Chapter 13[*]

Toward a New Architecture for U.S. Mortgage Markets:

The Future of the Government-Sponsored Enterprises

Overview

One of the most dramatic events of the financial crisis of 2008 was the collapse of the two Government-Sponsored Enterprises (GSEs), Freddie Mac and Fannie Mae. They were put into conservatorship in September 2008, and a $200-billion lifeline from the U.S. Government was extended to each. The GSE bailout will probably have the largest net costs (outlays minus recoveries) of all of the government's bailout efforts.

The GSEs have been performing two separate roles. Their first function – the guarantee function -- is arguably the most important: guaranteeing the credit risk in conforming (prime non-jumbo) mortgages. The GSEs buy conforming mortgages from mortgage originators, bundle them, and sell them off to private investors in the form of mortgage-backed securities. However, the GSEs bear all the default risk in these mortgages. They charge a small fee to the mortgage originators for this guarantee. They hold 45 cents of capital for every 100 dollars of mortgage face value guaranteed. Ex post, it appears that the GSEs received inadequate compensation for the default risk they were bearing. This is one reason why their capitalization is somewhat inadequate relative to the risks they bear.

The second role is essentially the proprietary trading function: purchasing both prime and non-prime (Alt-A and subprime) mortgage-backed securities. They financed these asset purchases by issuing debt (so-called "agency" debt). Because of the implicit government guarantee (which has now become an explicit guarantee), the GSEs are able to borrow at below-market rates. The leverage ratio of the GSEs was a stunning 40:1 at the height of the housing boom, again illustrating that GSEs – through their own choice of leverage -- have been inadequately capitalized. When the market prices of the prime assets, and especially the non-prime assets, in their portfolio reflected greater default expectations, the thin equity cushion was quickly wiped out. The GSEs are effectively insolvent.

The current financial legislation is completely silent on the future of the GSEs. We believe this is a mistake given the central role they played in the crisis, their systemic nature and their structural weaknesses, which will persist unless these issues are addressed with urgency.

Recommendation

We believe there are three key issues that need to be dealt with by the Obama Administration and the Congress:

(1) First and foremost, the proprietary trading function of the GSEs needs to be discontinued entirely. There is no role for a gigantic government-sponsored hedge fund, trading in mortgage-related contracts. The original rationale for this trading was to promote liquidity in the secondary

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mortgage market. This reasoning is obsolete, because markets have now had more than 30 years of experience in trading conforming mortgage-backed securities. We envision that the government could slowly wind down the assets on the GSEs' balance sheets, for example, by corralling them into a kind of Resolution Trust Corporation, like the one created to during the Savings and Loan crisis in the late 1980s and early 1990s. This entity could hold on to the mortgage-backed securities until maturity or slowly sell them to the private market. Management groups from the GSEs could raise private capital and could be among the purchasers of these assets.

(2) Second, the ownership structure of the guarantee function of the GSEs should be revisited and possibly discontinued. This could be accomplished in several ways.

One option is to fully nationalize the guarantee business for conforming loans. The rationale for such nationalization is that in the next large mortgage crisis, the government would inevitably bail out any private securitization firm, say the re-privatized Freddie Mac or Fannie Mae. A downside of this approach is that no market information is available to ensure the government receives the correct insurance fee and the guarantee function remains economically viable. The current guarantee fee is too low and needs to be recalibrated in case this option is employed.

A second option is to fully privatize the guarantee business. In this scenario, the GSEs would be completely dismantled. This would eliminate the distortions that arise because of the implicit government guarantees, such as artificially low financing costs and artificially low mortgage rates. Note that conforming mortgages are loans that are conservatively underwritten: For example, all loans in the pool have loan-to-value ratios of 80% or less and have documented debt-to-income ratios of 35% or less. Therefore, these loans will have low credit risk to begin with. The idea is to structure these loans into tranches. The most senior tranche would effectively have no credit risk, and therefore would not need any credit guarantees. This tranche could be as large as 70% of all conforming loans (the default rate would need to exceed 60% with a 50% recovery rate before the senior tranche would take its first dollar loss). Under this scenario, the remaining 30% of loans would be securitized as subordinated tranche(s) that would contain (some) credit risk, and trade as such in private markets. Subordinated tranches may or may not contain insurance from private companies, such as the monolines.

A third option, which is also a private option, would see the GSEs disappear, but it would keep all conforming mortgage-backed securities guaranteed. From the investors' side, one potential advantage of keeping all conforming mortgage-backed securities guaranteed (credit risk-free) is that an investment community with substantial human capital was built up around default-free mortgage-backed securities. Under this scenario, private mortgage securitizers would purchase mortgage loans from originators and issue default-free mortgage-backed securities. Instead of bearing the credit risk, private securitizers would purchase mortgage default insurance for the mortgage-backed securities. In practice, this would only be necessary for the 30% subordinated debt mentioned above. However, it still may require too much private capital to insure the credit risk of all conforming mortgages in mortgage-backed securities. We believe there is an important role for the government here. In particular, mortgage default insurance would be offered through a new private-public partnership structure, modeled after the Terrorism Risk Insurance Act of November 2002. Specifically, the securitizer would purchase, say, 10% of its insurance from a large monoline insurance company and 90% from a newly formed government entity. As with terrorism risk insurance, the private insurance market would help to establish a market price for mortgage default risk. The newly formed government entity would charge a fee based on this market price. This would ensure that the government also receives adequate compensation for the credit risk, a key difference with the pre-crisis approach.

In the private scenarios, regulation would need to be imposed to prevent securitizers from engaging in proprietary trading and to ensure that monoline insurance companies that provide private insurance are well-capitalized.

In principle, the public-private insurance could be purchased not only for conforming loan pools, but also extended to non-conforming loans (prime jumbo, Alt-A, and subprime). Indeed, such a structure may help to revitalize the non-prime mortgage market. In fact, we recommend such an approach for the non-conforming mortgage market, as well. It would ensure that the government receives compensation for the systematic credit risk, which it ultimately bears on all mortgages. As in the 2008 crisis, most of that default risk in the event of a major housing crisis is, in fact, concentrated in the non-prime mortgage segment.

Regardless of which option is chosen, we recommend abolishing the conforming loan limit (capped at $730,000 in 2009), as long as all other underwriting standards are preserved.

(3) Third, the GSEs should get out of the business of promoting home ownership for low-income households and underserved regions. We believe that whatever decision is made about the future of the GSEs, the current two mandates of making mortgage markets liquid and well-functioning and of promoting access to mortgage credit by underserved groups of regions are incompatible. The current approach of government intervention through the GSEs -- to keep mortgage interest rates artificially low for all households -- is both too expensive and ineffective. If the policy objective is to promote and subsidize low-income home ownership, then the Federal Housing Administration and its securitizer, Ginnie Mae, are much better suited to perform the role for the underserved groups or regions, rather than for all households at large. Such a focused approach would be both more transparent and more effective.