Options To Restructure Fannie Mae and Freddie Mac

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Summary

This report analyzes some options that Congress might wish to consider for the future of Fannie Mae and Freddie Mac, which are federally chartered, stockholder-owned corporations known as government-sponsored enterprises or GSEs.

As GSEs, Fannie Mae and Freddie Mac have special privileges and obligations. Their charters give them a close relationship to the federal government that was widely (but not universally) viewed as an implicit federal guarantee of their bonds and mortgage-backed securities (MBS). The Housing and Economic Recovery Act of 2008 (HERA, P.L. 110-289) authorizes the Secretary of the Treasury to purchase unlimited amounts of obligations and other securities from the GSEs.

On September 7, 2008, the GSEs agreed to allow the Federal Housing Finance Agency to take over management of the GSEs by placing them under conservatorship. While under conservatorship, the GSEs have assumed a leading role in efforts to resolve and prevent foreclosure. As of the middle of 2009, the Treasury and the Federal Reserve had purchased $833.3 billion of MBS, $82.8 billion of debt, and $92 billion of senior preferred stock from Fannie Mae and Freddie Mac.

The options analyzed in this report include returning Fannie Mae and Freddie Mac to stockholder control as GSEs, merging them into the federal government as part of a government agency (sometimes called nationalization), and privatizing them. In addition, this report examines co-op insurance, a utility regulation model, government reinsurance, and the role of private bonds in home finance markets.

In addition to considering the future of Fannie Mae and Freddie Mac, Congress might wish to consider the future of the third housing GSE, the Federal Home Loan Bank System.

This report will be updated as warranted by legislative developments.

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Introduction

This report analyzes options that Congress might wish to consider for the future of Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (commonly called Fannie Mae and Freddie Mac, respectively), which are federally chartered, stockholder-owned corporations known as government-sponsored enterprises or GSEs.[1] The GSEs' charters give them special benefits (such as exemption from certain securities laws and exemption from state and local income tax) and impose special obligations to support housing. In addition, prior to the GSEs going into conservatorship in 2008, the federal government was widely (but not universally) viewed as implicitly guaranteeing GSE bonds and mortgage-backed securities (MBS).

The GSEs were chartered by Congress with five purposes:

1. To stabilize the secondary mortgage market for residential mortgages;
2. To respond "appropriately" to the capital market;
3. To increase the liquidity of mortgages (including mortgages for low- and moderate-income families);
4. To promote access to mortgage credit in all areas of the nation (including underserved areas); and
5. To "manage and liquidate federally owned mortgage portfolios in an orderly manner, with a minimum of adverse effect upon the residential mortgage market and minimum loss to the Federal Government."[2]

It could be argued that between the time Fannie Mae and Freddie Mac became GSEs and the time that they were placed in conservatorship, they accomplished these goals except, perhaps, for operating with minimum loss to the federal government. Even under conservatorship, they continued (with assistance from the federal government) to fulfill their mission, although it can again be contested that they have operated with minimal loss to the federal government.

The Housing and Economic Recovery Act of 2008 (HERA, P.L. 110-289) authorized greater standby government support for the GSEs, including the FHLBanks, by allowing the Secretary of the Treasury to purchase unlimited amounts of obligations and other securities from the GSEs. The HERA-enhanced authority of the U.S. Department of the Treasury (Treasury) to assist the GSEs expires December 31, 2009. HERA created a new independent agency, the Federal Housing Finance Agency (FHFA), to regulate the GSEs.

On September 7, 2008, FHFA and the GSEs agreed to voluntary conservatorship, in which FHFA assumed control of Fannie Mae and Freddie Mac. Each GSE sold to Treasury $1 billion of senior preferred stock and gave Treasury warrants to purchase 79.9% of its common stock.[3] Treasury

[1] 2 U.S.C. 622(8) defines "government-sponsored enterprise." The Federal Home Loan Banks (FHLBanks) collectively are a third housing GSE. Following common practice, the report uses GSE to refer to Fannie Mae and Freddie Mac. If the FHLBanks are included, this will be explicitly stated.

[2] 12 U.S.C. 1716 (Fannie Mae), and 12 U.S.C. 1451 Note (Freddie Mac).

[3] A company's preferred stockholders do not elect the board of directors or otherwise exercise control over the firm, but payment of their specified dividend has a priority over the payment of dividends to common stockholders. A warrant is a type of option issued by a company to purchase stock at a specified price.

agreed to purchase a maximum of $100 billion (later raised to $200 billion) additional senior preferred stock to maintain a positive net worth of each GSE paying a 10% cash dividend, to purchase MBS from the GSEs, and to lend funds to the GSEs (including the FHLBanks).[4] In addition, the Federal Reserve has extended financial assistance to the GSEs in the form of MBS and debt purchases.[5] Conservatorship will end when the GSEs return to a safe and solvent condition.[6]

As of August 20, 2009, FHFA reported that the Treasury and the Federal Reserve had purchased $876.5 billion of MBS, $86.4 billion of debt, and $95.6 billion of senior preferred stock from Fannie Mae and Freddie Mac.[7] **Table 1** details this support.

Table 1. Government Financial Support for Fannie Mae and Freddie Mac

($ in billions)

Government Action	Fannie Mae	Freddie Mac	Total
Treasury Purchases of Senior Preferred Stock	44.9	50.7	95.6
Treasury Purchases of MBS	89.0	82.8	171.8
Federal Reserve Purchases of MBS	445.3	259.4	704.7
Federal Reserve Purchase of GSE Debt	45.1	41.3	86.4
Total Government Support	624.3	434.2	1058.5

Source: Federal Housing Finance Agency, *Current Data on Treasury and Federal Reserve Purchase Programs for GSE and Mortgage-Related Securities*, August 20, 2009, http://www.fhfa.gov/webfiles/14778/TSYFed082009.pdf.

This report discusses alternatives available to Congress for restructuring Fannie Mae and Freddie Mac; the list is not exhaustive—it probably is impossible to develop a complete list. The options take as a starting point that Fannie Mae and Freddie Mac return to financial health and are able to leave their current conservatorship. This might not occur. In 2008, Fannie Mae lost $58.7 billion, and Freddie Mac lost $50.2 billion. To maintain positive net worth, Fannie Mae has sold $44.9 billion of preferred stock to the Treasury, and Freddie Mac has sold $50.7 billion. If Fannie Mae or Freddie Mac were to fail, they would be placed in receivership and their assets sold to satisfy their creditors.

[4] The initial contracts to purchase a maximum of $100 billion from each GSE were amended May 6, 2009, to increase the maximum to $200 billion each. See CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses*, by Marc Labonte.

[5] Federal Reserve Bank of New York, "FAQs: MBS Purchase Program," press release, March 24, 2009, http://www.newyorkfed.org/markets/mbs_faq_090324.html and Federal Reserve Bank of New York, "FAQs: Purchasing Direct Obligations of Housing-Related GSEs," press release, April 21, 2009, http://www.newyorkfed.org/markets/gses_faq_090421.html.

[6] Federal Housing Finance Agency, "Questions and Answers on Conservatorship," press release, September 7, 2008, http://www.treasury.gov/press/releases/reports/fhfa_consrv_faq_090708hp1128.pdf.

[7] Mortgage-backed securities (MBS) are pools of mortgages that Fannie Mae and Freddie Mac combine and guarantee. The size and guarantee make MBS more attractive to institutional investors. Federal Housing Finance Agency, Current Data on Treasury and Federal Reserve Purchase Programs for GSE and Mortgage-Related Securities, August 20, 2009, http://www.fhfa.gov/webfiles/14778/TSYFed082009.pdf.

HERA requires that a GSE be placed in mandatory receivership and its assets liquidated if (1) the GSE's assets have been less than its liabilities for 60 consecutive days, or (2) the GSE has not been paying its bills (except for debts subject to bona fide dispute) for the past 60 days.[8]

In debating alternatives for the futures of Fannie Mae and Freddie Mac, Congress might wish to consider whether the five goals are still germane. For example, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (P.L. 103-328) may have made the fourth point in the GSEs' charters (promoting mortgage credit throughout the nation) unnecessary because the act allowed interstate banking and led to more equal access to call credit throughout the nation.

Fannie Mae's and Freddie Mac's Business Models

Fannie Mae's and Freddie Mac's business models have evolved similarly. They both

- purchase single-family mortgages that other companies have originated;[9]
- guarantee that the mortgages will be paid and pool the mortgages to create MBS;
- sell the MBS to institutional investors, or keep them in their own investment portfolios. If the GSE decides to keep the MBS, it borrows money by selling bonds to finance the MBS.

For many years, the GSEs were very profitable using this business model because they were widely viewed as having a close relationship to the federal government. Some called it an implicit guarantee. This allowed the GSEs to guarantee their MBS and to finance their investment portfolios at lower cost than competitors, which had neither GSE charters nor a special relationship with the federal government. GSE profitability was increased by their charter provisions such as those exempting them from state and local income taxes, and by lower capital requirements than their non-GSE competitors. To enhance profits, the GSEs used a variety of techniques, some of which increased the riskiness of the GSEs' finances:

- Because short-term interest rates are normally lower than longer-term interest rates, the GSEs financed their investment portfolios of MBS by borrowing for short periods of time. This strategy could reduce GSE profits if interest rates were higher when this debt was refinanced.[10] The GSEs reduced their vulnerability to increased interest rates by the use of financial derivatives.
- Having nationwide geographic diversification reduced the GSEs' credit or default risk. Regional declines in home prices—such as the home price decline of approximately 25% between 1985 and 1990 in the "Oil Patch"—were balanced by stable prices in other areas. The GSEs further reduced their risk by purchasing insurance from financial guaranty insurance companies.

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[8] P.L. 110-289, Sec. 1145. Actual dissolution of a GSE would require Congressional action.

[9] In addition, the GSEs purchase multifamily mortgages. These multifamily mortgages are a relatively small portion of the GSEs' purchases. In 2008, Fannie Mae purchased $617 billion of mortgages of which $34 billion were multifamily. In the same year, Freddie Mac purchased $382 billion of mortgages including $24 billion of multifamily mortgages. Source: Federal Housing Finance Agency, *2008 Report to Congress*, 2008, p. 122, http://www.fhfa.gov/webfiles/2335/FHFA_ReportToCongress2008508.pdf.

[10] Most 30-year mortgages are paid off because of refinancing or moving in 7 to 10 years. On average, the GSEs need to finance a 30-year mortgage (or MBS) held in portfolio for this 7 to 10 year time period.

- The GSEs found creative ways to satisfy the requirement in their charters that mortgages for more than 80% of the value of a house have credit enhancements such as mortgage insurance. For example, one GSE would purchase the first mortgage for 80% of a home's value, and the other GSE would purchase a second mortgage for 5% or even 15% of the same home's value. This resulted in larger mortgages and more fees for the GSEs, but increased the severity of losses when default occurred.
- Tax planning techniques, including purchasing tax-exempt bonds and low-income housing tax credits (LIHTCs), reduced taxes. The risk of these strategies was that if the GSEs' earnings decreased more than anticipated, the tax planning expenditures would not be usable and could increase losses.
- Compared with many other types of financial institutions, the GSEs were required to keep less capital as a reserve against possible losses. This increased leverage made possible higher profits, but increased the risk of larger losses compared to holding more capital.

GSE Financial Status

For the second quarter of 2009, Fannie Mae reported its eighth straight quarter of losses, whereas Freddie Mac reported a profit for the first time in eight quarters. Since the third quarter of 2007, Fannie Mae has reported total losses of $102 billion, and Freddie Mac has had a net loss of $63 billion. To maintain a positive net worth, Fannie Mae and Freddie Mac have sold to Treasury senior preferred stock in the amounts of $46 billion, and $52 billion, respectively. In short, if not for the provisions of HERA, both Fannie Mae and Freddie Mac would be insolvent. Prior to HERA, there were no provisions for the GSEs to enter receivership and hence no procedures available to liquidate their assets.[11]

The GSEs' main assets are the mortgages that they have in their investment portfolios. According to their monthly volume summaries at the end of 2008, Fannie Mae had a gross mortgage portfolio of $787 billion and other investments of $83 billion for a total of $870 billion in assets compared with debt of $884 billion. Freddie Mac had a mortgage portfolio of $805 billion and other investments of $64 billion for a total of $869 billion in assets compared with debt of $870 billion.

Alternatives to Liquidation

If FHFA's conservatorship is not able to return the GSEs to financial health, there are at least two approaches that could avoid complete liquidation of the GSEs.

[11] For more on conservatorship and receivership, see CRS Report RL34657, *Financial Institution Insolvency: Federal Authority over Fannie Mae, Freddie Mac, and Depository Institutions*, by David H. Carpenter and M. Maureen Murphy.

"Bad Bank" Option

First, the "bad bank" approach would mirror one technique used by the Federal Deposit Insurance Corporation (FDIC) to resolve insolvent banks.[12] The FDIC creates a "bad bank" to hold the problem assets, leaving the good assets with the original bank. Without the problem assets, the original bank is financially viable and possibly able to attract new capital. In the case of the GSEs, delinquent mortgages and MBS, with related guarantees, would be transferred to the new entity. The bad bank would need capital to purchase the nonperforming assets from the GSEs. Because the private sector would be unlikely to invest in the bad bank, the capital to purchase the assets would probably come from the federal government. Timing the creation of this new entity could be important to ensure that the GSEs do not become insolvent again.

The bad bank could require continuing funds from the government, but might continue in operation in the hope that as housing and financial markets recover, the value of the mortgages and MBS would increase to exceed the value of the guarantees.

Restructuring Senior Preferred Stock

Second, the GSEs' senior preferred stock could be restructured so that the 10% dividends were less of a financial burden to the GSEs. This could save the GSEs $8billion to $9 billion annually, but would reduce the federal government's income by the same amount. The federal government could accomplish this by writing off some or all of the cost of the senior preferred stock or by agreeing to accept a lower annual dividend.

The advantage of restructuring the senior preferred stock is that it would allow the GSEs to return to stockholder control, which is discussed in detail below. The disadvantage is that the GSEs and their stockholders would have received significant financial benefits without fully having paid for those benefits. This could lead to the expectation of future government support and encourage the GSEs to assume more risk than they would without this expectation.

Receivership

HERA provides for voluntary and involuntary receivership. FHFA is required to place a GSE in involuntary receivership if either the GSE's liabilities exceed its assets for 60 days, or if a GSE fails to pay its bills (except for those being disputed) for 60 days. FHFA is authorized by HERA to create a temporary successor.

Restructuring Options

Assuming that one way or another both GSEs return to financial solvency, some of the options that Congress might consider are

- return Fannie Mae and Freddie Mac to their stockholders with little or no change to their congressional charters;

[12] CRS Report RS22963, *Financial Market Intervention*, by Edward V. Murphy and Baird Webel.

- eliminate their GSE status and convert Fannie Mae and Freddie Mac into private corporations;
- eliminate their GSE status and convert Fannie Mae and Freddie Mac into a government agency; or
- make supplementary changes to support the secondary mortgage market, such as providing government reinsurance of MBS or encouraging the use of covered bonds.

Table 2 summarizes the options.

Table 2. Summary of GSE Restructuring Options

Category	Option	Summary
Maintaining GSE status	Return control to stockholders	Return GSEs to status prior to being placed in conservatorship with no changes to oversight
	Retain GSE status with additional regulation	Return GSEs to status prior to being placed in conservatorship with additional oversight
	Explicit guarantee	Federal government would explicitly guarantee MBS. (The explicit guarantee probably would eliminate the GSE status of Fannie Mae and Freddie Mac. See 2 U.S.C. 622(8))
	Utility model	Return GSEs to status prior to being placed in conservatorship, but regulate their profits
	Split GSEs	Return GSEs to status prior to being placed in conservatorship, but divide the two GSEs into many GSEs
	Combine with FHLBanks	Fannie Mae and Freddie Mac would be merged with the FHLBanks, which is the third housing GSE
Eliminate GSE status	Government agency	Merge the GSEs with FHA and Ginnie Mae, which are parts of HUD, or convert the GSEs into a new government agency
	Privatization	Remove all of the GSEs' special obligations and privileges by revoking their Congressional charters
	Privatization with Co-Op Insurance	Remove all of the GSEs' special obligations and privileges by revoking their Congressional charters, and organize a co-operative to provide first line insurance for MBS.
Supplementary	Reinsurance	Provide explicit federal backup insurance for MBS
	Covered bonds	Encourage the issuance of overcollaterized MBS

Source: CRS.

This report continues by discussing the advantages and disadvantages of these options and by adding more detail to the options.

Options Maintaining GSE Status

By law, the GSEs' conservatorship will end if they meet their minimum capital requirements, or when the FHFA director determines that ending conservatorship would be in the public interest. If this occurs, there are a number of options that could be considered that would include maintaining Fannie Mae and Freddie Mac as GSEs. These are returning control to the stockholders with no additional modification, imposing additional regulations on the GSEs, explicitly guaranteeing the GSEs' MBS, imposing utility-type profitability limits on the GSEs, merging Fannie Mae and Freddie Mac into the Federal Home Loan Bank System, and issuing additional GSE charters.

Option: Return Control to Stockholders

Congress could decide to make little or no change to the GSEs' charters. The GSEs would continue to be stockholder-owned companies with special charters and special obligations to support the housing market.

If this option were adopted, common stockholders would regain their right to elect the boards of directors, which in turn would appoint senior management. Dividends to preferred stockholders could resume. Dividends on the senior preferred stock owned by the federal government would continue. The GSEs would decide whether to retire the senior preferred stock held by the federal government. The boards of directors could resume common dividends. Bond payments would continue, and after December 31, 2009, the GSEs would shrink their portfolios by 10% annually until their portfolios were less than $250 billion.[13]

Return to stockholder control implicitly assumes that the GSEs would return to profitability. Since entering into conservatorship, the GSEs have issued to Treasury approximately $95 billion in senior preferred stock. This stock pays an annual cash dividend of 10% or an annual preferred stock dividend of 12%. Since 1980, Fannie Mae's income has been sufficient to pay this cash dividend in only four years: 2005, 2004, 2003, and 2001; Freddie Mac could have done this only in 2002. Based on historical data, the GSEs are unlikely to be able to sustain the annual cash dividend payments. Unless the government were to agree to a reduction in the 10% dividend or the amount of senior preferred stock, it seems unlikely that GSEs would have value to common stockholders.

Moreover, in agreeing to conservatorship, the GSEs each gave the federal government warrants to purchase 79.9% of their common stock at $0.00001 per share. Before effective control could be returned to common stockholders, the GSEs probably would need to reach some agreement with the federal government over the disposition of these warrants. Based on similar past government intervention such as Chrysler in 1979 and Continental Illinois in 1985, alternative dispositions of these warrants include federal government exercise, sale of the warrants through a federal government open market auction of them (which the GSEs could win), and federal government

[13] On February 18, 2009, Treasury announced that it was increasing each GSE's portfolio limit from $850 billion to $900 billion. See U.S. Treasury, "Statement by Secretary Tim Geithner on Treasury's Commitment to Fannie Mae and Freddie Mac," press release, February 18, 2009, http://www.treasury.gov/press/releases/tg32.htm, U.S. Treasury, "Amended and Restated Senior Preferred Stock Purchase Agreement," press release, September 26, 2008, http://www.treasury.gov/press/releases/reports/seniorpreferredstockpurchaseagreementfnm1.pdf, and U.S. Treasury, "Amended and Restated Senior Preferred Stock Purchase Agreement," press release, September 26, 2008, http://www.treasury.gov/press/releases/reports/seniorpreferredstockpurchaseagreementfrea.pdf.

cancellation of the warrants.[14] In mid-2009, with its stock trading at approximately $0.65, Fannie Mae had a market capitalization of slightly more than $700 million. This would make 80% of the enterprise worth $560 million. In mid-2009, Freddie Mac's stock price was $0.70 and its market capitalization was slightly more than $460 million, making 79.9% of Freddie Mac $368 million. Because the GSEs "have succession until dissolved by Act of Congress," it is not clear what limits there might be on an outside company purchasing the warrants.

Arguments in Favor

The argument in favor of the no change option is that by some measures the GSEs have been successes; since the GSEs became stockholder owned (1968 in the case of Fannie Mae, and 1989 in the case of Freddie Mac), only the recent exceptional housing markets have required government intervention.[15] Arguably, the GSEs have led to many changes in the nation's mortgage markets that have improved efficiency and consumer choice. Some might debate whether these innovations have been improvements and others might claim to have invented them before the GSEs:

- Standardizing mortgages, which has contributed to economies of scale and lower interest rates for homeowners;
- Automating and standardizing underwriting, which has reduced the cost of obtaining a home mortgage;
- Making widespread certain features such as assumable mortgages and mortgages without prepayment penalties, both of which facilitate refinancing;
- Tapping new sources of funding including pension funds, trusts, and international investors, which has led to lower mortgage interest rates;
- Eliminating state and local mortgage interest rate differentials, which has lowered mortgage rates in some parts of the nation, but possibly increased them in others;
- Innovating in affordable housing and equal housing opportunity, and
- Creating a liquid secondary mortgage market, which has lowered mortgage interest rates.

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[14] CRS Report RL34423, *Government Interventions in Financial Markets: Economic and Historic Analysis of Subprime Mortgage Options*, by N. Eric Weiss, and CRS Report RS22956, *The Cost of Government Financial Interventions, Past and Present*, by Baird Webel, Marc Labonte, and N. Eric Weiss analyze selected past government actions. Information on Fannie Mae's and Freddie Mac's warrants is available at U.S. Treasury, "Federal National Mortgage Association: Warrant to Purchase Common Stock," press release, September 7, 2008, http://www.treasury.gov/press/releases/reports/warrantfnm3.pdf and U.S. Treasury, "Federal Home Loan Mortgage Corporation: Warrant to Purchase Common Stock," press release, September 7, 2008, http://www.treasury.gov/press/releases/reports/warrantfrec.pdf. See also, CRS Report R40005, *Chrysler Corporation Loan Guarantee Act of 1979: Background, Provisions, and Cost*, by James M. Bickley.

[15] Fannie Mae became stockholder owned in 1968 by *Housing and Urban Development Act of 1968*, P.L. 90-448, 82 Stat. 536, and Freddie Mac in 1989 by *Financial Institutions Reform, Recovery, and Enforcement Act of 1989*, P.L. 101-73, 103 Stat. 429.

Arguments Against

There are at least three broad arguments against returning the GSEs to their former status. First, the GSEs' history includes previous financial and management problems. In 1982, Fannie Mae was in financial distress, and the government intervened after Congress passed the Miscellaneous Revenue Act of 1982, which provided some tax benefits for Fannie Mae.[16] In the early 2000s, Fannie Mae and Freddie Mac both had serious accounting and management issues that led to consent agreements with the Office of Federal Housing Enterprise Oversight (OFHEO), which then regulated them, and the Securities and Exchange Commission (SEC); and the GSEs' leaderships were replaced. Fannie Mae paid about $400 million in fines, and Freddie Mac paid $125 million in fines.

Second, many, if not all, of the changes used as points in favor of returning the GSEs to stockholder control arguably would have occurred without Fannie Mae and Freddie Mac, although possibly not as early. Other large mortgage market participants, such as banks and mortgage insurance companies, could have standardized and automated the lending process. Ginnie Mae, a government agency, issued the first MBS.

Prior to the Riegel-Neal Interstate Banking and Branching Efficiency Act of 1994 (P.L. 103-328), banks were not allowed to operate in more than one state. Banks in one state might have many deposits relative to the demand for loans, and reduce interest rates, including those on home mortgages, to encourage borrowing. At the same time, banks in another state might have relatively few deposits compared to loan demand and would increase interest rates. Because of the ban on interstate banking, money could not easily flow between states to equalize interest rates. One of the GSEs' roles was to move funds to where demand for home mortgages was greatest. After Riegel-Neal permitted interstate banking, it was arguably inevitable that interest rates and mortgage interest rates would become uniform across the nation.

Third, the conservatorship of the GSEs made several changes in the future financial environment of the GSEs.

- Having previously intervened, the federal government may be perceived as likely to provide any necessary future financial support to the GSEs to pay bonds, despite charter provisions that state that GSE debts are not guaranteed by the federal government.
- Attracting new common stockholders could be difficult because of the federal government's taking control and stopping dividend payments to common stockholders. The burden of the senior preferred dividends and the warrants could make it very difficult to raise additional capital by selling new stock.
- Attracting new preferred stockholders could be difficult since the federal government stopped dividend payments to preferred stockholders.

Option: Retain GSE Status with Additional Regulation

In returning the GSEs to stockholder control, additional statutory and regulatory oversight could be imposed. This could include increased minimum capital requirements, limits to executive

[16] Miscellaneous Revenue Act of 1982, P.L. 97-362, 96 Stat. 1726 et seq.

compensation, limits to stockholder dividends, changed accounting procedures, or portfolio size limits. Regulations arguably could help prevent future financial problems with the GSEs. An argument can be made that if the government were to give the GSEs more explicit or implicit assistance, the GSEs might have to broaden their support of housing.[17]

On the one hand, an advantage of returning the GSEs to their stockholders while imposing additional regulation is that it is a return to a familiar model. The GSE support for affordable housing could continue.

On the other hand, making changes to GSE regulation has been a very contentious issue whenever Congress debated it in the past; previous GSE regulation failed to prevent their going into conservatorship; and the federal government has expended large amounts of money to maintain the GSEs' financial viability.

Option: Retain GSE Status with Explicit Guarantee

It can be argued that prior to 1992, the implicit guarantee in the GSEs' charters was provided at no cost to the GSEs. The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (FHEFSSA, P.L. 102-550) authorized HUD to set explicit affordable housing goals for the GSEs. The GSEs were not expected to lose money on mortgages purchased to meet the housing goals, but they were not guaranteed that the housing goals mortgages would be as profitable as other mortgages. Thus the implicit guarantee was provided at an implicit cost. One problem with implicit guarantees and implicit costs is that since their terms are not clearly defined, they are hard to value.

A possible solution to this concern would be for the government to make the guarantee explicit and to charge an explicit guarantee fee. The exact terms of the guarantee could be stated. Homebuyers might directly pay this guarantee fee as they now pay the FHA's guarantee fee, or the GSEs could be charged the guarantee fee. In the latter case, the GSEs could decide how much of the fee to pass on to borrowers. By changing the guarantee fee, the federal government could increase or decrease the GSEs' profits.

Instead of guaranteeing the GSEs, the federal government could make the explicit guarantee available on all mortgages that met certain standards. This would be similar in effect to enlarging the FHA's guarantee program to cover more of the mortgage market. The federally guaranteed mortgages could be bundled and securitized. Since they would have a federal guarantee, Ginnie Mae could securitize these mortgages.

One issue with this option would be deciding what types of mortgages could be guaranteed and how new types of mortgages could be added to the program. Guarantees for mortgages that would be originated anyway would be an expense to the GSEs and a contingent liability for the government that would not increase homeownership. If a lender were to develop an extremely risky new type of mortgage, should the government guarantee it? Should the government charge an actuarially sound guarantee fee? If so, would not the private sector offer the same guarantee?

[17] Current GSE affordable housing goals were published in Federal Housing Finance Agency, "2009 Enterprise Transition Affordable," 74 *Federal Register* 20236-20263, May 1, 2009.

Option: Retain GSE Status with Utility Model

In what is frequently called the utility model, the federal government could explicitly regulate the GSEs' profit margins much as state utility regulators control utility profits. The federal government could either explicitly approve new GSE products, or new GSE products could be implicitly regulated by setting guarantee rates.[18]

Some have suggested that only one federally chartered company would be eligible for the guarantee, but others have suggested that at least two GSEs would be eligible. Public utilities' regulation has been justified on the basis that there are economies of scale that can be captured if there is only one utility. By restricting competition, only one water main, telephone line, natural gas pipe, or electrical line needs to be constructed to connect each home and business with the utility. The regulator is charged with balancing the economic interests of consumers against those of the monopoly provider. For example, while Fannie Mae and Freddie Mac have found their retained portfolios of MBS to be profitable, the net value to homeowners is subject to much debate. In the utility model, the retained portfolios might be restricted to simplify regulatory oversight and to reduce risks.

It is debatable whether there are economies of scale that would result in savings if there were only one or two mortgage companies receiving federal guarantees.

Option: Split the GSEs

Arguably, one of the sources of the GSEs' problems has been that there are only two of them. Over time, Fannie Mae and Freddie Mac became virtual twins and essentially divided the conforming U.S. mortgage market between them.[19] The result was, it could be argued, not much different from having a monopolist GSE that could charge high prices and make persistently large profits in the absence of competition. Prior to the financial turmoil that started in 2007, there were dozens of non-GSEs in the relatively small private label MBS market. Some claim that the market would have supported more than two GSEs issuing MBS, if more GSE charters had been issued.

One option to increase competition would be to split the GSEs into many more. If each GSE were split into, say, 10 equal parts (for a total of 20 housing GSEs), each of the 20 resulting GSEs would have mortgage portfolios of one-tenth its parent and have one-tenth of its parent's mortgage guarantees outstanding.[20] Based on year end 2008 financial statements, the baby Fannie Maes would each have a mortgage portfolio and outstanding guarantees of $298 billion; the baby Freddie Macs would each have a mortgage portfolio and outstanding guarantees of $221 billion.

It might be that 20 identical GSEs would be under financial stress at the same time. One way to reduce the probability of this would be to split the GSEs in such a way that they were not all the

[18] FHFA currently has authority to approve new products, (HERA, Section 1123).

[19] Conforming mortgages are those that conform to Fannie Mae's and Freddie Mac's purchase standards including the conforming loan limit, downpayment, and credit history. The phrase "conforming loan" is sometimes used to mean all loans at or below the conforming loan limit, regardless of any other factors that might make them ineligible for GSE purchase. For more on the conforming loan limit, see CRS Report RS22172, *The Conforming Loan Limit*, by N. Eric Weiss and Mark Jickling.

[20] According to this reasoning, the precise number of GSEs is of little importance as long as there are enough GSEs to provide meaningful competition, and no one GSE is "too big to fail."

same. To promote diversity among the new GSEs, they could be created with different geographic coverage, or to specialize in certain types of housing such as condominiums or multifamily rental housing. Existing stockholders would receive shares in the new GSEs. On the other hand, this specialization could leave new GSEs more vulnerable to declines affecting only certain types of housing.

The GSEs would continue to be regulated. One argument for creating many GSEs is that competition among the GSEs could supplement formal regulatory oversight.

Option: Incorporate Fannie Mae and Freddie Mac into Federal Home Loan Bank System

A slightly different option would be to incorporate the GSEs into the Federal Home Loan Bank (FHLBank) system. Each regional FHLBank is owned by its member banks; shares of the FHLBanks are not traded on a stock exchange. The 12 regional banks form a collective GSE that raises funds (called advances) that are lent to the members, who pledge mortgages and MBS as collateral. The debt is the joint and several liability of the individual FHLBanks; if one bank were to become insolvent, the other banks would remain responsible for its debts. Freddie Mac was created as part of the FHLBank system to sell its mortgages on the secondary market.

The FHLBank system could purchase Fannie Mae and Freddie Mac, which would become a mortgage securitization facility (or facilities) within the FHLBank system. The lenders that are members of the FHLBank system presently own the FHLBanks and would similarly own the GSEs.

Alternatively, Fannie Mae's and Freddie Mac's mortgage portfolios and other assets could be divided among the 12 FHLBanks. Some resources, such as mortgage securitization, could be merged into the FHLBanks' Office of Finance, which provides centralized financial services for the regional banks.

The advantage of this approach is that the FHLBank system has never—not even in the Depression—lost money on an advance. The counter argument is that history may not predict the future: FHLBank members are insured by the FDIC. In the event of a member failure, the FHLBank has the mortgages that the member pledged as collateral on its advances. If these are insufficient to meet the member's obligations to the FHLBank, the FHLBank can use its "super lien," which gives it a priority claim over other unsecured creditors. FDIC research suggests that the FHLBanks have no incentive to risk-adjust the interest rate on advances.[21] The FDIC argues that this encourages the FHLBanks to take excessive risks because the bank keeps the profit, but the FDIC gets the risk. In addition, in the event of a member failure, the FHLBank has priority ahead of the FDIC on assets.

[21] Rosalind L. Bennett, Mark D. Vaughan, and Timothy J. Yeager, "Should the FDIC Worry About the FHLB? The Impact of Federal Home Loan Bank Advances on the Bank Insurance Fund," FDIC Center for Financial Research, Working Paper 2005-10, August 18, 2006, http://www.fdic.gov/bank/analytical/cfr/2005/wp2005/CFRWP_2005_10_Bennett_Vaughan_Yeager.pdf.

Option: Issue Additional GSE Charters

Another option would be to issue new GSE charters. Congress could establish the requirements for obtaining these new charters and limit the activities that the new GSEs could undertake. The GSEs could, if Congress so desires, contribute to an insurance fund similar to the FDIC for banks. Either the existing GSE regulator, the FHFA, or a new regulator would oversee the GSEs. Since Fannie Mae and Freddie Mac would retain all of their current assets and liabilities, there arguably would be no need to compensate existing stockholders of Fannie Mae and Freddie Mac, but the stockholders might object to the new competition. The government could charge a fee for the GSE charters. Market competition among the many GSEs could supplement regulatory oversight.

Options Eliminating GSE Status

Fannie Mae and Freddie Mac are GSEs because of their charters, which were created by enactment of legislation, and legislative action could repeal the charters. In some circumstances, repeal might raise legal and other concerns about financial compensation for current common and preferred stockholders, assumption of responsibility for paying off existing bondholders, guarantees of timely payment of mortgages, and other liabilities. On the other hand, Treasury has warrants to purchase nearly 80% of each GSE's common stock at nominal cost making stockholder approval of a government proposal a certainty.

The GSEs could continue with state charters like other financial intermediaries including commercial banks. In the early 1990s, the Student Loan Marketing Association (Sallie Mae) sought to relinquish its GSE status because of the financial burdens that came with its being a GSE and to make loans that it could not as a GSE.[22] In 1996, Congress agreed to allow Sallie Mae to relinquish its congressional charter and give up its GSE status.[23] Sallie Mae became a stockholder-owned company with no special privileges in 2004.

If the GSE charters were repealed, Congress might wish to consider whether the GSEs' securitization of mortgages should be continued by a government agency. The GSEs have been able to compete against the government programs (FHA's mortgage insurance, the Veterans' Affairs mortgage guarantees, and the Department of Agriculture's rural housing programs) by creating a broader product than some government programs, and by competing on price.

Some research has suggested that the GSEs' biggest competitive advantage against other private sector mortgage lenders derived from the close relationship with the federal government which allowed the GSEs to borrow funds at lower rates compared to other mortgage lenders.[24] Without GSEs and their funding advantage, investment bankers might securitize conforming mortgages that were formerly securitized by the GSEs.

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[22] Olaf de Senerpont Domis, "Sallie Mae Shifting Gears For Move to Private Sector Series: 10," *American Banker*, November 13, 1996, p. 4, and Jaret Seiberg, "House Data Have Economists Gazing at a Murky Crystal Ball Series: 3," *American Banker*, September 26, 1996, p. 1.

[23] *Student Loan Marketing Association Reorganization Act of 1996*, P.L. 104-208.

[24] Andreas Lehnert, Wayne Passmore, and Shane Sherlund, *GSEs, Mortgage rates, and Secondary Market Activity*, Federal Reserve Board, 2006-30, Washington, DC, 2006, http://www.federalreserve.gov/pubs/feds/2006/200630/200630pap.pdf.

The impact of the GSEs on mortgage interest rates is much debated. The current spread between conforming and jumbo mortgages is greater than the historical average. A 2006 Federal Reserve study found that the GSEs did not reduce interest rates, but cites other studies that found interest rate reductions of 4 to 35 basis points with older studies finding greater reductions.[25] (One basis point is 0.01%.) This research suggests that there could be a small increase in mortgage interest rates if the GSEs were to cease securitizing mortgages.

In the current unusual financial environment, the GSEs, Ginnie Mae (which securitizes government-insured and guaranteed mortgages), and FHLBanks are by far the most active source of mortgage funds. However, the GSEs have been extremely dependent on selling their MBS to the Fed and Treasury. Without the Fed and Treasury, it is unlikely that the GSEs would be a significant source of mortgage funding.

Option: Government Agency

Another option would be to make the GSEs a government agency. Ginnie Mae, officially the Government National Mortgage Association, an office within the Department of Housing and Urban Development, purchases and securitizes government-insured and government-guaranteed mortgages in much the same way that the GSEs purchase and securitize conforming mortgages. Ginnie Mae contracts with investment banks on Wall Street to do the actual securitization of their mortgage purchases. This allows Ginnie Mae to function with approximately 60 employees yet be responsible for approximately $577 billion in Ginnie Mae MBS.

Ginnie Mae's contractor purchases government-insured and guaranteed mortgages and pools them into MBS. Ginnie Mae adds the federal government's guarantee that the MBS purchasers will be paid, and the contractor sells the MBS to institutional investors. Until it became stockholder owned in 1968, Fannie Mae was part of Ginnie Mae.

One issue that Congress might wish to examine is how to ensure adaptability of mortgage markets to meet changing conditions. The FHA's status as a government agency gives it limited flexibility to modify programs without legislative action.

On the one hand, this lack of adaptability has prevented FHA from responding to new market conditions, which has resulted in reduced market share. On the other hand, this has reflected Congress' will and FHA/Ginnie Mae did not guarantee or purchase subprime or Alt-A mortgages. At the end of the second quarter of 2009, 4.8% of FHA-backed mortgages were 90 or more days delinquent, compared to 3.67% of all mortgages.[26]

If Fannie Mae and Freddie Mac were to become a government agency, it is possible that many of the current staff and directors of the GSEs would find other employment. Potential reasons include duplication of functions, or because the salaries of current GSE employees would be reduced to fit the government pay schedule currently used at FHA and Ginnie Mae. Financial regulators, such as the Federal Reserve, FDIC, and Office of the Comptroller of the Currency, have the authority to use different pay schedules.

[25] Ibid.

[26] Mortgage Bankers' Association, *National Delinquency Survey*, Second Quarter 2009, pp. 4, 6.

Option: Privatization

Fully privatized GSEs would no longer have special status from the federal government. They would be owned by investors. GSE stockholders would receive stock in the new companies. The stock of the new companies probably would trade on one or more stock exchanges. The new companies would assume the assets (retained portfolios) and liabilities (bonds, MBS and guarantees) of the existing GSEs.

At the end of 2008, GSE MBS represented 64% of the nation's MBS, an increase compared to previous years due, at least in part, the withdrawal of other securitizers.[27] Some might consider this to be too dominant, and Congress might consider dividing the GSEs into many companies as part of a privatization process. Congress might wish to consider if each of the new non-GSEs should be similar, or if some might specialize in geography or some other factor. This could reduce the probability that multiple mortgage lenders would simultaneously encounter financial difficulty, but would eliminate some of the risk reduction that comes from diversification.

Option: Privatization with Co-Op Insurance

A co-op to insure MBS could be included in the privatization option. This would be similar to a private Federal Home Loan Bank System and share some features with Lloyd's of London, which also uses a co-op insurance business model. The co-op would create MBS from mortgages purchased from members. Members would be required to buy stock in the co-op proportional to the volume of mortgages sold to the co-op, and part of the proceeds from the mortgage sales would be posted as collateral against losses. The collateral could be released as the mortgages age.

The co-op members stock could be sold if collateral were insufficient to cover losses. Beyond this, members would have no liability. The result would be that individual co-op members would keep their profits and share their losses.

The co-op would decide pricing, eligibility requirements, and credit requirements. The government would supervise the co-op for safety and soundness, and it would explicitly bear the risk of catastrophic disaster. In return, the government could charge the co-op a fee for supervision and risk.

If the co-op's rules allowed for wide membership, this option could encourage competition in mortgage securitization. Members would have a stake up to the amount of equity in the co-op, in the behavior of other members. A member who used the co-op to insure risky mortgages would be risking all of the members' equity and increasing the risk that the federal government's catastrophic insurance might have to be used.

Supplementary Options

There are at least two supplementary options that could operate independent of how the GSEs are restructured: government reinsurance and covered bonds.

[27] Inside Mortgage Finance Publications, *The 2009 Mortgage Market Statistical Annual*, vol. 2, p. 10.

Reinsurance

The government could provide catastrophic reinsurance to the secondary mortgage market. This would be similar to the reinsurance provided under the Terrorism Risk Insurance Act of 2002 (TRIA, P.L. 107-297). GSEs and others selling MBS in the secondary market would provide primary insurance to purchasers. The GSEs or others creating MBS experienced losses exceeding a certain limit, the federal government would provide insurance. This would allow many financial institutions to compete in the secondary mortgage market.

The terms of this insurance could be determined by statute or by regulation. Some of the factors to be considered would be: how large of a loss (dollars or percentage) would primary insurance incur before the reinsurance became effective? Who should be eligible for the reinsurance program? Would the reinsurance be 100%, or would these losses be shared? How should premiums be determined?

Covered Bonds

Covered bonds are a method of raising funds for mortgages that provides more security to purchasers than non-GSE MBS provide currently.[28] While the GSEs guarantee that the purchasers of their MBS will receive timely payment of principal and interest, the issuers of private label MBS do not include any such guarantee. If a mortgage borrower defaults, the losses flow to the private label MBS holder as specified in the MBS prospectus.

Covered bonds seek to reduce the risk of financial loss to the bond purchaser. Regular bonds are backed by the income of the issuer and have no specific collateral. Covered bonds have collateral and a claim on the income and assets of the issuer. Typically, covered bonds have more collateral than the value of the bonds. If the value of the collateral declines (due to prepayment, default, foreclosure, etc.), the issuer must add additional collateral. In a best practices paper, Treasury said that there should be at least an extra 5% collateral coverage, that only 30-year fixed-rate mortgages should be included, and that the maximum loan-to-value ratio on mortgages included should be 80%.[29]

Because covered bonds have a priority claim on the assets of the issuer, the remaining claimants are likely to receive less in bankruptcy or receivership. In the case of an insured depository institution such as a bank or thrift, covered bonds would increase the FDIC's losses. Presently, covered bonds may not exceed 4% of an FDIC-insured institution's liabilities.[30] This currently limits the ability of insured depository institutions to issue covered bonds. Some have proposed that covered mortgage bonds could be issued using MBS from the GSEs or their successors.

Covered bonds are popular in Europe where the covered bond issuer typically originates the mortgage, which some analysts believe aligns the interests of originators and bond holders. European covered bonds reportedly have not defaulted since at least 1899.

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[28] CRS Report RS22925, *Covered Bonds: An Alternative to Securitization for Funding Mortgages*, by Edward V. Murphy.

[29] U.S. Treasury, "Fact Sheet: Treasury Releases Best Practices For Residential Covered Bonds," press release, June 28, 2008, http://www.treas.gov/press/releases/reports/factsheet.pdf.

[30] Federal Deposit Insurance Corporation, "Covered Bond Policy Statement," 73 *Federal Register* 21951, April 23, 2008.

Covered bonds are attractive because they could reduce the risks to purchasers of private label MBS and increase competition in the secondary mortgage market.

Legislative Action

No legislation has been introduced in the 111[1th] Congress to reorganize Fannie Mae or Freddie Mac. On June 3, 2009, the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Financial Services Committee held a hearing, "The Present Condition and Future Status of Fannie Mae and Freddie Mac."

Unless extended by Congress, Treasury's authority to purchase GSE obligations and securities, including MBS and senior preferred stock, will expire on December 31, 2009. Essentially, Treasury can continue to purchase senior preferred stock (up to $200 billion for each GSE) after December 31, 2009, but it cannot exceed the $200 billion limits.[31] The Federal Reserve's authority to purchase MBS and debt does not expire.

The Obama Administration has released a report that lists six options for the future of the GSEs:

1. Privatization,
2. Gradual liquidation,
3. Merger with a government agency,
4. Public utility-type regulation of the GSEs,
5. Conversion to an insurance company, and
6. Dissolution of the GSEs into smaller companies.[32]

The Administration is to report to Congress on these options as part of the FY2011 budget process.

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[31] Federal Housing Finance Agency, "U.S. Treasury Support for Fannie Mae and Freddie Mac," press release, January 18, 2009, http://www.fhfa.gov/webfiles/1240/mmnote091_218091.pdf.

[32] U.S. Department of the Treasury, *Financial Regulatory Reform: A New Foundation*, August 11, 2009, pp. 41-42, http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.