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Mortgage eligibility at heart of Fannie, Freddie debate

Policymakers to square off over future of Fannie and Freddie on Tuesday

By Ronald D. Orol, MarketWatch

WASHINGTON (MarketWatch) -- Policymakers in Washington discussing the future of Fannie Mae and Freddie Mac on Tuesday are set to battle over the kinds of mortgage securities that should be eligible for government guarantees -- a clash that could mean hundreds of dollars a month in additional payments to those with loans that don't get Uncle Sam's backing.

"One reason you need a federal guarantee is to keep mortgage rates in the 6% range that they have been in the past," said Paul Leonard, vice president of government affairs for the housing policy council at the Financial Services Roundtable.

Currently, most new mortgages are guaranteed by Fannie Mae (OTC:FNMA) and Freddie Mac (OTC:FMCC) and the Federal Housing Administration while the Federal Reserve has purchased $1.1 trillion in agency mortgage securities as a means of propping up the market and keeping loan rates affordable. See separate story on FHA loans.

The two mortgage giants were essentially nationalized at the peak of the crisis in 2008 to avoid losses and stem the credit contagion. So far, they've cost taxpayers roughly $145 billion in funds, used to cover their losses, with more losses expected on the horizon.

Replacing Fannie and Freddie

MarketWatch's Alistair Barr explains how a replacement for Fannie Mae and Freddie Mac might work and what's at stake, including the value of your home.

Many Washington legislative observers argue that no matter what structure will emerge - and dozens of different approaches are being considered - the government would offer some type of federal guarantee of mortgage securities to buyers in the market for a fee.

Treasury Secretary Timothy Geithner said he supports a federal guarantee though he hasn't provided many details about how it would work except to say that it should ensure that U.S. borrowers could easily finance the purchase of homes even in a deep recession.

Assuming that policymakers agree to permit some form of government backstop, a battle is expected to ensue over the quality of mortgages that the successors to Fannie and Freddie will be permitted to guarantee. The quality of mortgages that could be guaranteed will be subject to debate at the Fannie and Freddie conference.

"There will be a big fight in Congress about what constitutes a quality loan that would qualify for a federal guarantee," said Mark Calabria, director of financial regulation studies at the CATO Institute in Washington.

Calabria said some conservative lawmakers such as Sen. Bob Corker (R., Tenn.) are likely to seek legislation that would only permit guarantees of securities made up of the highest quality fixed, 30-year-mortgages with significant down-payments and strong borrower credit scores.

Meanwhile, Ted Gayer, fellow at the Brookings Institution in Washington, contends that Democrats will be under pressure both from the housing lobby and consumer advocates to give government guarantees for higher risk mortgage pools with lower borrower requirements, in part, to promote homeownership among lower income Americans.

"The right would say they will go deeper into high risk pools to promote home ownership among subprime borrowers," he said.

Calabria added that Democrats are likely to push to ensure that the future mortgage giants don't guarantee loans that have prepayment penalties; a provision in some mortgage contracts that in the event a borrower pays off a loan early they will pay a penalty.

One possible way of trying to deal with the dispute is for mortgage investors to be charged higher guarantee fees for riskier pooled mortgages and lower fees for plain-vanilla mortgage securities, Gayer said.

"If there are more subprime securities in the loan [pool] there would be a higher guarantee fee," Gayer said. "Lower fees would be for pools made up of mortgages with 30-year-loans with 10% down payments."

Lawmakers also expected to disagree over whether a limit should be placed on the dollar-figure size of each mortgage in the pool that could receive a guarantee.

FSR's Leonard said that the size cap for loans that will become approved for federal guarantees are expected to be lowered over time, limiting the kind of risk involved. Currently, he added that big and small loans are permitted to be purchased by Fannie and Freddie as part of the government's continued effort to stabilize the housing market.

Calabria said he would prefer that Fannie and Freddie be permitted to buy long-term mortgages with payments of at least 20% of the home's purchase price, but he added that it was unlikely lawmakers would agree to such a restriction.

"The industry is going to fight any onerous down-payment requirement, but people like Senator Corker are going to try to counter that pressure," Calabria said.

FSR's Leonard said he expects to see tighter underwriting standards for mortgages that could receive a government guarantee when they are pooled into securities. He expects that acceptable loans will be traditional, fixed, 30-year-mortgages with some sort of down payment requirement. Borrowers would be required to document their income, he added.

Reform is still a long ways off. The Obama administration is still in the early stages of identifying its own proposal, which is due for Congress to consider in January. After that, legislative efforts to reform the mortgage-giants would expand.