Selling Off GSE Assets Isn't Going to Be Easy

Paul Muolo & Brian Collins

Now that the White House has decided to pull the plug on Fannie Mae and Freddie Mac, the next question becomes: how do you liquidate roughly $1.5 trillion of MBS and whole loans sitting on their books?

According to investors, advisors and mortgage executives who for decades have done business with the GSEs, the answer is not easy. In fact, some suggested the two should not be liquidated at all, with their assets instead being allowed to "run off" over many years.

One stock analyst who used to cover Fannie and Freddie offered this: "You sell whatever assets you can now, at a profit. The rest, you let run off." The government guarantees on their off-balance-sheet assets would be allowed to remain, he said.

The analyst, requesting his name not be used, noted, "The first thing you do is stop adding new assets to their books," which is what will happen if the GSE White House plan released late last week becomes law. (See related story, page 18.)

At least one key congressman, Rep. Scott Garrett, R-N.J., favors speeding up the asset sales as soon as possible to reduce taxpayer risk and capture what he calls "unrealized gains." At a hearing, the new chairman of the House Financial Services Subcommittee on Capital Markets and GSEs said that as interest rates become more volatile, "it will become increasingly difficult to hedge a book that size against those movements."

A consultant to Fannie Mae laughed at the remark, however. "They have whole desks there that are involved in hedging all day long. I think Garrett has that part wrong."

Of course, the White House/Treasury Department "white paper" is merely a first draft of a plan that must be approved by a Democratically controlled Senate and a Republican controlled House. Many changes are expected and few believe an actual bill regarding the GSEs will be passed this year or even next.

Traditionally, Democrats have been strong supporters of both housing and mortgage finance, but the government takeover of Fannie and Freddie changed all that. Still, some Democrats are sympathetic to borrowers, and even builders and Realtors.

In all practicality, whatever liquidation plan is synthesized by the Congress and White House will be implemented over many years. (Anyone familiar with selling mortgage assets knows that flooding the market with available product will only depress prices.)

Also, any assets sold by the government first will need to be evaluated by a third-party evaluation firm-which means Wall Street. (Think BlackRock and Ranieri & Co.)

Meanwhile, Republican lawmakers and conservative think-tank analysts believe a private mortgage market eventually can emerge-but only if Fannie and Freddie disappear. "A private secondary market for prime, middle-class mortgages cannot develop while the GSEs wield market power derived from their government granted advantages," said Alex Pollock, a former president of the Federal Home Loan Bank of Chicago.

Pollock, who once created a FHLB program to compete against the GSEs, said the first step to creating a private market is to tell the industry how rapidly the government will reduce the conforming loan limit.

But a former Federal Housing Administration official warned that it's a "leap of faith" to predict that a private-label securities market will suddenly emerge if a vacuum is created. Sarah Rosen Wartell, executive vice president of the Center for American Progress, said much will depend on how regulators implement the risk retention provisions of the Dodd Frank Act. (Federal regulators are expected to issue a proposed rule on risk retention in March.)

She also stressed that new servicing standards are important to restore investor confidence.

"Reducing GSE market share before implementing risk retention and new servicing standards risks a shock to the housing market already struggling with inventory overhang and weak employment," Wartell said. (The CAP executive served at the FHA and White House during the Clinton years.)

Anthony Randazzo, director of economic research at the Reason Foundation, said lowering the loan limit and raising guarantee fees will open the door for the development of a robust private mortgage market. "To let private capital begin to step in slowly over time is not this leap of faith that just trusts in the capital markets," Randazzo said. "You are going to take these short-term steps so the private sector can adjust."

The size of the private jumbo market is estimated at $90 billion based on a Fannie/Freddie loan limit of $729,750 in high-cost markets, according to Mark Calabria, director of financial regulation studies at the Cato Institute. The GSE loan limit in high cost areas is slated to drop to $625,500 on Oct. 1.

In recent testimony before Congress, Calabria called for an immediate reduction in the loan limit to $500,000 along with annual reductions of $50,000 going forward.