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The Good, The Bad, And The Ugly Of Mortgage Reform

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There is lots of legislation being debated in Congress over the Reform of the Government Sponsored Entities (GSEs), Fannie Mae (OTCQB:FNMA) and Freddie Mac (OTCQB:FMCC). The bills and ideas range from complete reorganization to keeping the current system.

Johnson-Crapo Bill put \$5.2 Trillion More Debt on US Books

In a recent paper, the implications of the Johnson-Crapo bill are examined in depth. Ike Brannon, Senior Fellow at the George W. Bush Institute and President of Capital Policy Analytics, and Cato's Mark Callabria show how Johnson-Crapo would add \$5.2 trillion of debt from Fannie Mae and Freddie Mac to the federal balance sheet.

"The current reform plan that has garnered bipartisan support, the one proposed by Senators Tim Johnson and Mike Crapo, would wind down Fannie and Freddie and replace them with new entities. **In doing so it would also largely codify the Treasury's zeroing out of Fannie and Freddie's private shareholders.**

In order to allow the new entities to begin with a fresh balance sheet, the **legislation would have the federal government explicitly guarantee the \$5.2 trillion of debt of Fannie Mae and Freddie Mac.** While a booming economy could gradually reduce that figure with few untoward consequences for the government, if the housing market were to have another swoon, the government would undoubtedly find itself having to cover some portion of this debt."

The full working paper from CATO can be found at [this link](#).

Notably in this paper, these two experts discuss an IPO scenario for the government's shares.

IPO Scenario

An additional policy option widely discussed in the media would involve federal government selling its nearly 80 percent ownership stake in the GSEs. While CBO would likely view this

proposal as a reduction in subsidy costs relative to its baseline similar to the PATH Act, it is not clear how CBO would contemplate the disposition of warrants on common stock relative to the current baseline. To the extent that the CBO baseline does not contemplate an equity sale of Treasury's stake in the GSEs, that sale would score as deficit reduction. **This would be highly dependent on valuation, but one estimate suggests a net deficit reduction of \$118 billion.** OMB would observe this approach by taking the cash windfall from the **sale realized through the exercise of Treasury's warrants on 79.9 percent of common stock** in the GSE's netted against future dividends assumed in the budget. Estimates for the Treasury's gain are subject to considerable certainty, but could range from \$145 billion to \$250 billion. Of course such an estimate does not include the costs of any potential federal rescue of a re-privatized Fannie Mae and Freddie Mac.

For those of you that are wondering, a \$118 billion value derived from a 79.9% ownership interest puts the common stock price at just over \$16 per share.

Maloni Weighs-in On Johnson-Crapo

Bill Maloni, former Senior Vice President at Fannie Mae made the following sarcastic point regarding Johnson-Crapo recently.

"Congress could just achieve almost every bit of what the sponsors claim they want--and much sooner-by **nationalizing** Fannie and Freddie and letting them do all of this, with the federal government behind them much as they will for the FMIC."

Essentially, it appears he is saying that Johnson-Crapo is a complete nationalization of the mortgage market, which completes the actions started by Congress and the Treasury in 2008. Shareholders are left with nothing and most of the risk is placed with taxpayers while the system is rebuilt from complete destruction.

The Bill Sponsored by Maxine Waters

Maxine Waters also offered up some details of her bill referred to as Housing Opportunities Move The Economy (HOME) Forward Act of 2014. The first notable difference from Johnson-Crapo is the amount of private capital required in a first loss position, which is 5% under Water's plan.

Here is the full text of the bill at this link. The payment of shareholders and wind-down of the existing structure and is summarized below.

Sec. 501. Transition.

Provides for cessation of new guarantees and other new business by the enterprises 5 years after enactment. Enables the Secretary of the Treasury to extend that period for no more than one year.

After new business is ceased, provides for distribution of the net earnings of the enterprises under the conservatorships as follows:

- 1) Repayment of Senior Preferred Shares owned by Treasury;
- 2) Payment of interest to Treasury at a rate of 10 percent per year for the term of those shares;
- 3) Establishment of any reserve fund Treasury determines are needed to complete wind-down of the businesses of the enterprises;
- 4) Payment of any deferred contributions to the Housing Trust Fund and Capital Magnet Fund that have not yet been paid;
- 5) Purchase of any **other preferred shares**;
- 6) Purchase of outstanding **common shares, including any warrants** held by Treasury.

Permits later payments after all obligations and earnings of the enterprises are extinguished or received.

Permits Treasury, in consultation with the Administration and FHFA, to sell assets of the enterprises to the Issuer. Permits Treasury to issue preferred shares in connection with such sales.

Places the full faith and credit behind the remaining obligations of the enterprises. States that Treasury remains obligated to ensure that the enterprises are in a position to make payments on all obligations or debt of the enterprises, including continuing employees.

Sec. 502. Wind down.

Authorizes the FHFA, in consultation with Treasury and the Administration, to take all necessary actions to wind down the operations of the enterprises, consistent with this act. Limits such actions where the Administration has notified the FHFA in writing that it has determined that a proposed sale or other disposition of assets would interfere with the ability of the Administration to carry out this act. Prohibits FHFA from selling any of the guarantee obligations or fees of the enterprises. Provides authority for distribution of assets and to establish holding companies or trusts.

So, it appears that this bill does include a liquidation payout to investors, but it hands the new system over to a whole new group of owners, whoever those owners may be. Shareholders get the scraps and crumbs that hit the floor after everyone else eats their fill. That's more than nothing, perhaps.

Is there any historical precedent for two massively profitable companies to be completely disbanded, wound-down, and liquidated like this? Their business would be handed over to a separate group of organizations doing essentially the same thing. If there is a similar plan in the past that worked, then one would think that this would be presented.

A Shareholder's Perspective

Some current shareholders of Fannie and Freddie are skeptical of any bill presented by Congress. Glen Bradford, an investor in the common stock, had this to say,

"There is no question that the best way to provide the least expensive long term mortgages requires both public and private components. In truth, Fannie Mae and Freddie Mac are a better solution for all Americans in terms of home affordability than any reform proposal. Lastly, the US government is a currency issuer and not a currency user and the metric used to measure its effectiveness should be the prosperity of its people."

A pragmatic approach may be to simply work with the existing system. It held up well for many decades and recently proved resilient by showing a strong reversal from deep losses to high profitability. Millions of mortgages were reworked and refinanced using the GSEs as a market mechanism. Additionally, access to mortgage credit remained strong without taxpayers losing a dime.