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Legislative battle on horizon for future of Fannie and Freddie

White House continues work on developing housing-reform proposal for 2011

By **Ronald D. Orol**, MarketWatch

WASHINGTON (MarketWatch) -- Now that the most sweeping financial reform bill since the Depression is law, Washington is finally getting around to dealing with the hard part: Fannie Mae and Freddie Mac.

But even as the Obama administration prepares for an Aug. 17 conference on the U.S. housing finance system, lawmakers on Capitol Hill are preparing to battle each other and the powerful housing lobby over the future of the mortgage-finance giants.

The goal of the conference is to come up with a system that would win the support of enough lawmakers on Capitol Hill to pass while also ensuring a fully functional housing market that doesn't rely on taxpayer backing -- even in a severe economic downturn.



Rebuilding 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.

It's a tall order. Many Republicans want to fully privatize the two entities altogether, while numerous Democrats want to enshrine a permanent government agency -- or agencies -- to buy and sell mortgages and mortgage securities.

"Conservatives are saying the government should be out of the business altogether and they should be privatized to compete in the private market," said Bob Kuttner, senior fellow at research and advocacy group Demos in Washington. "Democrats say if the government is going to run it, it should be a government agency and have set standards."

Treasury Secretary Timothy Geithner is seeking a middle ground where the government would continue to offer some type of federal guarantee of mortgage loans to ensure that U.S. borrowers can easily finance the purchases of homes. But he has yet to provide specific details. [Read Geithner's comments.](#)

Among the obstacles for any agreement are the mid-term elections, fresh fears that the economy will fall back into recession, and the still precarious state of the housing market fully two years after the onset of the credit crisis.

Still, the administration is working to develop a proposal with the aim of delivering it to Congress by early next year.

Crucial players

Practically all new U.S. mortgages are guaranteed by Fannie Mae (OTC:FNMA) and Freddie Mac (OTC:FMCC) and the Federal Housing Administration. Since the credit crisis began the Federal Reserve has purchased \$1.1 trillion in agency mortgage securities as a means of propping up the market and keeping loan rates low.

As the financial crisis intensified in September 2008, Fannie and Freddie were essentially nationalized to avoid losses and stem the credit contagion. They were taken over by the government in a conservatorship. Roughly \$145 billion in

taxpayer funds have been used to cover their losses.

Before their downfall, Fannie and Freddie were hybrid government-sponsored quasi-private entities that purchased whole mortgages, mortgage securities and asset-backed securities from banks and other direct lenders, packaged them, and sold them back to private investors as mortgage backed securities. The system was designed to ensure that adequate capital was available to banks and other financial institutions that lend money to home buyers.

However, starting in the 1990s Fannie and Freddie dramatically raised the risk they took on their balance sheets, and eased their underwriting standards, at the behest of lawmakers seeking to make home ownership possible for less qualified Americans.

Their expansive purchases -- along with risky loans taken on by private mortgage investors -- helped drive the subprime boom and bust that took the economy to the brink in 2008.

Partial consensus

Despite the divergent views, lawmakers actually are moving towards agreement that Fannie and Freddie should stop borrowing heavily from the capital markets.

"There is a broad bipartisan mood to get rid of their portfolio activities and that was impossible seven years ago," said Mark Calabria, director of financial regulation studies at the CATO Institute in Washington. "The ground has shifted a lot."

Instead, Geithner and other Democrats seem to be moving in the direction of turning Fannie and Freddie into much smaller entities that buy individual mortgages, pool them and sell them back into the market to private investors who would pay a fee for a government guarantee of the security, argues Ted Gayer, fellow at the Brookings Institution in Washington.

It's that guarantee that lies at the heart of the debate over Fannie and Freddie's future.

Republicans who don't back a fully private market are likely to push for a government guarantee that is available for any corporate mortgage investor packaging loans, not just Fannie and Freddie.

"Are you going to say these are government agencies that package mortgages and sell them with a guarantee or are you let the government sell a guarantee to any institution?" Gayer asked.

Without such a guarantee, selling mortgage backed securities will be harder, if not impossible, and the flow of capital into the housing market will falter, crushing housing values again.

Calabria added that some sort of government guarantee is likely because of the influence of the housing lobby, including the Mortgage Bankers Association, the National Association of Realtors and the National Association of Home Builders, who have been pushing for some sort of government backstop.

However, he argues that any sort of government backstop is a bad idea because it would subsidize mortgage risk, leading to further taxpayer losses.

"The housing industry is dead set on having guarantees," Calabria said. "They will continue to have considerable sway among Republicans and Democrats."

Fighting efforts to keep a government guarantee in place, a small contingent of conservatives, led by Rep. Jeb Hensarling (R., Texas) are seeking to wind-down Fannie and Freddie to an eventual point where they are fully private sector companies competing "on a level playing field" with the private industry. So far, his bill, "The GSE Bailout Elimination and Taxpayer Protection Act," has attracted 21 co-sponsors in the House.

Other issues

The policy debate over Fannie and Freddie will also be intense over other issues including:

- The quality of any loans Fannie and Freddie will still be allowed to buy
- Whether mortgage investors should be charged higher guarantee fees for riskier pooled mortgages and lower fees for plain-vanilla mortgage securities
- Whether the companies should be broken up into smaller units to minimize the impact to taxpayers and the economy of any one of them failing.

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