A market to prop up

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T heir nicknames are affectionate and they have long been known as the kindly siblings that help millions of Americans to buy a home. But Fannie Mae and Freddie Mac, just like many of their mortgage holders, have fallen on hard times. The government helped out with a multi-billion dollar rescue but now wants them back on their own feet - and that is turning out to be the trickiest part of all.

Hearings begin today in Congress that will help determine whether the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation are to be split up and part of their operations wound down. The issue is fraught as November's midterm congressional elections loom - not least because these so-called government-sponsored entities (GSEs), along with the Federal Housing Administration, provide financing for nearly all of the mortgages being issued in the US today.

Overhauling agencies that are together propping up a fragile market is not only a political quagmire but one that holds serious economic implications as well. "No one wants to rock that boat," says Bert Ely, a banking consultant. But doing nothing is not an option either. Barney Frank, who as Democratic chairman of the House of Representatives financial services committee will conduct the hearings, says: "When it comes to resolving the financial crisis, housing finance is the next piece of the puzzle."

A mishandling of the problem would have implications not just for US homeowners, who could face scarcer financing, but also investors the world over, including the Chinese, Japanese and other governments and central banks. For instance, foreign investors own about one-third of Fannie's and Freddie's noncallable notes. The notes, which cannot be redeemed prior to maturity, are used as a barometer because they are easily trackable. Although the agencies' debt does not carry an explicit government guarantee, the US Treasury has gone out of its way to reassure investors that it is almost as safe as investing in its own bonds.

If investors came to doubt the soundness of Fannie and Freddie debt, they would demand a higher return or shift their money elsewhere, which could drive up the cost of housing finance. For that reason, it is unlikely that the Treasury would renege on its promise. Nevertheless, some politicians, including Mr Frank, have pointed out that because this debt is not on the same legal footing as US Treasuries, investors could be forced to accept a valuation that is less than full - the feared "haircut", in other words - in the event that Fannie and Freddie were restructured.

"I don't know if the American taxpayer recognises that in bailing out the GSEs we're really bailing out foreign investors, and we're doing that despite the fact there are no explicit guarantees," says Scott Garrett, a Republican member of Mr Frank's committee.

At an estimated cost of $177bn (€131bn, £118bn), the rescue of these entities is already shaping up to be the mother of all bail-outs. It is set to exceed the $153bn spent during the savings and loans crisis of two decades ago when nearly 750 thrifts that made mortgage and other personal loans failed, as well as the projected $117bn price of the troubled asset relief programme, which in 2008 threw a lifeline to ailing financial institutions and automakers.

The final price tag may be even higher. Spencer Bachus, senior Republican on the committee, accuses Democrats of ignoring the problem and hiding the cost by keeping Fannie's and Freddie's debt out of the federal budget. "You can't address the cause of the financial crisis without reforming Fannie and Freddie," he says.

The Congressional Budget Office estimates that if the entities had been included in the 2009 federal budget, they would have added $291bn to the deficit, pushing it up by 20 per cent. "We've got to wean ourselves off government support of the housing market or else we're heading for disaster," says Anthony Sanders, a professor of real estate finance at George Mason University and one of the panellists scheduled to testify at the hearings.

Unlike most developed countries, in the US the government has long played a direct role in the housing market. Fannie Mae was created in 1938 and Freddie Mac in 1970 to provide liquidity by buying mortgages originated by banks, thereby freeing the banks to make more loans. Over the years the companies, which are chartered by Congress, became the underpinning of a policy that made home ownership as American as apple pie by purchasing an ever-larger number of mortgages from borrowers on low and moderate incomes.

The goals for affordable housing, set by regulators, climbed dramatically through much of the past decade, from 42 per cent of overall purchases in 2000 to 56 per cent in 2008. (They have since fallen to roughly 43 per cent.) Critics have suggested that this sharp rise contributed to the financial crisis by encouraging Fannie Mae and Freddie Mac to buy riskier and riskier loans.

"It became all about getting everyone into a house," says Mike Berman, chairman-elect of the Mortgage Bankers Association and another scheduled panellist. "Regulators, congressmen and prior administrations all lost their discipline with respect to underwriting standards. The whole country was complicit in this."

Leading the charge were Wall Street banks, which were going wild over subprime securities and other types of exotic mortgages that were predicated on the belief that house prices would continue rising indefinitely. The banks originated these loans and then sold them to investors as pools of mortgage-backed securities. When home prices collapsed in 2007, private investors stopped buying these securities, essentially leaving Fannie and Freddie as the only game in town.

As losses on Fannie's and Freddie's bad loans mounted, the government seized control of both companies in 2008. Taxpayers have since pumped in close to $112bn and the tally is expected to rise. Although possible solutions range from privatisation to full-scale nationalisation, a consensus seems to be emerging that calls for breaking Fannie and Freddie up into public and private pieces.

The first part, containing the bad debt that is backed by the government, would wind down by collecting on the loans, investments and insurance fees, and use that money to repay existing debt as it matures. No new debt would be issued. Any losses would be met by taxpayers. The second part would be a government agency with an explicit, but limited, goal of supporting affordable housing. Importantly, the cost of running this agency would be accounted for in the federal budget. The third part would consist of a private company, or series of companies, charged with originating as well as buying mortgages.

The debt issued by the privatised bits of Fannie and Freddie would not be backed by the federal government. In one sense these new companies would add competition, but by eliminating the two large GSEs they would also level the playing field. Orphaning the bad debt in an entity to be wound down could meanwhile have negative implications for investors by making it less liquid and, therefore, less valuable.

Perhaps the biggest criticism of any plan to break up the GSEs and withdraw government support from the housing market is that it could make mortgage financing less available.

The market for privately financed mortgages is unpredictable and, as the past couple of years have shown, can dry up. For "jumbo" mortgages - those in excess of $417,000 that are generally too big for Fannie and Freddie to purchase - financing is very difficult to obtain and borrowers are being required to put down as much as half of the loan value.

"With less government support, mortgage rates are likely to rise and credit is likely to become less available," says Peter Niculescu of Capital Market Risk Advisors, a financial advisory firm.

Also drawing scrutiny is the durability of the fixed-rate mortgage, which protected homeowners when interest rates soared in the 1970s and 1980s. Although countries including Canada, Britain and France survive with variable-rate mortgages or those that are fixed over a shorter period, the vast majority of Americans can lock in rates for 15 or 30 years. Doing away with that system injects further uncertainty into the mortgage market and could mean that homeowners will face rising rates at times when they are least likely to be able to afford them.

Amid all this, there remains the question of what the final cost to the taxpayer will be. One immediate stumbling block is the 10 per cent dividend that the GSEs are required to pay the government on preferred stock issued as part of the bail-out. "Payback is wishful thinking," says Robert Eisenbeis at Cumberland Advisors, a fund manager. "That money is gone."

Next, there may be a further price to pay. The FHA, intended to help some of the lowest-income borrowers own homes by allowing them to put as little as 3 per cent down, could end up being another drain on taxpayers. "The question is not their embedded losses but how much more will they put on the books over the next two years," says Mr Ely, the consultant.

Last, if the GSEs are privatised, they will be forced to recapitalise. Congressional legislation proposes requiring lenders to retain 5 per cent of the loan value for every mortgage that is sold into the secondary market, in an attempt to get the originating banks to keep some "skin in the game". Given that the GSEs have a combined balance sheet of $5,500bn, they would need to raise some $250bn to meet those requirements.

As a result, any changes will be a long time in the making. Tellingly, in its latest budget last month the administration provided no details of how it wants to reform the GSEs. Tim Geithner, Treasury secretary, has said that there are no plans to tackle the issue until next year. If the housing market continues to falter, any meaningful overhaul could be pushed even farther into the future.

Yet, in spite of that uncertainty, there is a growing sense of urgency that something needs to be done. "The current model for Fannie and Freddie isn't working," says Mark Calabria of the Cato Institute, who plans to argue for the break-up of the entities when he appears at the hearings. "No one is suggesting we should go back to what was. And that, in itself, is a sea change."

Jumbo mortgages

'If you are lending your own money, you are a bit more diligent'

Whenever mortgage rates fall, US homeowners such as Steve Persky try to lock in lower monthly payments. Such refinancing can be done by agreeing a new loan and paying off the old one, usually without any penalties. It is a system that has resulted in a steady stream of business for banks and brokers.

Having refinanced the mortgage of more than $800,000 on his California home seven times in the past decade, Mr Persky had come to regard this as a routine process. He would call his banker, fill in a few forms and about six weeks later he would have a new mortgage - and reduced monthly interest payments.

Last year, this changed. "My bank wanted three years of tax returns, all my financial statements, three years of corporate tax returns. It took months," says Mr Persky, an investor who buys, among other assets, securities backed by subprime mortgages.

Nothing has changed in Mr Persky's financial situation and his mortgage remains less than one-third of the value of his home. What has changed is the way mortgages are financed in the US. Banks used to sell mortgages into the mortgage-backed securities market, which allowed them to keep selling new mortgages. With the collapse of the housing bubble, parts of the MBS market previously used to finance such debt also collapsed.

Banks are still selling home loans financed by MBS - but the only buyers are the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, the government-sponsored mortgage financing entities (GSEs) known as Fannie Mae and Freddie Mac. However even they will not take very large "jumbo" loans, traditionally defined as above $417,000. Now, though, the GSEs have agreed to increase the ceiling to $729,750 in high-cost areas such as New York and California.

Banks agreeing to make new loans to homeowners that are bigger than the increased upper limit now have to keep the loans on their books until they are paid off. This is why lending standards have become so strict. "If you are lending your own money you are going to be a bit more diligent," says Keith Gumbinger of HSH Associates, which tracks mortgage rates.

As well as the extra paperwork, the breakdown of the mortgage-backed securities market has resulted in higher rates for homeowners who borrow large amounts. This is causing concern, as it may deter people from buying or selling homes and thus delay a recovery in prices. In 2005, for example, new jumbo mortgages worth $570bn were agreed, 18 per cent of all home loans, according to Inside Mortgage Finance, which tracks the sector. Last year, it was $92bn, or 5 per cent of all new mortgages. "It is not a normally functioning market," says Guy Cecala, chief executive of Inside Mortgage Finance.

Meanwhile, Mr Persky has found a way to lock in lower mortgage rates once again. He has reduced his mortgage to below $729,750 - meaning it can now be bought by Fannie Mae or Freddie Mac - and in doing so reduced his interest rate.

Covered way forward

To reinvigorate private investment in housing finance, some US bankers and lawmakers are pushing to create a market for covered bonds. Widely used in Europe, these are senior secured liabilities backed by the cash flow from underlying real estate.

Because the issuing bank is required to keep the bonds on its balance sheet, they are considered safer and more transparent than mortgage-backed securities, which banks were able to sell to investors and thereby divorce themselves from the risk of default. Covered bonds do not transfer the risk to a third party.

"The bank that issues the bond is responsible for maintaining the flow of redemptions," says Tim Skeet at Bank of America Merrill Lynch.

Scott Garrett, a Republican congressman, has launched a bill to create a covered bond framework. But the proposal has run into opposition from bank regulators, who worry that holders of the bonds would be ranked ahead of depositors should an institution fail.