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LIMITING THE POSTAL SERVICE'S INTEREST RATE SUBSIDY; A LESSON FROM FANNIE MAE AND FREDDIE MAC ON WHAT WOULD WORK AND WHAT WOULD NOT

Executive Summary

Proposed Congressional legislation, the "Postal Accountability and Enhancement Act", would make major changes in the Postal Service's powers and the regulatory oversight it receives. (H.R. 4341 is the House version, and S. 2468 is the Senate version.)

Currently, the Postal Service, which is part of the federal government, borrows directly from the government at just slightly above the interest rate on Treasury securities. Because lenders think Treasuries are free of default risk, the Treasury interest rate is significantly lower than even the most credit worthy private-sector business can obtain.

One provision of H.R. 4341 and S. 2468 would try to make the Service pay a normal, unsubsidized market rate of interest when it borrows to finance products that the bills classify as competitive. The provision would require the Service to do its competitive-product borrowing in the private credit market and issue securities there that would carry no government guarantee. (For products sheltered by the Postal monopoly, the Service could continue borrowing directly from the government at just above the interest rate on Treasury securities.)

The proposal is well intentioned but unrealistic. Real-world experience with Government Sponsored Enterprises (GSEs) like Fannie Mae and Freddie Mac demonstrates that lenders would still believe a federal credit guarantee exists, albeit an implicit one. Hence, lenders would offer the Postal Service a lower interest rate than they would offer private-sector businesses of comparable riskiness.

Experience with GSEs like Fannie Mae and Freddie Mac also shows that an implicit government credit guarantee and the subsidized borrowing associated with it create economic problems. It would be foolhardy to establish another GSE-style problem, this time at the Postal Service.

A workable alternative would be to require the Postal Service to turn to the federal government when it wishes to borrow for its competitive-product activities and require the government to charge an interest rate pegged to what private-sector businesses are paying in the private credit market.

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LIMITING THE POSTAL SERVICE'S INTEREST RATE SUBSIDY; A LESSON FROM FANNIE MAE AND FREDDIE MAC ON WHAT WOULD WORK AND WHAT WOULD NOT

The Postal Service is part of the federal government ("an independent establishment of the executive branch of the Government"[1]), and it possesses government-granted monopolies on non-urgent letter delivery and on access to mailboxes. Earlier this year, House and Senate committees unanimously reported out legislation, the "Postal Accountability and Enhancement Act", that would make major changes in the Postal Service's powers and the regulatory oversight it receives. The House version of the proposed legislation is H.R. 4341, and the somewhat different Senate version is S. 2468.

Among their many features, H.R. 4341 and S. 2468 would roll back several of the indirect government subsidies (tax and fee exemptions and other government-based privileges) that the Postal Service now enjoys. An earlier IRET paper examined most of the proposed rollbacks and concluded they were desirable, although modest compared to the Postal Service's array of indirect subsidies. (Michael Schuyler, "Legislative Proposals Would Modestly Trim Some Hidden Government Subsidies To Postal Service," *IRET Congressional Advisory*, No. 176, July 15, 2004) It left for this paper an evaluation of one proposed rollback, which concerns the interest rate that the Postal Service pays when it borrows funds.

Currently, the Service uses its government status to borrow at a government-subsidized interest rate – just 1/8th percentage point above the interest rate on new marketable Treasury securities of comparable maturity. Because lenders regard Treasuries as being free of default risk, the Treasury interest rate is significantly lower than even the most credit worthy private-sector business can obtain. H.R. 4341 and S. 2468 seek to end the interest rate subsidy in cases where the Postal Service borrows for products that the bills classify as competitive.

This provision may superficially give the appearance of ending the interest rate subsidy on products classified as competitive. Unfortunately, the provision would not achieve its objective and could cause serious harm because it ignores an important lesson taught by Government Sponsored Enterprises (GSEs) like Fannie Mae and Freddie Mac. Government credit guarantees can exist and result in significantly lower borrowing costs even if they are only *implicit*. Although the provision is defective in its current form, it could be corrected to meet its goal, if Congress is willing.

Given how few days remain in this session of Congress, it is not clear if Congress will take up H.R. 4341 and S. 2468 when it reconvenes in September. However, postal issues are not going away. Whether Congress considers the bills this year or returns to the issue in a future year, it is desirable that legislative proposals be well crafted and strengthened where they are weak.

A look at Fannie Mae and Freddie Mac and their implicit interest rate subsidy. Fannie Mae and Freddie Mac are private companies with federal ties. On the one hand, they are large, stockholder-owned, for-profit companies that are listed on the New York Stock Exchange. On the other hand, they are Government Sponsored Enterprises (GSEs) that were chartered by Congress and given the mission of strengthening the secondary market for residential mortgages, especially for low- and moderate-income families. Fannie Mae and Freddie Mac receive several government-based privileges by statute: they are exempt from state and local income taxes; they are exempt from Securities and Exchange Commission (SEC) disclosure requirements and registration fees; banks can generally use Fannie's and Freddie's securities as collateral in place of Treasury securities; and they have credit lines ($2.25 billion each) at the U.S. Treasury.[2] The

President is also allowed to appoint several of their board members.

Federal law, though, expressly states that when Fannie and Freddie issue securities in the credit market, those securities are not debts of the federal government and are not guaranteed by the government. As directed by law, the companies include that disclaimer in their prospectuses. Nevertheless, based on Fannie and Freddie's mission and other governmental ties, many creditors believe that an implicit guarantee exists, under which the federal government would rescue GSEs like Fannie Mae and Freddie Mac if those institutions were to encounter severe financial problems. In Congressional testimony, Treasury Secretary John Snow commented on both the perceived government guarantee and why it is undesirable: "[E]ven though the obligations of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are not backed by the full faith and credit of the United States government, market participants have come to believe that some sort of implied guarantee exists, weakening market discipline of the enterprises."[3]

Investors vividly displayed their confidence in the implicit guarantee in the early 1980s when they continued to lend money to Fannie Mae at relatively low interest rates even though Fannie was insolvent at the time, in the sense that its debts exceeded the market value of its mortgages by about $10 billion.[4] Investors have seen Congress bail out GSEs in the past. For example, in the 1980s, Congress pledged up to $4 billion to save the Farm Credit System from defaulting on some of its bonds, although the bonds carried no explicit government guarantee.[5]

Because of the implicit credit guarantee, lenders demand less of an interest rate premium for default risk from a GSE than they would from a normal private-sector company. The Congressional Budget Office (CBO) recently estimated that the implicit federal credit guarantee provides housing GSEs (Fannie and Freddie are the main ones) with an interest rate subsidy of "41 basis points ... on debt and 30 basis points on mortgage-backed securities."[6] A study conducted at the Federal Reserve estimated that Fannie and Freddie enjoyed roughly a 40 basis point interest rate advantage over the period 1998 to mid-2003.[7] In dollar terms, the interest rate subsidy is orders of magnitude bigger than Fannie and Freddie's other subsidies.[8] Fannie and Freddie have used the perceived federal credit guarantee and the associated interest rate subsidy to issue a vast quantity of obligations. Testifying to Congress in October 2003, CBO Director Douglas Holtz-Eakin reported that the housing GSEs' "outstanding securities now exceed $4 trillion—or more than the entire U.S. public debt [at the end of fiscal year 2003]. In the process, Fannie Mae and Freddie Mac have come to dominate the U.S. residential mortgage market..."[9]

Although the interest rate subsidy may slightly lower mortgage rates, it is an inefficient way to help home buyers. A Federal Reserve study estimates that the executives and shareholders of Fannie and Freddie retain most of the benefits[10], and a CBO study estimates they keep about 35% of the gains.[11]

Meanwhile, the interest rate subsidy causes much harm. It exposes taxpayers to considerable risk, given the small but nonzero danger that the federal government may have to pay for a bailout of Fannie and Freddie at some point in the future. It has distorted the competitive marketplace to the detriment of fairness and market efficiency by allowing Fannie and Freddie to expand in the secondary mortgage market based on their government subsidy, not on their inherent efficiency, while disadvantaging other firms.[12] Federal Reserve Chairman Alan Greenspan explained, "Because Fannie and Freddie can borrow at a subsidized rate, they have been able ... to gradually but inexorably take over the market for conforming mortgages."[13] The implicit credit guarantee and the associated interest rate subsidy lack transparency, which violates the principle that government activities should be as visible as possible to help citizens make good choices about the appropriate level of government. There is also evidence that Fannie and Freddie have behaved anticompetitively by using their dominance in the secondary mortgage market, which they attained through their hidden government subsidies, to

pressure mortgage originators into buying other products they sell.[14] Moreover, Fed Chairman Greenspan warns that Fannie and Freddie have grown so large due to their subsidies that they could injure the overall economy if they should encounter major problems.[15]

The proposal in the Postal Service bills.[16] The Postal Service can currently borrow directly from the U.S. Treasury at just slightly above the interest rate on Treasury securities.[17] H.R. 4341 and S. 2468 would leave that authority in place for borrowings related to products judged to be sheltered by the Postal Service's dual monopolies (mainly the Service's core products).[18] However, the bills would establish a new procedure for borrowings associated with products that the bills classify as competitive.[19] In the future, when the Service wants to borrow for its competitive-product activities, it would have to sell debt to lenders in the private credit market, rather than obtaining loans from the U.S. Treasury. The obligations that the Postal Service would issue to finance its competitive products would state that they are not guaranteed by the government, are backed only by competitive product revenues and assets (if those are pledged), and carry no exemptions from state and local taxes (unlike Treasury securities.) The goal is to require the Postal Service to pay a market-based interest rate when it borrows for its competitive products.[20]

During a transition period, H.R. 4341 and S. 2468 would also allow the Postal Service, on occasions when it preferred, to continue borrowing from the federal government for its competitive-product activities. To use this option, however, the Service would have to obtain a credit rating based solely on its competitive products from a nationally recognized credit rating service, and the government would be required to charge the Service an interest rate corresponding to what the market is charging borrowers with that credit rating.[21]

Assumed behavior versus real-world behavior. The bills assume that lenders will accept at face value the no-government-guarantee language. If lenders behaved that way, they would then judge the riskiness of the Postal Service's competitive-product activities based solely on the assets, revenues, and costs related to the agency's competitive-product lines. That is, lenders would regard the agency's competitive product lines as though they formed a separate company that must stand or fail on its own, without assistance from the rest of the Postal Service and certainly without assistance from the U.S. Treasury. The monetary risk would motivate potential lenders to examine diligently the performance and prospects of the agency's competitive-product operations. If all this happened, the Postal Service would find when it went into the private credit market to borrow for its competitive-product activities that it would have to pay an interest rate similar to what a private-sector company of comparable riskiness would pay, not a government-subsidized rate, and the scrutiny of potential lenders would provide further market discipline.

In the real world, of course, lenders do not behave that way at all, as years of experience with GSEs like Fannie Mae and Freddie Mac have demonstrated. Many lenders would believe an implicit government credit guarantee exists, whereby the government would protect from default all securities the Postal Service issues on behalf of its competitive-product operations. Hence, the proposed borrowings by the Postal Service for its competitive-product activities would receive preferential interest rates in the private credit market: higher than the Treasury rate but much lower than private-sector businesses can obtain. Lenders would be especially likely to assume that the Postal Service has an implicit federal guarantee because it is not merely sponsored by the government but actually an arm of the government.[22] Instead of sending the Postal Service into the private credit market as though it were a normal business, the borrowing provision in the Postal bills would, in effect, create a new GSE.

To put the danger in perspective, it would not be as great a threat as that posed by the interest rate subsidy going to Fannie Mae and Freddie Mac. The Postal Service already receives an interest subsidy on all its borrowings, in that it is now able to borrow at just above the Treasury security rate. The

provision in the bills would actually force the Service to pay a somewhat higher rate on competitive-product borrowings than it pays now, although a significant interest rate subsidy would remain. Another mitigating factor is that the provision does not appear to change the Postal Service's overall borrowing limit of $15 billion[23]. That limit places a ceiling on how much the Service can borrow to expand its competitive-product operations (or other operations).

How, then, could the provision cause harm? The provision could be damaging if, as is likely, it creates the illusion of market discipline, with the result that less attention is paid to how much the Postal Service borrows within its $15 billion debt cap and how it uses the borrowed funds. With the Service estimating that it will have outstanding borrowings of under $5 billion at the end of 2004[24], it could undertake new borrowings of over $10 billion before reaching its debt limit. The currently unused portion of the Postal Service's credit authority needs to be watched carefully because it could cause serious problems if not managed prudently; it has the potential to finance a large wave of economically unjustified expansion in competitive markets. The provision, as currently written, could cause further damage because the false sense of confidence it would engender about supposed market discipline might lead Congress in the future to increase the Service's debt limit. With a higher cap, the Service could finance still more unjustified expansion in competitive-markets.

Sending the Postal Service into the private credit market is not a free-market solution. When a lender thinks a borrower has explicit or implicit government backing, normal free-market discipline is lacking. The lender does not care very much whether the borrower, individually, would be a good credit risk and does not bother to monitor the borrower's activities very carefully. This problem goes by the technical name of moral hazard. The lack of market discipline undermines the usual ability of the free-market system to direct resources to their most highly valued and productive uses. In addition to allowing a vast expansion by GSEs, moral hazard is blamed for greatly worsening the savings and loan debacle of the 1980s and for contributing to several international debt crises.

When an organization borrows in the private credit market, the source of the moral hazard must be removed in order to achieve a true free-market result, with properly risk-adjusted interest rates and an efficient allocation of resources. Unfortunately, moral hazard is very much present when the GSEs borrow in the private credit market, and it would assuredly be present if the Postal Service borrowed there, given that the Service is part of the federal government and performs a core service that Congress values highly. (Even if the Postal Service's competitive products were spun off as a separate legal entity, the perception of government backing and the moral hazard problem almost certainly would remain if the new entity continued to be owned or controlled by the Postal Service.)

Workable alternatives. The proposal's goal of removing one of the Postal Service's special advantages and forcing the agency to use its resources more wisely is certainly worthwhile. However, a "reform" that allowed the government-owned Postal Service to go into the commercial credit market for its competitive-product borrowings under the fanciful pretense that it would be treated like a normal private-sector business would not accomplish that objective and would invite trouble. As is currently seen with GSEs, the Postal Service's links to the federal government would let it borrow at a preferential interest rate.

An alternative would be to require the Postal Service to go to the Treasury for its competitive-product borrowings and to direct the Treasury to price the monies it lends based on the rates private borrowers pay in the corporate bond market.

One method of doing this would be to require that when the Postal Service wishes to issue securities to help finance competitive product activities, the Secretary of the Treasury must assess the riskiness of the Postal Service's competitive market operations and set the price of those securities based on that risk assessment. Depending on the results of the risk assessment, the interest rate

that Treasury determines to be appropriate could range from Aaa to junk bond status. It should be acknowledged that this approach is not perfect. Because the risk assessment would be subjective, it may expose Treasury to considerable political pressure to understate the riskiness of the Postal Service's competitive-product securities and offer an unjustifiably low interest rate. Nevertheless, this approach would surely reduce the interest rate subsidy compared to current law and, by not turning the Postal Service loose in the private credit market, avoid a GSE-style problem.

Another option would be to adopt a formula-based approach: When the Postal Service wishes to borrow for its competitive product activities, the Treasury could be required to price the Competitive Products Fund securities using a broad index of market interest rates on corporate bonds, perhaps of all investment grade corporate securities.[25] In effect, this would give the Postal Service the average borrowing cost of a large portion of the corporate sector. This technique would be objective and transparent, which should give it some resistance to political pressure. Admittedly, using an index of commercial bonds might give too high or low a credit rating to the Postal Service's competitive product borrowings, and would not reflect the specific and ever-changing risk characteristics of the Postal Service's competitive-product operations. Nevertheless, it would be a lot closer to the truth than current law.

Of course, the ultimate solution would be to turn the Postal Service into a truly private company, which means no government ownership and no special government ties and privileges. With true privatization, private-credit-market borrowing would then be the right way to go.

Conclusion. It is questionable whether the government-owned Postal Service should be in competitive markets at all, but if it is, it certainly should not be able to expand in those markets by borrowing funds at subsidized interest rates. The Postal bills H.R. 4341 and S. 2468 are on the right track in seeking to end that indirect subsidy. In their current form, however, the bills would not succeed.

The bills naively ignore the fact that government credit guarantees need not be explicit to distort market behavior. GSEs like Fannie Mae and Freddie Mac have shown that government credit guarantees can be implicit, can cause serious problems via subsidized interest rates, and, once created, can be very difficult politically to curtail. It would be foolhardy to establish another GSE-like problem, this time at the Postal Service. The bills' provision should not be enacted in its current form. Fortunately, it would be possible to remove the subsidy by using a different procedure that would align the Postal Service's borrowing rate with the market-determined interest rate for private-sector businesses of comparable riskiness.

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Endnotes

1. P.L. 91-375, The Postal Reorganization Act Of 1970, sec. 201, August 12, 1970.

2. See Congressional Budget Office, "Effects of Repealing Fannie Mae's and Freddie Mac's SEC Exemptions," May 2003, pp. 1-3, accessed on the Internet at ftp://ftp.cbo.gov/41xx/doc4199/05-06-03-GSEs.pdf; and Congressional Budget Office, "Federal Subsidies And The Housing GSEs," May 2001, pp. 13-14, accessed on the Internet at ftp://ftp.cbo.gov/28xx/doc2841/GSEs.pdf.

3. John W. Snow, Secretary, U.S. Department of the Treasury, "Proposals For Improving The Regulation Of The Housing GSEs," Testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs, October 16, 2003, accessed on the Internet at http://www.ustreas.gov/press/releases/js905.htm.

4. Congressional Budget Office, "Assessing The Public Costs And Benefits Of Fannie Mae And Freddie Mac," May 1996, pp. x and 6, Accessed on the Internet at ftp://ftp.cbo.gov/0xx/doc13/Fanfred.pdf.

5. See Congressional Budget Office, Douglas Holtz-Eakin, Director, "Regulation of the Housing Government-Sponsored Enterprises," Testimony before the Committee on Banking, Housing, and Urban Affairs United States Senate, October 23, 2003, pp. 4-5, accessed on the Internet at ftp://ftp.cbo.gov/46xx/doc4642/10-23-GSE.pdf.

6. Congressional Budget Office, "Updated Estimates of the Subsidies to the Housing GSEs," Letter to the Honorable Richard C. Shelby, Chairman, Senate Committee on Banking, Housing, and Urban Affairs, April 8, 2004, p. 1, accessed on the Internet at ftp://ftp.cbo.gov/53xx/doc5368/04-08-GSE.pdf.

7. Wayne Passmore, "The GSE Implicit Subsidy and Value of Government Ambiguity," Board of Governors of the Federal Reserve System, Finance and Economic Discussion Series, No. 2003-64, p. 3, December 2004, accessed on the Internet at http://www.federalreserve.gov/pubs/feds/2003/200364/200364pap.pdf.

8. CBO, "Updated Estimates of the Subsidies to the Housing GSEs," *op. cit.*, p. 8.

9. See Holtz-Eakin, "Regulation of the Housing Government-Sponsored Enterprises," *op. cit.*, p. 2.

10. Passmore, "The GSE Implicit Subsidy and Value of Government Ambiguity," *op. cit.*, p. 26 and Exhibit 6. Also see Alan Greenspan, Chairman, Federal Reserve Board, "Government-Sponsored Enterprises," Testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 24, 2004, accessed on the Internet at http://www.federalreserve.gov/boarddocs/testimony/2004/20040224/default.htm. The Federal Reserve study notes that the aid to home buyers is even smaller than the estimate might suggest because when mortgage rates decline, home prices tend to rise, which allows home sellers to capture some of the benefit of the lower mortgage rates.

11. CBO, "Updated Estimates of the Subsidies to the Housing GSEs," *op. cit.*, p. 8.

12. Fed Chairman Greenspan explained, "Because Fannie and Freddie can borrow at a subsidized rate, they have been able to pay higher prices to originators for their mortgages than can potential competitors and to gradually but inexorably take over the market for conforming mortgages." (Greenspan, "Government-Sponsored Enterprises," *op. cit.*)

13. Greenspan, "Government-Sponsored Enterprises," *op. cit.*

14. See Peter J. Wallison, "Applying The Microsoft Decision To Fannie Mae And Freddie Mac," in R. Richard Geddes, ed., *Competing With The Government; Anticompetitive Behavior And Public Enterprises* (Stanford, CA: Hoover Institution Press, 2004), pp. 59-84.

15. Greenspan, "Government-Sponsored Enterprises," *op. cit.*

16. The proposal examined here is contained in H.R. 4341, sec. 301 and S. 2468, sec. 401.

17. Technically, the borrowing is done through the Federal Financing Bank. Another technicality is when the Postal Service wishes to sell obligations, it must first offer them to the Treasury (39 U.S.C., sec. 2006). The Treasury generally agrees to purchase what it is offered. However, if the Treasury were to decline and the Postal Service did not insist (the Service can require the Treasury to purchase its securities in some cases), the Service could then presumably sell the obligations in the private credit market and could ask the Treasury to certify that the obligations have full government backing. (The Treasury must agree to the certification if it determines that doing so would be in the public interest.)

18. More precisely, the bills classify Postal Service products as either market dominant or competitive. For the most part, the agency's core products are on the market-dominant list and its non-core products are on the competitive list. However, in a few cases, the bills seem to have erroneously placed competitive products on the market-dominant list. For instance, the Senate bill (but not the House bill) classifies single-piece parcels as a noncompetitive product, even though the market for package services is intensely competitive. Both bills list money orders as a noncompetitive product (under special services), even though Postal Service money orders may be in competition with private-sector money orders.

19. The House bill classifies as competitive products: priority mail, expedited mail, mailgrams, international mail, and parcel post (H.R. 4341, sec. 202). The Senate bill excludes single-piece parcels and single-piece international mail from the list and classifies as competitive products: priority mail, expedited mail, bulk parcel post, bulk international mail, and mailgrams (S. 2468, sec. 202).

20. Even if this provision worked as planned, some interest rate subsidization might remain. If the bills define competitive products too narrowly (which appears to be the case, as observed in footnote 18), the competitive-market products that are erroneously not listed as being competitive-market products could still obtain funds at just above the Treasury security rate. Also, because of accounting challenges in determining which costs are related to monopoly-sheltered products and which are related to competitive-market products, some funds borrowed at the Treasury security rate might find their way to competitive-market activities.

21. This approach has the weakness of expecting a credit rating organization to provide a rating based on an unrealistic assumption, namely, that no federal help would be forthcoming if the Postal Service were about to default on some of its debts. The people at the credit rating agency would recognize that the federal government would almost certainly intervene to head off a default by the Postal Service's proposed Competitive Products Fund, and that awareness would probably influence their credit assessment, instructions to the contrary notwithstanding. As a result, the private rating service would tend to give the Postal Service's competitive-market activities an unduly high credit rating.

22. Lenders would reason that, if push came to shove, Congress would not permit a partial default by a federal agency that traces its government lineage back to 1775. Congress might also intervene because of concern that if the Postal Service did default on competitive-product securities, lenders might attempt to attach Postal Service assets and revenues in a manner that would interfere with the agency's core, governmental operations. In addition, lenders might suspect that the Treasury and Federal Reserve would not want to see a government agency default on some of its obligations lest that spill over into a loss of confidence in U.S. Treasury securities, which would disrupt government debt-financing operations. Because of these considerations, the odds are high that the federal government would not allow a default by the Postal Service on its competitive-product borrowings.

23. 39 U.S.C., sec. 2005(a). The same section of current law also places yearly limits on net increases in borrowings for capital improvements and operating expenses: $2 billion and $1 billion, respectively.

24. United States Postal Service, "Quarterly Financial Report, Postal Quarter II FY 2004," p. 19, accessed on the Internet at http://www.usps.com/financials/_pdf/Q22004QtrlyReportFinalv1-2.pdf.

25. The index would be chosen so that it contains securities that are of comparable maturity to the securities the Postal Service is issuing.

Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.