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Cost of Fannie, Freddie rides on new agency

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Just two weeks ago, the U.S. Treasury and the Federal Housing Finance Agency (FHFA, the newly created federal regulator of Fannie Mae and Freddie Mac) acted to bail out the firms' bondholders and mortgage-backed security investors in a weekend action that is becoming all too common. Unlike the investment banks (Bear Stearns and Lehman Bros.), Fannie and Freddie have always been government-sponsored and the dominant participants in the U.S. mortgage markets. Fannie and Freddie are now in a conservatorship under the complete control of the FHFA; the firm's top management and board of directors are dismissed.

The Treasury also is committed to making capital infusions as needed, in return for which taxpayers now own new senior preferred shares in Fannie and Freddie. Investors in Fannie's and Freddie's senior agency debt, subordinated debt, and mortgage-backed securities are home free, while it is unclear if the firm's common and preferred shareholders will receive any future payments; stock market trading will determine the immediate value of these shares. The ultimate cost to the government will depend on Fannie's and Freddie's future losses relative to the returns earned on the government's new loans and senior preferred stock.

Lesson learned

As many observers have been noting for more than 20 years, Fannie's and Freddie's management had every incentive to take risky positions to maximize shareholder profits, knowing that taxpayers would foot the bill if catastrophic losses were to occur. That has come to pass, and the bailout should put to rest any hope that a government-sponsored enterprise can sensibly operate with a public mission but under private management and profit incentives.

Advocates of market discipline also have to be disappointed, in two ways. First, the implicit, and now explicit, guarantee for Fannie and Freddie bondholders and mortgage-backed securities investors clearly precluded any substantive role for market discipline. Second, the government has been forced to bail out the subordinated debt holders along with the senior debt holders, thus eliminating subordinated debt as a viable instrument to promote market discipline in the future.

What to do about fannie and freddie

With the conservatorship a done deal, the issue of restructuring Fannie and Freddie is squarely on the table. It is important to recognize that both firms carry out two business activities, both involving mortgages, but with very different economic benefits and risks. Their mortgage-backed securities underwriting creates mortgage-backed securities that are sold to capital market investors. If this underwriting were the firms' only business, they would not today be the focus of major regulatory action. Their mortgage-backed securities underwriting, moreover, provides an efficient mechanism through which the firms satisfy their charter mission: "To provide stability in the secondary market for residential mortgages." It thus is important that this activity continue under direct governmental control, in parallel with the existing and successful FHA and GNMA programs for government guaranteed mortgages.

For the second Fannie and Freddie business, called their retained-mortgage portfolios, the firms acquire and hold large portfolios of mortgages and mortgage-backed securities. These portfolios are the primary source of the firms' losses and required bailout, and when the dust has settled, they should disappear or revert to private market management without any government ties.

Fannie and Freddie support of mortgages for lower-income borrowers, a further mission in their charters, is an additional issue. Over the years, Congress has used housing goals and similar mechanisms to create action in this regard. Most evidence is that these programs rarely achieved significant benefits. Moreover, guaranteeing mortgages for lower-income borrowers is basically an insurance function, and the government has an entity - the Federal Housing Administration - to do exactly this. The FHA operates an insurance fund, normally charging fees that are adequate to cover its actuarially expected losses. Or, in cases where an explicit subsidy is desired - as with the recently legislated Hope for Homeowners program to support subprime borrowers facing foreclosure, a congressional appropriation is required to cover the expected losses.

To be sure, Congress has always preferred to support lower-income borrowers through a free ride on Fannie and Freddie, but it is now clear that the ride was never free. Congress should now recognize that specific appropriations to the FHA represent a much more effective means to help low-income borrowers than any link to Fannie and Freddie can provide.

How to talk like a mortgage investor

Fannie Mae and Freddie Mac. These are two government-sponsored enterprises, created with the primary mission of stabilizing the market for residential mortgages in the United States. They are under the regulatory control of the government, but issue debt and shares of stock in the financial markets. Their size is enormous, representing more than $5 trillion in financial market obligations and being associated with almost half of all U.S. residential mortgages.

Federal Housing Finance Agency (FHFA). This is the federal agency with far-reaching supervisory and regulatory powers over Fannie Mae and Freddie Mac. These powers include the right to put the firms into a conservatorship (under which the government manages their operations) or a receivership (which is the first step toward a bankruptcy liquidation of the firms). The government actions on Sept. 7 put the firms into a conservatorship.

Mortgage-backed securities (MBS). These are securities that represent a large pool of individual residential mortgages. This creates a standardized instrument that is large enough to be efficiently traded in the financial markets, whereas an individual residential mortgage is much too small and idiosyncratic to be traded in these markets. The creation of mortgage-backed securities that are sold to capital market investors (such as mutual, hedge, and sovereign funds) remains one of the primary business activities of Fannie Mae and Freddie Mac today. Most subprime mortgages were sold to investors in the form of private-label, mortgage-backed securities.

Retained mortgage portfolios of Fannie Mae and Freddie Mac. One of the business activities of Fannie Mae and Freddie Mac has been to create extensive portfolios - totaling today about $1.5 trillion - consisting of mortgages and mortgage-backed securities. The primary source of money to fund these portfolios is debt issued by the two firms. Market investors have always assumed that this debt had the implicit guarantee of the U.S. Treasury. The actions on Sept. 7 made this guarantee explicit.

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