mission of the Farm Credit System is to provide credit and financially related services to farmers, ranchers, producers, or harvesters of aquatic products, farmer-owned cooperatives, and rural homeowners, businesses and communities.</p>	<p>As of January 2010, FCS included 93 banks and associations—5 Farm Credit banks, 85 Agricultural Credit associations, and 3 stand-alone Federal Land Credit associations. In addition, the Federal Farm Credit Banks Funding Corporation issues and markets debt securities to raise loan funds for the banks and associations.</p> <p>FCS associations are cooperatives owned by their borrowers, and Farm Credit banks are cooperatives primarily owned by their affiliated associations.</p>	<p>Although jointly and severally liable, the banks and associations each have their own boards of directors composed of directors elected by the voting shareholders and at least one outside director. Each bank and association manages and controls its own business activities, operations, and financial performance. The Farm Credit Act and FCA regulations and guidance establish criteria for the management of FCS banks and institutions.</p>	<p>FCS banks and associations are subject to varying capital requirements. For example, they are required to maintain a permanent capital level of at least 7 percent of their risk-adjusted assets.</p>

Source: GAO.

Objective 2 Cooperative Model Is a Component of Structural Reform Options for the Enterprises

- Generally, Congress and the administration are considering various reform options for the enterprises, including the three options that GAO discussed in its September 2009 report: creating a new government corporation or agency, reestablishing for-profit enterprises with government sponsorship but with additional restrictions on their activities, or privatizing or terminating them (see slide 19).
- Each of the options would function differently, and each would involve trade-offs (see slide 20).
- As indicated in our report, the cooperative model is generally viewed as a component of these larger options rather than an option by itself.
- While the cooperative model could conceivably fall under any of the three overall options, it is generally seen as most closely associated with the option of reconstituting the GSEs.



Summary of Options to Revise the Enterprises' Structures

Potential structure	Proposed function
Government corporation or agency	Focus on purchasing qualifying mortgages and issuing MBS but eliminate mortgage portfolios, which are complex to manage and can result in losses because of fluctuations in interest rates. Responsibilities for promoting home ownership for targeted groups could be transferred to the Federal Housing Administration (FHA).
Reestablish for-profit enterprises with government sponsorship	Restore the enterprises to their preconservatorship status but add controls to minimize risk. These controls might include eliminating or reducing the enterprises' mortgage portfolios or subjecting the enterprises to public utility-type regulation, which involves business activity restrictions, profitability limits, and executive compensation limits. Potentially convert enterprises from shareholder-owned corporations to cooperative associations owned by mortgage lenders.
Privatization or termination	Abolish the enterprises and disperse mortgage lending and risk management throughout the private sector. Potentially establish a federal mortgage insurer to help protect mortgage lenders against catastrophic mortgage losses.

Source: GAO-09-782.

Structural Reform Options Involve Trade-offs

Potential structure	Potential trade-offs
Government corporation or agency	This option could mitigate some of the safety and soundness risks and may have some advantages over private entities in terms of supporting housing finance during periods of economic stress. However, it is not clear whether government corporations would be able to obtain the resources and staffing necessary to manage a potentially complex secondary mortgage market function. A government corporation may need sufficient flexibility in its operations to be able to meet these challenges.
Reestablish for-profit enterprises with government sponsorship	While this option may represent the least potential change in the current housing finance structure and thus help ensure continuity, it has potential risks from a safety and soundness standpoint. For example, if the federal government explicitly guaranteed certain financial obligations of reconstituted GSEs, it could further undermine market discipline. Proponents believe that eliminating or reducing their mortgage portfolios may minimize potential safety and soundness risks.
Privatization or termination	This option could mitigate potential safety and soundness risks by helping ensure mortgage underwriting decisions are based on market factors. However, the federal government may need to support a largely privatized mortgage lending industry in a financial crisis, as lenders may withdraw from the market in such a situation.

Source: GAO-09-782.



Cooperative Model Is Most Closely Associated with Reconstituting the Enterprises as GSEs

- Proponents of reestablishing the enterprises as GSEs generally favor establishing a private entity or entities, which would issue MBS, be federally guaranteed, and perhaps have mortgage portfolios.
- The potential ownership structures for these private entities could be shareholder-owned (similar to the enterprises' current structure), cooperatives, or perhaps nonprofit.
- It has also been proposed that the enterprises be subject to public utility regulation. That is, a regulatory agency could issue regulations governing their activities and rate of return (profitability). Likewise, the ownership of such entities could also be the cooperative model or shareholder owned.



Cooperatives Are Not Viewed as Integral to the Government Corporation or Agency Option

- As a public entity, a government corporation or agency would not likely be capitalized by lenders, nor would they likely have a role in its governance or operations, as is the case with cooperatives.
- It is conceivable that Congress and the administration could also choose to organize lenders into cooperatives that would then sell mortgages to a government corporation or agency.
- However, such lender-owned cooperatives are not viewed as integral to the government corporation or agency option. Ginnie Mae—the Government National Mortgage Association—is a government corporation that guarantees the timely payment of principal and interest on MBS collateralized by pools of mortgages that are guaranteed or insured by FHA or the Department of Veterans Affairs. Lenders, rather than Ginnie Mae, issue MBS on which it guarantees the payment of principal and interest, and these lenders are not members of cooperatives.

Privatization Option Could Involve Cooperatives but Would Depend on Market Factors

- Proponents of privatizing or terminating the enterprises generally believe that mortgage lending should be dispersed throughout the banking system and based on market considerations rather than government support or subsidies.
- While lenders may choose to form cooperatives in the event the enterprises are privatized or terminated, this decision would likely depend on whether they decide that doing so is in their economic interests.
- One observer we contacted suggested that Congress and the administration could facilitate the establishment of lender-owned cooperatives in conjunction with a decision to privatize or terminate the enterprises. This observer stated that organizing mortgage lenders as cooperatives might be one means to help ensure the enterprises' safety and soundness because lenders' capital would be at risk through their participation in the cooperative.

Objective 3 Potential Advantages of Cooperative Model

- As discussed, a potential advantage of the cooperative model, as cited by proponents, is that it would promote safer and sounder mortgage underwriting practices. Proponents note that lenders would have financial incentives to engage in sound mortgage underwriting because, if they do not, then poorly underwritten mortgage loans sold to the cooperatives could result in significant losses. Ultimately, those losses could adversely affect the capital investments that lenders have in such cooperatives.
- However, a cooperative model does not necessarily guarantee safe and sound operations. Several FHLBanks have recently suffered significant losses because of their investments in nontraditional mortgage assets (e.g., private-label MBS collateralized by Alt-A and subprime mortgages) for their investment portfolios, and FCS suffered significant losses in the 1980s because of poor lending practices. The federal government provided financial assistance to FCS to help address these losses.

Potential Advantages of Cooperative Model (continued)

- Under the cooperative model, the potential also exists that recapitalization could occur more quickly than with other structures. For example, the cooperative might have rules requiring its members under certain circumstances, subject to review and approval by their primary safety and soundness regulator, to invest additional capital if its capital levels are declining because of deteriorating financial conditions. Under the shareholder-owned model, the entity may face difficulties raising capital in financial markets in a financial emergency, as market participants may not be interested in investing capital in or providing loans to the entity.
- The potential also exists that a limited number of cooperatives could promote standardization and consistency within the housing finance system because such cooperatives would likely have common forms, rules, and procedures.



Potential Disadvantages of Cooperative Model

- Because of cooperatives' structure, some observers believe that cooperatives can take an extended period to achieve consensus on key business issues as compared with individual companies because all members are involved in making the final decisions. As a result, some question whether the cooperative model and any associated delay in decision making would be well suited for complex and dynamic secondary mortgage market functions.
- Consistent with the discussion of establishing multiple GSEs in our September 2009 report, multiple cooperatives could lead to fragmentation of the housing finance system. Some observers believe that a key benefit of the enterprises' activities has been that they have helped create a nationwide housing finance system, which includes deep and liquid markets for their MBS and debt securities.

Potential Disadvantages of Cooperative Model (continued)

- Some observers also believe that large lenders could potentially dominate any cooperative that is established to replace the enterprises in their current structure. While cooperatives may have rules in place to limit the influence of large members, such as elections based on one vote per member rather than the volume of business each member does with the cooperative, some observers believe that large members may still circumvent such rules through their sheer size. Concerns about consolidation within the mortgage industry have grown in recent years as many lenders have failed and the remaining lenders have acquired their business. As of year end 2009, the top five mortgage lenders accounted for about 62 percent of all mortgages outstanding.



Objective 4

Decisions on Enterprise Structural Reform Require Consensus on Key Issues

- Congress and the administration will need to discuss and analyze the merits and trade-offs of the overall reform options and agree on a preferred approach.
- During this process or subsequent to it, other key decisions will need to be made such as whether the entity or entities would
 - provide a secondary market function for a narrow range of conservatively underwritten mortgage products or seek to serve more potential borrowers and promote innovation and risk by expanding the range of mortgage products offered,
 - be responsible for and equipped to support the mortgage market in both good and bad economic periods, and
 - serve specific mortgage credit needs that provide benefits to targeted groups, such as low-income borrowers and renters.

Consensus Required on Key Issues (continued)

- Key decisions would also be required on such issues as
 - explicit federal guarantees on the entity or entities' financial obligations, such as their MBS;
 - granting the entity or entities permission to maintain mortgage portfolios and, if so, their size;
 - the appropriate capital structure and requirements, if applicable (not necessarily the case for a government corporation or agency option), for the entity or entities to help mitigate safety and soundness risks; and
 - the appropriate oversight framework for the entity or entities.



Decisions Necessary if Cooperative Model Is Included in Overall Structural Reform

- As part of this process, if Congress and the administration decide that the cooperative model is an appropriate approach, among the decisions that would need to be reached are
 - the number of cooperatives that would be established;
 - the cooperatives' membership requirements;
 - the cooperatives' organization, governance, and capitalization structure;
 - the appropriate rules and regulations governing the cooperatives' involvement in secondary mortgage markets;
 - the appropriate oversight structure for the cooperatives to help ensure that they operate in a safe and sound manner and achieve their mission objectives.



Transition Considerations for the New Structure

- Once such decisions are finalized, a potentially lengthy transition process may be needed to move from the current situation, where the enterprises are in conservatorships, to the new structure, including cooperatives as applicable.
- Some key considerations in designing any transition process would include the following:
 - how to ensure the market viability of the new entity, particularly if reconstituted GSEs or termination/privatization are the preferred options, and
 - the process by which the new entity or entities will raise capital, if applicable (may not be applicable for government corporation or agency).

Transition Considerations for the New Structure (continued)

- Key transition issues would also include the following:
 - ensuring the entity or entities have sufficient resources, staffing, and technology to carry out their responsibilities, and
 - if applicable, determining the best means and time frames for lenders to establish cooperatives.
- Finally, consideration would also need to be given to ensuring that regulators have sufficient authority, resources, and technology to carry out their functions.

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