Order Code RS21663
Updated September 9, 2008

CRS Report for Congress

Government-Sponsored Enterprises (GSEs): An Institutional Overview

Kevin R. Kosar
Analyst in American National Government
Government and Finance Division

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 the arguments for and against GSEs. This report will be updated as events warrant.

What Is a Government-Sponsored Enterprise?

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). For the purpose of budgetary treatment, Congress has defined the term "government-sponsored enterprise" in the Omnibus Reconciliation Act of 1990 to refer to

> a corporate entity created by a law of the United States that —
> (A) (i) has a Federal charter authorized by law;
> (ii) is privately owned, as evidenced by capital stock owned by private entities or individuals;
> (iii) is under the direction of a board of directors, a majority of which is elected by private owners;
> (iv) is a financial institution with power to —
> (I) make loans or loan guarantees for limited purposes such as to provide credit for specific borrowers or one sector; and
> (II) raise funds by borrowing (which does not carry the full faith and credit of the Federal Government) or to guarantee the debt of others in unlimited amounts; and

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

(B) (i) does not exercise powers that are reserved to the Government as sovereign (such as the power to tax or to regulate interstate commerce);
(ii) does not have the power to commit the Government financially (but it may be a recipient of a loan guarantee commitment made by the Government); and
(iii) has employees whose salaries and expenses are paid by the enterprise and are not Federal employees subject to title 5.[2]

Few scholars of public administration and finance are likely to argue that this definition is incorrect. However, some have argued that the above definition omits an essential characteristic — a GSE "benefits from an implicit federal guarantee to enhance its ability to borrow money."[3]

Each GSE is created by Congress with its particular attributes defined in its enabling legislation and charter. Despite this diversity, there are at least four readily observable characteristics of GSEs: (1) private sector ownership, (2) limited competition, (3) activities limited by congressional charter, and (4) chartered privileges that create an inferred federal guarantee of obligations.

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."[4] 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.[5] 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.[6]

---

[2] 104 Stat. 1388-607, Sec. 13112; and 2 U.S.C. 622(8).

[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.

[4] 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.

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

[6] 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.

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, 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.[7]

How Many GSEs Exist?

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.[8]

What Are the 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.

Today, GSEs primarily act as financial intermediaries to assist borrowers in housing and agriculture. Although they are privately owned, they benefit financially from

---

[7] 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.

[8] 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.

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.[9] 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.

What Are the 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.[10]

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 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

---

[9] 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.

[10] 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. A former Secretary of Housing and Urban Development disagreed. "[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.

> government backing of Fannie Mae as sufficient indication of the quality of Fannie Mae obligations.[11]

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.[12]

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."[13] 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.[14] The for-profit nature of the GSE also means it has incentives to seek profits in product and service markets outside its government charter.[15]

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.[16] 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 outstanding in 2003.[17] GSE securities are held by both U.S. and foreign banks and

---

[11] As quoted in Stanton, *Government Sponsored Enterprises*, p. 35.

[12] 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: GAO 1994).

[13] 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.

[14] 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.

[15] For example, GSEs used their government privileges to raise funds for nonmortgage investments, a policy that has attracted the attention of GAO. See U.S. General Accounting Office, *Federal Oversight Needed in Nonmortgage Investments*, GAO/GGD-98-48 (Washington: GAO, 1998).

[16] 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.

[17] 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].

financial institutions. Therefore, some observers believe the failure of a GSE has the potential to create worldwide, destructive spillover effects.[18]

Subsidization. GSEs borrow money at significantly lower interest rates than competitors because of the inferred federal guarantee and the government-bestowed privileges. The Congressional Budget Office estimated this federal subsidy to the housing GSEs to be over $13.5 billion in the year 2000 alone.[19] This subsidy generates at least three major issues. Critics ask the following: (1) Is it is fair for the government to give GSEs an advantage over private banking firms?[20] (2) If the banking system no longer suffers from barriers to the free flow of credit, why continue to have GSEs? Why not, critics ask, evolve the GSEs into private companies, as was done with Sallie Mae?;[21] and (3) Are GSEs really the most efficient way to subsidize home purchases and agricultural activities? Would another policy be less costly?

Issues for Congress

On September 7, 2008, the U.S. Treasury placed two of the GSEs — Fannie Mae and Freddie Mac — into government conservatorship. Secretary of the Treasury, Henry M. Paulson, Jr., said that the agency did this to provide stability to financial markets, support the availability of mortgage finance, and protect taxpayers. He stated that policymakers now face the challenge of resolving "the systemic risk created by the inherent conflict in the GSE structure."[22]

The financial troubles of these two GSEs raise many questions: Are GSEs still needed? Should the GSE model be replaced with a different type of entity? Should GSEs' subsidies be provided in some other form? These are some of the questions that Congress may wish to consider.

---

[18] For example, see International Monetary Fund, *Global Financial Stability Report*, September 2003.

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

[20] U.S. Congressional Budget Office, *Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac* (Washington: CBO, 1996), p. xii.

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

[22] "Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers," press release, Sept. 7, 2008, available at [http://www.treas.gov/press/releases/hp1129.htm].