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Fannie and Freddie by Twilight

By Peter J. Wallison

Having now become explicitly government-backed entities, Fannie Mae and Freddie Mac (and their supporters in Congress) can no longer argue that they do not pose a risk to taxpayers. It is not politically feasible for the government to back private companies when their shareholders and managements keep the profits but the taxpayers cover the losses. Thus, even if they escape their current precarious financial straits, Fannie and Freddie are now operating in a kind of twilight before they will eventually have to be nationalized, privatized, or liquidated. In addition, the recent attention to covered bonds as a way to finance mortgages suggests that, in the future, Fannie and Freddie's traditional business—buying and holding or securitizing mortgages—will no longer be essential to U.S. housing finance. An analysis of the available options for policymakers suggests that the best course—from the standpoint of taxpayers—is not to keep Fannie and Freddie alive through the injection of government funds but to allow them to go into receivership. A receiver can continue their operations in the secondary mortgage market and—using the Treasury line of credit recently authorized by Congress—meet their senior debt and guarantee obligations as they come due. A decision to nationalize, privatize, or liquidate them can be made at a later time and can be implemented more simply and efficiently through a receivership than if the companies are helped to survive through government recapitalization.

It took a hair-raising crisis in the housing and international capital markets, but for Fannie and Freddie, the wondrously generous world of Washington—the world they have dominated for so many years with threats, intimidation, and sheer financial and political muscle—is at last coming to an end. Both companies are hovering near insolvency. Whether they can avoid eventual receivership will depend on how much further housing values fall. But even if they are lucky enough to survive this current crisis, their halcyon days will never return. This is not because Congress has learned any kind of lesson. Without question, the preferred position in Congress, especially on the Democratic side of the aisle, will be to reconstitute Fannie and Freddie as newly recapitalized government-sponsored enterprises (GSEs).

But this will not fly politically. The world was irretrievably changed by the Housing and Economic Recovery Act of 2008 (HERA) signed by President Bush on July 30, 2008. The act, in effect, authorized the bailout of the companies by giving the secretary of the treasury the authority to make unlimited loans to, and equity investments in, both GSEs. Thus, HERA resolved once and for all whether Fannie and Freddie were actually backed by the U.S. government; it provided the explicit backing that investors always believed would ultimately be there and that the enterprises themselves vigorously denied. But now that they are explicitly backed by the U.S. government, the GSEs can no longer claim that they represent no risk to taxpayers. As explicitly government-backed entities, they cannot deny the obvious: that their profits will go to their managements and shareholders while their losses will be picked up by taxpayers. This fact is crucial to their future.

The privatization of profit and the socialization of risk inherent in this new arrangement is politically untenable, even though it may take some time for Congress to see the substantial difference between their former status as merely government-

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sponsored and their new status as explicitly government-backed. Inevitably, however, the light will dawn and their form will have to be changed. The question, then, comes down to whether Fannie and Freddie will, in the future, become government agencies, private companies, or just unpleasant memories.

Moreover, there are strong indications that a far more efficient and sensible mechanism for financing home mortgages in the United States is about to be born. In mid-July, the Federal Deposit Insurance Corporation (FDIC) issued a final policy statement on how it would treat covered bonds in the event of a bank's failure,[1] and at the end of July, the Treasury issued a long statement on best practices for covered bonds.[2] In a covered bond transaction, mortgages remain on the books of the bank or other depository institution but serve as collateral for bonds issued to finance the acquisition of the mortgages. If the mortgages in the covered bond pool default, the bank that established the pool has an obligation to replace the assets with performing mortgages that will continue to serve as collateral for the outstanding bonds.

In other words, this structure requires lending banks to retain an interest in the quality of the mortgages they make and addresses the problem that no one in the securitization process has a continuing interest in sound underwriting after the mortgages are sold to Fannie and Freddie. Trillions of dollars in covered bonds have been issued in Europe over many years without any substantial losses. There are, of course, issues associated with the widespread use of covered bonds in the United States—mostly in balancing the interests of the FDIC and bank depositors in gaining access to the assets of a failed bank—but if these can be balanced with the need for a strong residential finance system, covered bonds could, over time, make the Fannie and Freddie business model obsolete. This is one more indication that Fannie and Freddie, both as GSEs and as essential elements of the U.S. residential finance market, are on their way out.

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The Gathering Storm

It is axiomatic that Congress only acts in a crisis, and this crisis was so serious that Congress was compelled to do three important things that under ordinary circumstances it would never have done: it adopted legislation, HERA, that significantly strengthened the regulation of Fannie Mae and Freddie Mac; it authorized the appointment of a receiver to take over either company if it becomes "critically undercapitalized"; and it gave the Treasury Department a blank check, limited only in time and by the U.S. debt limit, to make loans or equity investments in both companies. With its new powers, the regulator should be able to reduce the size of the GSEs and prepare them for one of the three fates: liquidation, privatization, or nationalization.

It need not have been this way. Congress was warned over two decades, by both Democratic and Republican administrations, about the dangers presented by Fannie and Freddie. But Congress, under both Democratic and Republican control, did nothing. The same process is now unfolding with respect to Social Security, Medicare, energy, securities class actions, and probably a dozen other long-term problems that Congress is seemingly unable to address. It makes you wonder why 98 percent of them are reelected.

Not that this and previous administrations are blameless. Although at their higher reaches—usually in the Treasury—they recognized the dangers, their bank regulatory arms continued to allow banks to invest in Fannie and Freddie securities without the percentage limitations normally applied to investments in privately owned business corporations. The regulators obviously believed that the government would eventually stand behind Fannie and Freddie and thus permitted U.S. banks to load up on Fannie and Freddie debt in preference to U.S. government securities. Now, thousands of banks hold more than their total Tier 1 capital in the form of Fannie and Freddie debt. A 2004 FDIC report showed that the holdings of GSE-related securities by commercial banks and savings associations aggregated more than 11 percent of the total assets of these institutions and more than 150 percent of their combined Tier 1 capital.[3] Holding Fannie and Freddie debt gave the banks some extra earnings over what they would receive from Treasuries, but it also sent signals to the capital markets that the government saw Fannie and Freddie as virtually risk-free. And when the prospect arose a few weeks ago that Fannie and Freddie debt might decline in value, Uncle Sam had to step in to prevent

thousands of U.S. banks from becoming insolvent because of their GSE investments.

In any event, the Fannie and Freddie crisis has now arrived, and, in order to avert a disaster in the housing and financial markets, the United States government has been forced to put its credit behind these two ill-conceived and badly managed institutions. During the past month, as the dimensions of the problem have become clear, sensible people have actually wondered whether the credit of the United States might actually be impaired by the obligations it might be required to assume on Fannie and Freddie's behalf. That idea, previously unthinkable, is still highly unlikely, but what is clear is that the size of the taxpayers' losses will grow as housing prices continue to decline. There is no telling how deep into insolvency Fannie and Freddie might sink, and the further down they go, the more potential losses they will impose on the government and ultimately the taxpayers.

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This, of course, is all water over the dam. The damage—allowing two privately owned companies to grow so large that they become both wards of the government and threats to the financial system—has been done. Now the only relevant question is how we get out of this mess with minimal cost to taxpayers. In the end, the options available to the Treasury Department and the new GSE regulator, the Federal Housing Finance Agency (FHFA), are both unpleasant and few. They are outlined below.

Option 1: Muddling Through

This is not so much an option as a hope—one that seems increasingly distant as the housing market continues to decline and the GSEs continue to register losses. Nevertheless, under this scenario, the residential mortgage market stabilizes in a few months, Fannie and Freddie succeed in raising a few billion dollars in additional equity capital, and they survive the subprime meltdown. What happens then? As suggested above, it is not possible for Fannie and Freddie to continue as GSEs. There is no precedent for the U.S. government to back the obligations of private, shareholder-owned companies. The closest analogy is the FDIC's administration of the deposit insurance system, but this is inapposite for two reasons. First, taxpayers are not at risk in the deposit insurance system. The FDIC administers the program, but since the Federal Deposit Insurance Corporation Improvement Act of 1991, the FDIC has had the power to tax all insured banks in order to recover its losses from bailing out the depositors of any failed bank. Second, the deposit insurance system only covers deposits up to $100,000, and thus the total obligations of the FDIC (and the banking system that backs it) are substantially less than the total deposits in any single bank or in the banking system as a whole. However, the senior debt of the GSEs, which currently amounts to somewhat more than $5 trillion, is backed by taxpayers without limit. This does not mean that the losses will be anywhere near $5 trillion, but it does mean that the losses are potentially very large.

Accordingly, at some point, Congress—as much as it would like to let the whole issue drop and go back to business as usual—will have to address the future of Fannie and Freddie. In that event, if Fannie and Freddie survive, there will be two realistic choices: nationalization or privatization. If they do not survive and have to be taken over by a receiver, liquidation becomes an additional option.

Option 2: Assisted Survival

There has been a lot of speculation recently that Treasury Secretary Henry M. Paulson might use his new HERA authority to recapitalize Fannie and Freddie. This seems highly unlikely. Most of this speculation assumes that the Treasury's investment will wipe out the existing shareholders or allow Paulson to take control of the companies, but he does not have the power to do either. HERA only authorizes the secretary to *offer* an equity infusion on terms he determines; the GSEs have no obligation to accept this offer and would probably not do so if it means wiping out their shareholders or ceding control. The act's language in this respect is fairly explicit, and it was obviously intended to protect the enterprises from a government takeover: "Nothing in this subsection requires the corporation [Fannie or Freddie] to issue obligations or securities to the Secretary without mutual agreement between the Secretary and the corporation."

Thus, if Paulson wants to recapitalize the GSEs, he will have to offer attractive terms to the existing shareholders. The more attractive the terms, of course, the greater the

adverse political fallout for the secretary. And justifiably so, because there is no good reason to use taxpayer funds to keep Fannie and Freddie alive. Since they cannot remain as GSEs, they must either be nationalized or privatized at some point in the future. If nationalization is the choice, keeping them alive today only sets up a huge fight with the shareholders in the future over the value they should receive for the companies. In other words, if Paulson injects equity today to keep them operating, he would only be setting up conditions for more taxpayer funds to be used in the future to acquire them. A capital injection now would simply be a gift to the existing shareholders. This would be a serious mistake and thus is highly unlikely to occur.

In addition, there is the specter of the savings and loan (S&L) debacle of the late 1980s and early 1990s. In that case, failed institutions were allowed to keep operating, in part because the deposit insurance fund for the S&L industry was insufficient to bail them out and in part because it is always the inclination of regulators to forbear closing down the entities they supervise. As a result, the S&L managements—which were able to raise funds because of a government guarantee of their deposits—were able to take substantial risks in an effort to return to profitability. At the time, this was called "gambling for resurrection," and the same incentives would prevail for Fannie and Freddie's managements if—after a Treasury capital injection—they remained in control of the enterprises. Indeed, in June, Fannie's mortgage portfolio expanded at an annualized rate of 23 percent, and Freddie's at a rate of 33.4 percent. The GSEs' portfolios are their most profitable activity, and also their riskiest. An expansion of their portfolios is exactly what one would expect to see when companies—with the benefit of government backing—are able to increase their risk-taking in an effort to recover their profitability and avoid receivership. Accordingly, unless a Treasury injection of capital enables the department to take full control of Fannie and Freddie and replace their managements, keeping them alive would simply result in a replay of the S&L debacle of twenty years ago—on a much larger scale.

Thus, the better policy for the Treasury by far will be to leave both enterprises to sink or swim on their own. If they succeed in raising sufficient capital from investors and if the housing market stabilizes in the next few months, they may be able to survive. At that point, nationalization or privatization will still be the only options, but the U.S. government will not have made it more expensive to do either by infusing them with taxpayer funds. If, on the other hand, they cannot survive through their own efforts or good fortune, nationalization can occur through a receivership, avoiding concerns about buying out existing shareholders.

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Option 3: Nationalization through a Receivership

There are a number of wholly owned government corporations that could serve as models for the nationalization of Fannie and Freddie. The National Railroad Passenger Corporation (Amtrak), the Corporation for Public Broadcasting, and the Tennessee Valley Authority are three prominent examples. Assuming, then, that Fannie and Freddie survive, Congress could nationalize them if it believes they serve a necessary purpose in the mortgage markets. There are two ways for nationalization to occur: through the acquisition of all the outstanding shares of the GSEs if they weather the current storm, or through a receivership authorized under HERA if they do not.

Under HERA, if Fannie and Freddie are insolvent or are on the verge of insolvency—the statutory term is "critically undercapitalized"—the FHFA is authorized to appoint a receiver for each company. That would automatically wipe out the shareholders and replace the management. Given the current financial condition of the GSEs, the receivership provisions of HERA are among the most important elements of the new act. They consist of two parts, both of which come into effect if the GSE is critically undercapitalized: the director of FHFA has the discretion to appoint a receiver if, among many other things, it appears that the assets of the enterprise are less than its liabilities or if, in his judgment, neither enterprise will be able to meet its obligations as they come due; however, the director is required to appoint a receiver if he determines that for any period of sixty days the obligations of the enterprise have been greater than its assets. Thus, the director is *required* to appoint a receiver even if the GSEs are still able to borrow in the markets, as long as their assets are worth less than their liabilities for an extended period. No particular accounting methodology is specified, so it is worth noting in this connection that in their last financial reports, Fannie had net assets of $12.5 billion (a tiny

amount in relation to its total assets of $2.5 trillion) on a fair value accounting basis, while Freddie had *negative* net worth of $5.6 billion on a fair value basis. Theoretically, then, the director of the FHFA could appoint a receiver for Freddie at the end of September (sixty days after he gained the authority).

Under these circumstances, it becomes even clearer that the Treasury should not try to keep the GSEs functioning by infusing capital into either Fannie and Freddie—especially if the secretary cannot wipe out the shareholders by doing so. Since HERA authorizes the director of FHFA to appoint a receiver, the interests of the shareholders and management of either company may be eliminated without giving them a taxpayer-funded gift and without having to go through the arduous process of buying out the existing shareholders if, after the Treasury's infusion, one or both companies manage to survive.

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After the enactment of HERA, everything necessary for a successful receivership appears to be in place. First, it is vitally important that the receiver have a source of financing. The holders of GSE debt must be paid in full as their debt matures. Any other policy will cause the value of the outstanding debt to decline, and, as noted above, this will impair the capital of the thousands of U.S. banks that have been allowed by their regulators to hold as much GSE debt as they want. Moreover, the mortgage markets must be kept functioning, and this too requires that Fannie and Freddie continue to operate normally under the receiver's control. Finally, unlike the normal insolvency, the receiver cannot sell Fannie and Freddie's assets in order to raise the funds to pay off their debt. Selling GSE assets would drive down the market value of the mortgages and mortgage-backed securities (MBS), weaken the financial condition of the financial intermediaries and banks that hold these assets, and drive up mortgage rates—probably bringing an already weak housing market to a dead halt.

Therefore, it is essential that the receiver be able to borrow from the Treasury for the working capital necessary to operate the receivership. This is made possible by section 1145 of the act, which authorizes the receiver to step into the shoes of the enterprises for all purposes: "The Agency shall, as conservator or receiver, and by operation of law, immediately succeed to—(i) all rights, titles, powers, and privileges of the regulated entity, and of any stockholder, officer, or director of such regulated entity with respect to the regulated entity and the assets of the regulated entity." This language also makes clear that the receiver can continue to carry on the business of the GSEs after they are taken over and thus continue to serve the mortgage markets as Fannie and Freddie do today. Accordingly, the receiver, acting in his Fannie or Freddie capacity, will be eligible to borrow from the Treasury, and the secretary, in effect, is authorized to lend to the receiver. Indeed, the availability of the Treasury line should enable the receiver, acting in his capacity as Fannie or Freddie, to continue to issue debt securities and guarantees of MBS, just as the two enterprises have done in the past. The existence of the Treasury line will reassure the markets that the receiver will be able to meet the obligations of the companies as they come due. Accordingly, with the line of credit available, it is possible that the receiver will never actually have to use it, since he can borrow in the name of Fannie or Freddie and have these borrowings credibly backed by the credit line at the Treasury.

There is, of course, the further question of whether nationalization would be good policy. That question involves issues beyond the scope of this *Financial Services Outlook*, but the answer does not depend on looking at the condition of the mortgage markets today. These markets have been grossly distorted over the years by the presence of Fannie and Freddie, which have driven out most of the competition for middle-class housing finance and forced most housing finance into the securitization mold. The likelihood is that the resulting lack of competition prevented innovation—such as covered bonds—and kept mortgage rates higher than they would otherwise have been. Studies by the Federal Reserve have shown that the maximum amount by which Fannie and Freddie might have lowered interest rates for home mortgages was seven basis points, with a strong possibility that they would have had no effect on interest rates whatsoever. The authors of the Fed study noted in summary: "We find that GSE portfolio purchases have no significant effects on either primary or secondary mortgage rate spreads. Further, we examine GSE activities and mortgage rate spreads in the wake of the 1998 debt crisis, and find that GSE portfolio purchases did little to affect interest rates paid by new mortgage borrowers."[4]

Accordingly, the argument for government intervention simply to lower mortgage rates through secondary market activity is weak. Although there is a possible role for government in subsidizing affordable housing, there is no particular reason to use a nationalized Fannie or Freddie for this purpose. The same assignment could be given to Ginnie Mae and the Federal Housing Administration. In addition, nationalization would prevent taxpayers from realizing whatever inherent value remains in Fannie and Freddie's intangible assets—among other things, their relationships with other participants in the mortgage markets; their automated underwriting systems; and the information they have on home values, neighborhoods, and mortgagors. These assets, as discussed below, would be recoverable by the taxpayers if Fannie and Freddie were privatized or liquidated after a receivership but would be lost in a nationalization.

Option 4: Privatization

If Fannie and Freddie survive the current crisis, privatization would be a better policy choice than nationalization. Among other things, it would relieve taxpayers of the cost of buying the two enterprises from their existing shareholders. There are a number of ways that privatization could be accomplished, but one certain condition must be that both companies be reduced in size. It will be very difficult for the private market to absorb two companies that each have obligations exceeding $2 trillion. In our book, *Privatizing Fannie Mae, Freddie Mac, and the Federal Home Loan Banks*,[5] Bert Ely, Thomas H. Stanton, and I proposed one approach to privatization. Briefly, we would require Fannie and Freddie to set up ordinary state-chartered corporate parent companies that would acquire the GSEs. Over time, the GSE portfolios would be sold off and their new securitizations gradually transferred from the GSEs to private-sector subsidiaries of the new holding company. After a period of years, any remaining obligations on the GSEs' securitization guarantees would be defeased with U.S. government securities. We also recommended that their information and other intangible assets be licensed to all comers, so as to make available to their competitors the intangible assets that they were helped to acquire by their government backing.

The most serious technical obstacle to privatization will be the disposition of the GSEs' guarantees of MBS. There are currently about $3.7 trillion in such guarantees, and this obligation can only be eliminated when the mortgages in the securitization pool disappear through refinancing, payoff, or sale of the underlying residence. This could take as long as thirty years, so, if Fannie and Freddie are to be privatized, some way must be found to back the MBS with credit that is at least as good as that of Fannie and Freddie when they were still GSEs and implicitly backed by the U.S. government. One way to do this might be to keep the GSEs in being only for this purpose. They would not be able to engage in any new business and might be transferred as entities to Ginnie Mae for administration. Fannie and Freddie would have to indemnify the government for any losses incurred on these guarantees for as long as they remain in existence. This would be done most effectively by setting up a defeasement mechanism involving a deposit of U.S. government securities.

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Apart from the financial difficulties of privatization, Congress in general will not want to see Fannie and Freddie disappear as GSEs. The two enterprises have been the source of considerable campaign funding for their supporters in Congress, lucrative jobs for congressional staffers, and good publicity for incumbents in their districts and states. The Democratic Congress, in particular, will prefer continued intervention in the mortgage market so that they can continue to establish priorities that will benefit favored groups in the Democratic political coalition. In addition, the banks and other mortgage lenders that might be compelled to compete with Fannie and Freddie will certainly oppose privatization. Other groups—home builders, the securities industry, realtors, and other traditional allies who profit from the activities of Fannie and Freddie—will also be in opposition. So, while nationalization will be expensive to accomplish if the government has to purchase the interests of the GSEs' shareholders, privatization will be politically difficult.

Option 5: Privatization through a Receivership

Privatization is less difficult, however, if Fannie and Freddie are taken over by a receiver. In that case, the receiver can trim them down to manageable size, isolate the bad assets in a good bank/bad bank structure, and sell shares in the good banks (i.e., what remains of Fannie and Freddie) to the public after organizing the good banks as ordinary

state-chartered corporations with no continuing ties to the government. There have been a number of suggestions recently that in any privatization of this kind, Fannie and Freddie should be broken up into a number of smaller units. This may be good policy if they are to continue as GSEs—since the implicit government backing of GSEs allows them to grow without restraint while maintaining the fiction that taxpayers are not at risk for their losses. However, now that it is clear that Fannie and Freddie are explicitly backed by the U.S. government, the GSE structure—as discussed above—does not work politically. So the question is whether it is necessary to break Fannie and Freddie into smaller pieces when they are privatized without any connection to the U.S. government. In that case, it is likely that they will be more valuable as larger entities—thus returning more to the taxpayers who will bear the losses on the bad bank's assets—so it seems best not to break them up. The political difficulties associated with privatization through a receivership would be avoided because Congress would not have to participate in the process.

The receiver would also have more flexibility for dealing with the MBS guarantees. For one thing, under the receivership provisions in HERA, the receiver can repudiate all contracts entered by Fannie and Freddie before the receivership commenced. The receiver will certainly not want to repudiate the obligation on the guarantees since, again, these are held by thousands of U.S. banks, but the power to repudiate the guarantees themselves may enable the receiver to set up alternative defeasement structures that will adequately protect the MBS while reducing the administrative costs to the government. The receiver can determine, for example, whether the fees received from the securitized pools will be adequate to defray the government's risk on the guarantees or whether some supplemental payment from Fannie or Freddie's remaining assets is necessary to ensure that the government does not take any further losses in the future.

The central point, however, is that if Fannie and Freddie are eventually taken over by a receiver, the process of privatization is much easier than it would be if both companies had been kept alive by infusions of capital from the Treasury.

Option 6: Liquidation, Now or Never

The final option is liquidation. This would not be possible to achieve if Fannie and Freddie survive the current crisis. The political and financial pressure to keep them in being—either through nationalization or privatization—will be too great. Moreover, each of them will be too large for any single entity to acquire. So liquidation of Fannie and Freddie does not appear to be a viable option—if they remain going concerns by raising their own capital, by receiving a capital infusion from the Treasury, or because the housing market stabilizes before they become insolvent.

On the other hand, if they are taken over by a receiver, liquidation becomes a real possibility. The receiver will be able to marshal their assets and sell these assets over time for the maximum return. The proceeds of these sales could be used to pay off debt, defease the obligations on the MBS guarantees, and keep the losses to a minimum. This is approximately the same process that the FDIC used in resolving the thousands of failed S&Ls and commercial banks in the early 1990s. There is no time limit on the receiver's authority, so this process could take place over many years. During that time, the receiver could continue to operate both companies as they have been operated in the past, maintaining a functioning secondary market for mortgages until a functioning private secondary market has developed or until the covered bond financing system develops sufficiently to assume the largest role in residential finance.

Notes

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3. FDIC, "Assessing the Banking Industry's Exposure to an Implicit Government Guarantee of GSEs," March 1, 2004, revised April 14, 2004, available at www.fdic.gov/bank/analytical/fyi/2004/030104fyi.html (accessed August 25, 2008).

4. Andreas Lehnert, Wayne Passmore, and Shane M. Sherlund, "GSEs, Mortgage Rates, and Secondary Market Activities" (Finance and Economics Discussion Paper, Divisions of Research and Statistics and Monetary Affairs, Federal Reserve Board of Governors, Washington, DC, September 8, 2006), 3, available at www.federalreserve.gov/pubs/feds/2006/200630/200630pap.pdf (accessed August 25, 2008).

5. Peter J. Wallison, Thomas H. Stanton, and Bert Ely, *Privatizing Fannie Mae, Freddie Mac, and the Federal Home Loan Banks: Why and How* (Washington, DC: AEI Press, 2004), available through www.aei.org/book794/.

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