The Daily Dish

The Future of the GSEs, Release or Reform?

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Eakinomics: The Future of the GSEs, Release or Reform?

Recall the housing government sponsored enterprises (GSEs) Fannie Mae and Freddie Mac. At their heart was a simple business: buy mortgages from banks and other originators and package them into mortgage-backed securities (MBS); i.e., securities in which investors got their returns from the mortgage payments of the underlying homeowners. This provided the banks value by taking the mortgage off their balance sheet and replacing it with cash that they could deploy to the next lucrative opportunity. It gave the investors value by providing diversification across mortgages, regions, and income groups. One could make a little money doing this. The GSEs made even more money by adding another service: selling the investors a guarantee that they would make up for any underlying missed payments by the homeowners. This is risky, of course, but the GSEs could hold capital against the prospect of any losses and make good on the guarantee.

But here is where things got interesting. Because of their government origins, the GSEs were festooned with special features — presidential appointments to the board, a line of credit at the Treasury, exemption from SEC securities registration requirements, and so forth. This gave the impression that the GSEs were part of the government, an impression that the GSEs were happy to have continue, so that they would have government backing if they ever got in trouble. The GSE business model took full advantage of this by holding very, very little actual capital against the risks they held, and borrowing cheaply (since they seemed to be practically Treasuries). The highly leveraged structure raised their riskiness further.

Then the GSE doubled down on this by holding large portfolios of their own MBS. Notice that if the underlying mortgages went bad, the GSEs got hit twice. First, they would have to come up with the cash to cover the guarantees. Second, they would not get income from their portfolios to cover the costs of the borrowing they did to purchase the MBS. But that would never happen, right?

Of course, the housing bubble broke in the-mid 2000s, defaults were rampant, and the GSEs were taken over by the government — put into conservatorship — in 2008 as the Treasury forked out hundreds of billions of dollars to fill the financial gap generated by the ill-conceived business model. They remain in conservatorship today.

Now, once again, there are rumblings that change is in the wind. Politico reports “Joseph Otting, acting director of the Federal Housing Finance Agency, told employees last week that the administration would not wait on Congress, where attempts to overhaul the housing finance system have repeatedly faltered in the years since Fannie and Freddie were rescued during the financial crisis, according to a recording of his remarks obtained by POLITICO. ‘In the next two to four weeks you’re going to be able to see some communication that comes out of the White House and Treasury that really sets a direction for what the future of housing will be in the U.S. and what the FHFA’s part of that will be,’ Otting said at a Jan. 17 staff meeting.”

Taken at face value, this is puzzling at best and shocking at worst. The administration cannot change the underlying legal structure of the GSEs; only Congress can do so. So any “plan” would be a *de facto* decision to re-embrace the business model that led to failure in the first place. Not a good idea. Of course, during conservatorship the portfolios have been run down and are no longer the risk they once were. The Federal Housing Finance Authority (FHFA) — the GSEs’ regulator — could ensure that they not reappear in the future. But the GSEs would still require capital to back any guarantee losses and their capital reserves have been run down as well. Either the Treasury thinks that it can inject hundreds of billions of additional capital — at the taxpayers’ expense — or it thinks it will be a promising business venture for Wall Street to do so. Both seem dubious; the former is politically untenable and the latter assumes that the GSEs are not instantly designated as Systemically Important Financial Institutions (SIFIs) by the Financial Stability Oversight Council (FSOC). They would simply have to be, putting the GSEs into a stronger Federal Reserve regulatory regime with substantial additional capital requirements. This should be the road not taken.

The alternative is congressional reforms. *The Wall Street Journal* reports “Lawmakers from both parties plan to take a fresh crack at getting Fannie Mae and Freddie Mac, two companies that underpin nearly half of U.S. mortgages, out of government control.” “‘All the policy puzzle pieces are out there, what is lacking is the political will to put them together,’ Rep. Patrick McHenry (R., N.C.) said in an interview, adding, ‘Divided government is the best time for us to legislate.’” This is the sensible policy path: decide what the government role in mortgage finance should be and reconfigure the GSEs via Congress to fit into that new schema. If that good policy is now good politics, the moment is right for Congress to move on GSE reform.