AMERICAN BANKER
On Focus and In Depth

One Year Later, GSEs' Future Even Less Certain

American Banker | Friday, September 4, 2009

By Steven Sloan

WASHINGTON — Nearly a year after Fannie Mae and Freddie Mac were seized by the federal government, the fate of the government-sponsored enterprises seems less certain than ever.

The conservatorship was supposed to turn Fannie and Freddie around while reviving shattered mortgage markets. Instead, it has fueled uncertainty about the future of the secondary market, cost the taxpayers billions and raised concerns about a perpetual government ownership.

"What's amazing to me is we're not having any discussion about what Fannie and Freddie should be when they come out of conservatorship," said Joe Murin, the managing director of the Collingwood Group, who stepped down as the chief executive of Ginnie Mae last month. "We're constantly dealing in the negative and looking in the rearview mirror and not looking forward."

Instead of reaching a consensus about the GSE's future, the debate has instead grown more complex.

When the GSEs collapsed Sept. 7, the prospects for their future seemed to be limited to three options: privatization, nationalization or a return to the status quo.

In the year since, the options have only multiplied, including turning the GSEs into a public utility model, forming a good bank/bad bank structure or allowing banks to form special purpose vehicles to operate in the secondary market, an idea trumpeted this week by the Mortgage Bankers Association.

The only player seemingly without a plan to restructure the GSEs is the Obama administration, which essentially has punted on the issue. In its regulatory reform proposal this spring, it said it would not address the future of the GSEs until early next year.

"Nature abhors a vacuum and you can say a policy debate in Washington also abhors a vacuum," said Cornelius Hurley, the director of the Morin Center for Banking and Financial Law at the Boston University School of Law. "Into that vacuum has been sucked the MBA proposal, the public utility idea and everything else."

The plethora of potential resolutions for Fannie and Freddie, combined with their central role in the Obama administration's efforts to modify mortgages, could spell a longer conservatorship than most observers imagined a year ago.

"Those changes aren't going to happen fast," said John Courson, the president and chief executive of the MBA. "This isn't a month or a year. This is a time frame that's going to happen over a longer period of time."

The delay amplifies uncertainty in the mortgage market, particularly if foreign debt investors turn their backs on Fannie and Freddie. That would cut off a crucial source of funding to the GSEs and could raise mortgage rates.

"You'll see investors that have stayed on the sidelines likely continue to do so and that certainly has an impact on the rate at which mortgages are offered," said Brian Harris, an analyst with Moody's Investors Service.

At the same time, the GSEs' drain on the government continues to grow. The Federal Reserve Board has purchased $624.4 billion out of a potential $1.25 trillion in mortgage-backed securities from the GSEs. On top of that, the Treasury Department has invested $36.9 billion in capital at Freddie so far this year and $34.2 billion at Fannie, with another $10.7 billion on the way by the end of the month.

Given the precarious situation in which the GSEs find themselves, some observers are raising a possibility that would have been viewed as radical a year ago: a mortgage market without Fannie and Freddie. "I'm now one of those who say 'maybe the GSEs aren't what we need,' " said Judy Kennedy, the chief executive of the National Association of Affordable Housing Lenders. "Maybe they can't be rehabilitated."

Both GSEs have evolved over their history. Created during the Great Depression, Fannie was once on the federal government's balance sheet only to be given to shareholders in the 1960s. Until the Financial Institutions Reform, Recovery and Enforcement Act of 1991, Freddie was owned by the Federal Home Loan Bank System.

But given their association with the current financial crisis, some question whether Fannie and Freddie can survive another evolution. "We would be doing a disservice if we continue to call it Fannie and Freddie," Murin said. "No matter how much good it did, not only investors but taxpayers — everyone has a bad taste in their mouth. I'm not sure what you can do to cleanse that."

But what would replace Fannie and Freddie is a wide open question — and one that Congress has not touched.

Most interviewed for this article said that at least some type of government involvement is needed in the secondary mortgage market.

"We are convinced if you are going to restore investor confidence and maintain investor confidence that will continue through all economic cycles, it is going to require an explicit government guarantee," Courson said.

But some said the government could dial back its support from Fannie and Freddie levels.

"Do we have to subsidize housing to the extent that we have?" Hurley asked. "My answer is less than we have. We ought to be looking more at subsidizing job creation than housing."

The plan advanced by the MBA this week would allow banks to create entities that would take loans from institutions and securitize them. The new entities would be fully private organizations and would head off losses by charging risk premiums.

There would presumably be more than two of these entities, which in theory would reduce the risk that major firms like Fannie and Freddie would emerge to dominate the housing market. But if one of the organizations were to fail, the government would step in with a backstop. "The only risk that a government backstop takes is the timely payment of principal and interest," Courson said. "They don't take credit risk. They don't take interest rate risk."

But Kennedy questioned why the government should be in line to take any risk.

"What we'll be trying to educate people about going forward is this doesn't necessarily involve subsidy," she said. "It's a matter of access to capital markets through some mechanism, whether it's a GSE or some other mechanism."

A spokeswoman for the Federal Housing Finance Agency said that under the conservatorship, "Fannie Mae and Freddie Mac are remediating their past weaknesses and fulfilling their mission of providing liquidity, stability, and affordability to the mortgage market."

The Obama administration is expected to give a better sense of where Fannie and Freddie are headed when it releases its next budget in February. But some cautioned against expecting a final chapter in the saga of the GSEs anytime soon. "Even if a range of options are proposed in February, I don't expect anything to have happened by this point next September," said Bert Ely, an independent analyst in Alexandria, Va. "Fannie and Freddie could drag on like this for years."
