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Fannie and Freddie In Partes Tres

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The American housing finance system is unique in the world for the dominant role played by the housing government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac. Fannie and Freddie did, and now that they are officially wards of the state do even more, play a disproportionate role in U.S. mortgage finance. They were and are among the largest issuers of debt securities in the world, all trading on the credit of the U.S. Treasury and the taxpayers. The largest owner of their obligations is now the Federal Reserve.

Bond salesmen, pushing trillions of dollars of GSE debt and mortgage-backed securities to investors all over the world, said something like this: "You can't go wrong buying this, because it is really a U.S. government credit, but it pays you a higher yield! So you get more profit with no credit risk." Although there was, and still is, no formal U.S. government guaranty of Fannie and Freddie's obligations, nonetheless what the bond salesmen told the investors was true, as events have fully confirmed. It was absolutely true that the U.S. Treasury would protect them, so they could receive higher returns while owning a U.S. government credit. The Treasury has announced that its financial support of Fannie and Freddie is unlimited.

Protecting the foreign and domestic creditors of Fannie and Freddie will cost American taxpayers something in the range of $200 billion to $400 billion, it seems—estimates vary. In any case this will be much more than the $150 billion cost of the notorious savings and loan collapse of the 1980s. Both collapses, it should be noted, reflect the yearning of the government to sponsor loans on housing.

Addressing the GSE Risk Turkey

The failure of Fannie and Freddie creates a perfect time to address the fundamental restructuring of these previously world famous, now broke, government-sponsored enterprises.

In September, 2008, the giant GSE risk turkey, weighing in at $5 trillion, entered regulatory conservatorship and thereby came to roost in the dome of the U.S. Capitol. Like Edgar Allan Poe's celebrated raven, it won't go away. It roosts there, so the elected representatives of the people can't forget the mistakes they made in fattening it up so much.

But while Poe's raven croaked "Nevermore," should we let the GSE risk turkey gobble "Evermore"? Is this risk a permanent burden on the public finances? Should it be? Obviously the answer is No. But the majority of the elected representatives of the people just passed a 2,300 page financial "reform" act which carefully avoided addressing the gigantic disaster of Fannie and Freddie.

A libertarian critique of the GSEs' failure by Sheldon Richman, "Bailing Out Statism," says, "The key to understanding the saga of Fannie Mae and Freddie Mac is this: They were created—intentionally—to distort the housing and mortgage markets. Government planners were not content to let voluntary exchange configure those industries. So they intervened."

That is an accurate statement. The ongoing and unlimited bailout of Fannie and Freddie is without question a government intervention to save previous interventions. Since the entire intellectual premise of the Dodd-Frank regulatory expansion act is that government intervention in financial markets will improve things, it was obviously difficult for its supporters to admit that the massive intervention represented by Fannie and Freddie turned out to be a massive government blunder.

Richman continues, "The collapse of Fannie and Freddie is government social engineering predictably gone bad." But here is something very interesting: Fannie and Freddie went bad in a way nobody predicted—namely: from credit risk, or put simply, bad loans.

There were hundreds of articles and speeches over the years either attacking Fannie and Freddie or defending them, many of them by experts in the matter, but everybody thought that the GSEs' credit risk function was all right, that if anything, it demonstrated duopoly profits (as it did for a long time).

Nobody predicted that credit risk would take Fannie and Freddie down. But it has.

Now they are both insolvent, if you don't count the preferred stock bought by the government. Their common shares have lost more than 99% of their value and have been de-listed from the New York Stock Exchange.

Many people have suggested that the way to fix Fannie and Freddie is to limit them to mortgage securitization—in other words, to guaranteeing credit risk. But the fact that is that they failed through credit risk, so this is a more than dubious notion. (Many people also assert that securitization was the "original" purpose of the GSEs. For Fannie, this is distinctly false: Fannie had existed for more than 40 years before it did its first securitization.)

You could solve the problem of future GSE credit risk by strictly limiting Fannie and Freddie's securitization only to prime, high quality mortgage loans. But this would render very unhappy the many politicians who want them to finance and subsidize riskier loans. Of course, trying to make these same politicians happy contributed significantly to Fannie and Freddie's credit risk expansion, vast losses and resulting insolvency.

More fundamentally: Does the 21st century need GSEs in order to have securitization of prime mortgage loans? No, it doesn't.

Create a private secondary market for prime, conforming mortgage loans

The future mortgage finance system should have a robust private secondary market for the largest segment of the business: prime, conforming mortgage loans. In this market, private investors should put private capital at risk, and prosper or lose as the case may be. This is the most obvious case where the risks are manageable and no taxpayer subsidies or taxpayer risk exposures are required or desirable.

There may, decades ago, have been a case for GSEs to guarantee the credit risk of prime mortgage loans in order to overcome the geographical barriers to mortgage funding, which were themselves created by government regulation. There was lately a case for using GSEs to get through the financial crisis which they themselves did so much to exacerbate. But as we move into the future mortgage finance system, the prime mortgage market should stand on its own. Covered bonds, as well as securitizations, might well be part of this evolution.

A private secondary market for prime mortgages should have been a natural market development. Why did it never develop? The answer is obvious: no private entity could compete with the government-granted advantages of the GSEs. There could be no private prime conforming mortgage loan market while the GSEs used those advantages both to make private competition impossible, and to extract duopoly profits (or “economic rents,” as economists would say) from the private parties.

This duopoly element of the old housing finance system should not survive.

Transition to no GSEs

A direct way to take the old GSE duopoly out of the prime market is to structure a transition to a world of no GSEs. The Congress should take up Congressman Jeb Hensarling’s bill, the “GSE Bailout Elimination and Taxpayer Protection Act” (HR 4889), which lays out how this might be done, and how an orderly transition might actually be put in gear. Depending on the results of the 2010 Congressional elections, perhaps it will.

Disaster-prone housing finance inflation was at the center of the financial crisis, and the GSEs were at the center of housing finance inflation. For any mortgage system reform to be meaningful, it must address Fannie and Freddie. Everyone now agrees with this, although the Congress wrote 2,300 pages of the Dodd-Frank Act without doing so.

The core issue about GSEs is this: You can be a private company, with market discipline; or you can be part of the government, with government discipline. But you can’t be both. Congress should not try to make you both. Trying to be both-- in other words, being a GSE--means you avoid both disciplines. Fannie and Freddie, or each part of Fannie and Freddie, should become either one or the other.

Moving toward the required transition has become somewhat easier because now Fannie and Freddie are in substance no longer GSEs, although they retain the form. They are in substance government housing banks, owned overwhelmingly and entirely controlled by the government.

Therefore it is clear that, as recommended by the Congressional Budget Office, they should be on the federal budget. Fair and transparent accounting demands that they not get off-balance sheet accounting treatment, which comes in for so much criticism by politicians in other areas. In this context, I recommend that Congressman Scott Garrett’s bill, the “Accurate Accounting of Fannie Mae and Freddie Mac Act” (HR 4653) should be enacted by the Congress. Honest, on-budget accounting would give the

Congress a strong incentive to junk the failed GSE model and proceed to restructure Fannie and Freddie on the correct principle of "one or the other, but not both."

Divide Fannie and Freddie into three parts, so no GSE is left

Julius Caesar famously wrote that Gaul overall was divided into three parts (as many of us remember, "Gallia est omnis divisa in partes tres"). The fundamental reform of Fannie and Freddie should be the "Julius Caesar strategy": divide them into three parts.

To begin the process, Fannie and Freddie should be put into receivership (not the current conservatorship), so that the small remaining value of the common shares and all their governance rights are wiped out. Then the restructuring into three parts can proceed.

The first part, unfortunately, must be two liquidating trusts or "bad banks" which will bear Fannie and Freddie's deadweight losses, the $145 billion already spent by the Treasury and the additional losses which are already baked in the GSE cake and will be recognized over time. As discussed, the total losses will be a number of hundreds of billions of dollars, which will unjustly but at this point unavoidably be borne by the taxpayers.

All the current debt and MBS obligations which bear the "implicit" but very real guaranty of the Treasury should be put in these trusts to run off over time, with all the current mortgage assets of the GSEs dedicated to servicing them. The substantial excess of the liability cash outflows over the asset cash inflows will create the realized losses. These trusts will be the liquidating old GSEs and can be modeled legally on the structure used for the privatization of Sallie Mae.

The second part of Fannie and Freddie should be formed by the privatization of their prime mortgage loan securitization and investing businesses. All their intellectual property, systems, human capital and business relationships should be put into truly private corporations, sold to private investors, and sent out into the world to compete like anybody else-- sink or swim, flourish or fail. Being fully private corporations, they will be free to do anything they think will create a successful business—except trade on the taxpayers' credit card.

The final element of the former Fannie and Freddie consists of those activities which are properly those of the government: such as providing housing subsidies in one form or another and providing non-market financing of risky loans. These should stay explicitly in the government. They should be fully subject to the discipline of Congressional approval and appropriation of funds.

This would be in sharp contrast to the practices of GSEs, which receive huge subsidies and pass on some subsidies to court political favor, all concealed off-budget. Instead, the funding for these activities would have to be appropriated by Congress in a transparent way, subject to the disciplines of democracy.

These governmental functions of Fannie and Freddie should be merged into the structure of the Department of Housing and Urban Development along with the government mortgage programs of the FHA and Ginnie Mae.

In sum, the GSEs should be divided into three parts: liquidating trusts, private mortgage businesses, and a government agency inside HUD. With this Julius Caesar strategy, no GSEs would be left—a consummation devoutly to be wished.

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