Freddie Mac, Fannie Mae and the Future of Mortgage Markets

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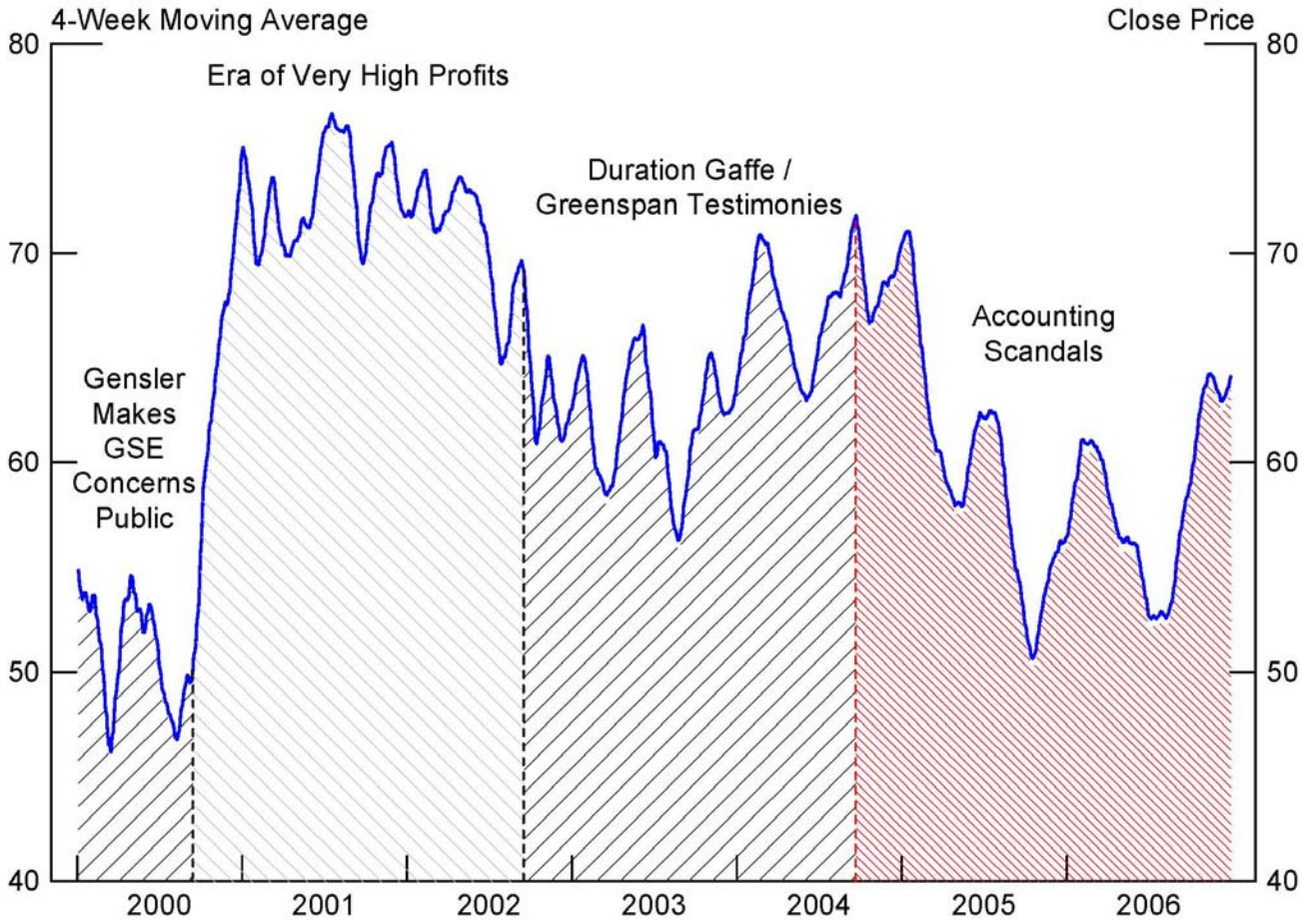
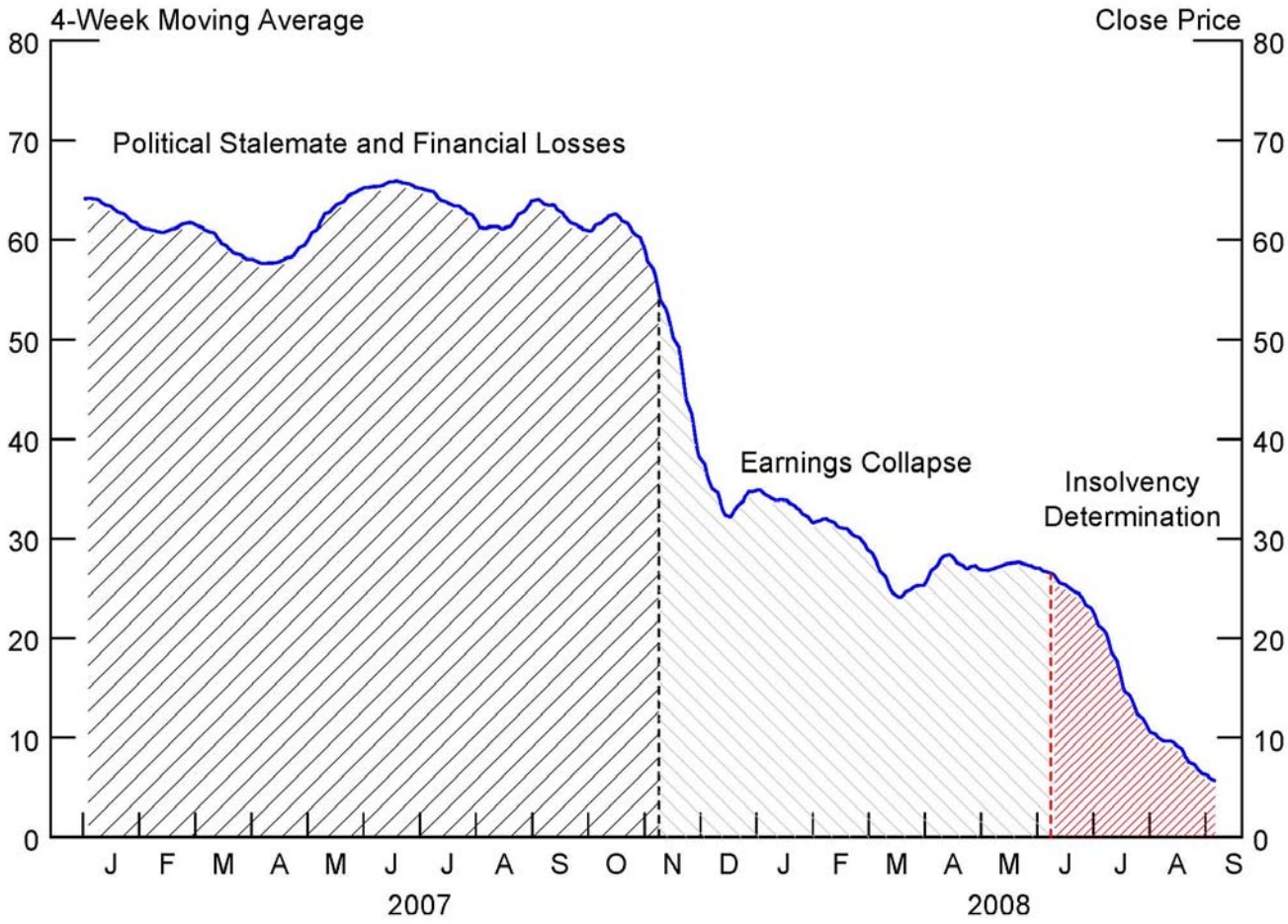
* The views expressed do not necessarily reflect those of the Board of Governors of the Federal Reserve System, or its staff.

GSE history (2000-2006)



GSE history (2007-conservatorship)



The Federal Reserve's concerns about the GSEs Prior to Conservatorship

- Close ties to government allowed the GSEs to borrow at lower interest rates
- Private ownership and duopoly structure meant limited pass-through of benefits
- Allowed rapid portfolio growth and high profits
- Created incentives for regulatory capture
- Created systemic risk (Greenspan, February 2004)

Systemic risk: GSE portfolios, not GSE mortgage securitization

- Portfolio growth and profit pressures
  - Lowered underwriting standards
  - Accumulation of Alt-A mortgages
- Low capitalization
- Lack of ongoing market discipline
  - Accounting scandal created lack of confidence in internal controls
  - Debt costs did not rise throughout scandal
- Rollover risk
  - Debt investors fled
  - Concerns arose about credit quality of mortgage portfolio, “liquidity portfolio,” and pledging of assets for secured borrowing

How the GSE Portfolio Created Failure

- Most GSE losses associated with credit guarantee, not the holding of securities in the portfolio
- How a crisis unfolds—debt holders flee
  - GSE senior debt holder is unsecured
  - MBS holder has access to underlying collateral
  - Losses, whatever the source, wipe out the capital
  - GSE debt holders "run" if substantial losses are likely, even from the credit guarantee
- GSE debt holders are more likely to run because the credit losses and portfolio values are opaque and because capitalization is thin
- No GSE portfolio implies…
  - GSEs are only servicers and guarantors of MBS principle and interest
  - If GSE guarantee comes into question, the MBS investors have underlying collateral
  - If capitalization of GSE is inadequate to cover "double default," then MBS price falls in secondary market
  - But not a run that makes it impossible to rollover unsecured debt in a very short timeframe
  - Government guarantee for MBS is still needed to cover catastrophic risk

What to do with Fannie Mae and Freddie Mac?

- Bernanke (2008)
- Option 1: Privatization
  - Unclear what this means; not evident that private sector would securitize mortgages without government support
    - Private sector finds it difficult to insure against catastrophic risk
    - MBS markets have failed in the past (e.g., during the Great Depression)
  - Strong social interest in maintaining a stable source of capital market funding for mortgages
  - Suggests private firms with some form of government backstop or regulation
  - Hancock, Passmore (2008, 2009): Bond insurer
    - An Analysis of Government Guarantees and the Functioning of Asset-Backed Securities Markets
    - http://www.federalreserve.gov/pubs/feds/2010/201046/201046abs.html

Option 2: Covered bonds

- Debt obligations are issued by financial institutions and secured by a pool of high-quality mortgages
  - Pool is actively managed by originating financial institution
  - Common method of funding mortgages in Europe
  - Relatively robust financing during financial crisis
  - Usually have some form of explicit or implicit government backing
  - Difficult to start in the United States because it competes with FHLB funding; FDIC has resolution concerns

Option 3: Government agency or public utility

- Private shareholders overseen by utility board (Paulson)
- Consolidate FHA and GSEs into a government agency
- Cooperative structure like FHLBs (trade associations)
- Davidson / New York Federal Reserve Staff Proposal

Retail Investor Runs, Asset Securitization, and an Analysis of Government Secured Bond Insurance

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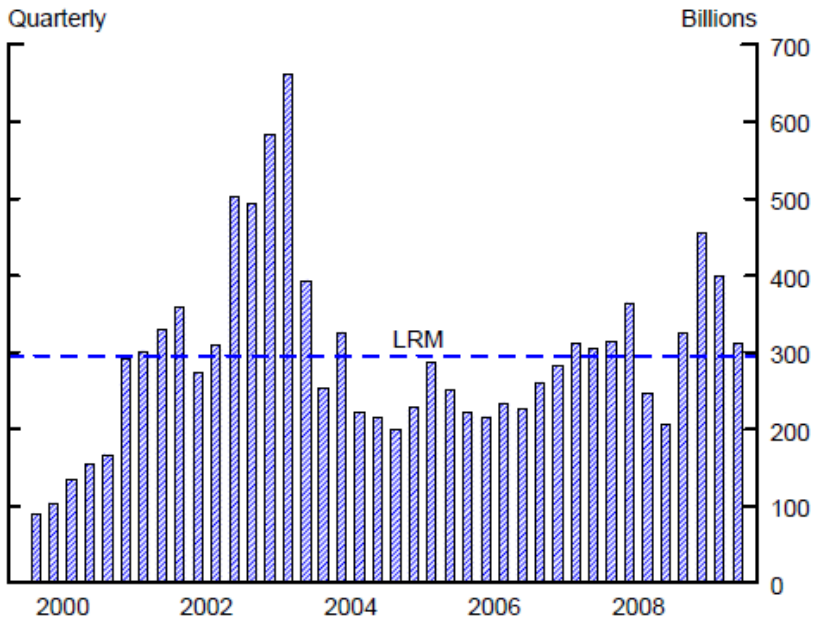
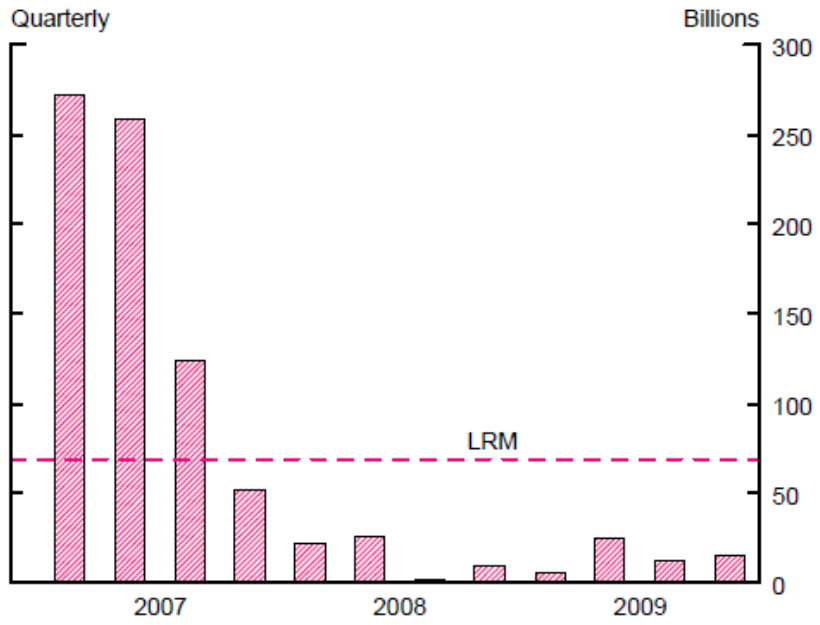
Two different outcomes during the financial crisis: Agency (left-panel) and Non-agency MBS Issuance (right-panel)





The Analysis in Our Paper

- What is the market failure in the mortgage market that creates a financial crisis?
  - Our analysis of loan market equilibriums shows that the additional liquidity of securitization may or may not lower mortgage rates, but does create the potential for significant market disruption if guarantee-sensitive investors doubt the credit quality of the asset-backed bonds.
  - Moreover, the secondary markets for asset-backed securities can be subject to "runs" because guarantee-sensitive investors rely on selling assets quickly rather than undertaking due diligence and holding assets throughout the credit cycle.
  - Generally, these runs occur only during extreme financial market disruptions (so-called tail risk).

Policy implications of financial crisis for securitization

- Government-backed insurance for ABS: Because securitization ceases during a financial crisis without a credible government backstop
- Regardless, government bears the "tail risk" associated with a systemic shock
  - Should manage this risk like an insurer
  - Would mitigate disruptions during a financial crisis if managed *ex ante*
- We propose: FINSAIF (financial institutions' secured asset-backed insurance fund)
- Structured like FDIC:
  - Explicit risk-based insurance premiums charged to ABS originators
  - Insurance fund maintained
  - Insures only against very extreme financial disruptions (e.g., catastrophic risks)
- Expands GSE function from securitizing mortgages to all loan types
- Provides possible role for Fannie Mae or Freddie Mac

Advantages of FINSAIF

- Explicit government guarantee fosters financial stability
- Ensures that similar risks for assets held across all FIs (big and small) are treated similarly (mitigates TBTF)
- Makes funding of longer-term assets by FIs easier
- Provides retail investors with a diversity of assets to purchase and removes their search for implicit government backing

Is More than a Government Insurer Needed?

- If the government is only a catastrophic risk insurer, then…
  - Insurer sets underwriting standards (like Fannie and Freddie do now)
  - Conforming mortgage securitization will be initially the domain of large banks
    - Can others enter the business of forming pools and creating securities that qualify for government insurance?
    - Economies of scale and scope? Unknown at this time.
    - Is a cooperative structure to do securitization (e.g. among credit unions) possible without government backing?
  - Who insurers against the first losses (before government backing kicks in)?
    - Homeowner's down-payment
    - PMI companies
    - Self-insurance by banks (representations and warranties)
    - Private entities that issue junior bonds?
  - Will the TBA market function?
    - We would argue that government insurance is the key to a functioning TBA market
    - As long as guarantee is credible, the TBA market would be unchanged
      - The securities could trade under the FINSAIF name
  - How are affordable housing goals handled?
    - One possibility: An explicit tax on the guarantee fee that funds a quasi-government fund