Pondering the Fate of Fannie, Freddie

The government will huddle to figure out what to do with the giant, money-sucking mortgage backers. The fate of and Freddie Mac remains unresolved as the Obama administration prepares to begin public deliberations Tuesday about what to do with the essentially-nationalized mortgage giants.

It's not clear what the administration plans to do with the GSEs, although Treasury Secretary Timothy Geithner has mentioned ideas ranging from standardization of mortgages to a government role in mortgage insurance or securitization. The aimed at reforming the financial markets did not address the mortgage giants directly, instead requiring Treasury to come up a report by January on some possible solutions for the two companies.

There remains heavy debate as to whether Fannie and Freddie should be eventually fully absorbed into the government, spun off into fully-private enterprises or simply euthanized once mortgage markets return to normal. The only thing that seems to be agreed on is that both companies will continue to cost the taxpayers billions of dollars quarterly for the foreseeable future. It's a fate that U.S. taxpayers cannot avoid, financial experts, economists and industry watchers said.

Further, it is generally agreed that Fannie and Freddie have to continue to function at least until the mortgage market returns to normal and it can be taken off government-sponsored life support. Since being brought into conservatorship in September 2008, Fannie and Freddie have cost U.S. taxpayers about $145 billion, according to the Congressional Budget Office. And while the amount of money needed by the two each quarter is smaller than it was a year or two ago, both companies have said they expect to continue to need regular injections of taxpayer capital.

By 2019, the CBO expects the rescue of Fannie and Freddie to hit nearly $390 billion – none of which is officially counted the federal deficit because of the nature of how the conservatorship of Fannie and Freddie was constructed.

"Although [we] anticipate that the mortgage market will eventually normalize … it is expected the federal government will continue subsidizing the market through Fannie and Freddie," the CBO said in a January report. "Although [Fannie and Freddie's] fees and other income on new commitments may be sufficient to cover average losses on those commitments, they are not high enough to fully cover the cost of the risks" undertaken during the mortgage bubble.

Fannie, Freddie Are The Mortgage Market

The fate of Fannie and Freddie is crucial and will impact virtually every American. The two agencies guarantee or own half of all outstanding U.S. mortgages at a worth of around $5 trillion and when government lender Ginnie Mae and the Federal Housing Administration are added to that mix, the market share rises to 90%. Fannie and Freddie, along with the FHA, are essentially propping up the U.S. housing market. "If you're originating a conventional mortgage right now, you're going through Fannie and Freddie and if not you're going through FHA," said Drew Kessler, managing director with KMG Mortgage Consulting.

And because the mortgage giants are now essentially arms of the government, they have been able to borrow at exceptionally low rates – as low as 1% in recent bond auctions – making it difficult for the private sector to offer mortgages that aren't backed by Fannie and Freddie.

"The private sector banks, the Wells Fargo's (NYSE:WFC) and Bank of America's (NYSE:BAC) of the world, will never be able compete against Fannie and Freddie's current funding advantage," said Mark Calabria, at the libertarian Cato Institute think tank. So with the mortgage market and the broader economy woven into the very pattern of Fannie and Freddie, the question becomes how to un-weave going forward, something policy experts are expected to address on Tuesday. Experts believe it is possible to wean the mortgage market off of a nationalized Fannie and Freddie in time. At the height of the housing bubble, the GSE's market share had declined to approximately 50% of the market, with FHA taking up about 10%, leaving the rest to the private-label mortgage market.

Larry White, a business professor with the NYU Stern School of Business, said he favors among many options a possible "bad bank/good bank" scenario where the current toxic legacy mortgages of Fannie and Freddie get absorbed by the taxpayer and the new Fannie and Freddie get spun off, raise private capital, and continue with their original purpose. "The reason for not eradicating them is because there might be some value in [Fannie and Freddie's brand name], the systems they have created and the human capital behind it," White said. "Why not keep that intact if there is value but we have to make sure it's a wholly-private sector enterprise."

Fannie and Freddie could be absorbed into the U.S. government, as Fannie existed during the Great Depression. The problem with that option is that two government agencies already do Fannie and Freddie's jobs: the Federal Housing Administration provides mortgage insurance and Ginnie Mae provides mortgage securitization.

If Fannie and were reabsorbed into the government, they would most likely become part of FHA or Ginnie Mae. The government would also have to take Fannie and Freddie's mortgage portfolios – and the losses related to them – onto the taxpayers' balance sheet. "Politically that's a hard thing to swallow," Kessler said. Of the options discussed, none will be available before the housing market and the economy improve, experts said. Recent data have shown the economy slowing again and the Federal Reserve attempting to push mortgage rates as low as possible.

"I would like to see Fannie and Freddie disappear tomorrow; but we have created a market, for good and for bad, and locked ourselves into a situation that [removing Fannie and Freddie] would take a very long time to adjust to market reality," said Adolfo Laurenti, chief U.S. economist with Miserow Financial in Chicago