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COVER STORY

The Future Of The GSEs

Stuck in Limbo

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The future of our nation's housing finance system is slowly coming into focus, as Fannie Mae and Freddie Mac await life beyond purgatory. Here's a look at what the industry can expect when Congress finally moves to fix housing finance.

BY JERRY ASCIERTO

"THIS COMMITTEE WILL be recommending abolishing Fannie Mae and Freddie Mac in their current form and coming up with a whole new system of housing finance," said Rep. Barney Frank (D-Mass.), chairman of the House Financial Services Committee at a Jan. 22, 2010, meeting.

Tossed out as an aside during a discussion on executive compensation, the statement was particularly shocking coming from Frank, who was once the most ardent supporter of the government-sponsored enterprises (GSEs). And the quote was an opening salvo in a brewing political battle, as Congress geared up to debate the fates of Fannie and Freddie.

Seventeen miles away at Freddie Mac's headquarters in McLean, Va., employees were working weekends in an effort to comply with new financial accounting regulations. The rules required the company to take all of its off balance-sheet securities and put them on the books, processing more than 12 million individual transactions. The grueling effort cost around $50 million, and Freddie Mac was finally in sight of the finish line.

"But after the 'abolish' comment, people called in and said, 'Should I even bother coming in?'" says Freddie Mac's CEO Ed Haldeman. "It raised the level of insecurity and uncertainty."

Though Frank backed off of those comments 10 days later—sending a letter of support that was circulated to Freddie's employees—the episode reflects what life in limbo is like at the GSEs these days. One word is all it takes to upset the apple cart.

Haldeman has inhabited limbo before. He was named president and CEO of scandal-plagued Putnam Investments in 2003 during an SEC investigation that cost the Boston-based firm $193 million in fines.

"At my worst days at Putnam, when it looked like the whole company was going to collapse, I at least could paint a picture for our employees of what could happen if we got through that," Haldeman says. "But one can't really do that right now at a GSE."

Indeed, the GSEs have been operating in a sort of purgatory, a state of temporary banishment awaiting purification, since being seized by the government. But even before the conservatorship, the entities inhabited a particular middle space in the American economy—a private company with a public mission, chartered and regulated by Acts of Congress.

Many say it was precisely this model— where profits were privatized and losses were ultimately socialized —that led to their downfall. "The political [pressure] on the companies was constant, yet they had shareholders that were expecting returns," says Doug Bibby, president of the Washington, D.C.-based National Multi Housing Council (NMHC) and a

WHOSE INSOLVENCY?

How political expediency and foreign policy factored into the conservatorship.

WHEN THE FEDERAL GOVERNMENT seized Fannie Mae and Freddie Mac, it was a shocking conclusion to the distinct public/private model of the government-sponsored enterprises (GSEs).

At the time, words like "insolvency" were splashed around the front pages to justify the government's commandeering of the GSEs. But insiders say that perhaps the most surprising thing about the conservatorship was that it didn't need to happen the way it did.

In the spring and summer of 2008, Treasury Secretary Henry Paulson saw the foreclosure crisis gathering on the horizon. And he pleaded with the GSEs to grow their portfolios and keep on lending to ensure a continued flow of liquidity to the housing markets, as per their public mission.

Paulson didn't need to remind the GSEs that they enjoyed many government-related benefits, most notably the implicit government guarantee that helped the GSEs attract investors. Now, the Treasury Secretary was cashing in that chip, former 16-year veteran of Fannie Mae. "When I left in 1998, I said, 'As a business model, it just can't keep going this way. At some point it's going to blow up.'"

And blow up it did, in spectacular fashion. Now Congress will start from scratch, sifting through the ashes to figure out where it all went wrong. And as Barney Frank indicated, all options are on the table.

Indeed, trade organizations and think tanks from across the ideological divide are proposing their own frameworks for the future at ongoing Congressional hearings. Many of the plans look and sound similar in the broad strokes, but the devil is in the details. And the future is, at best, unclear. Despite this, here are six things that seem to be certain when it comes to what fate holds in store for Fannie and Freddie.

1. No one really knows for sure what will happen.

The whole housing finance system is up for review, says Sheila Crowley, president of the Washington, D.C.-based National Low-Income Housing Coalition. "I don't think anything is immune from being re-engineered."

The lack of clarity stems from a lack of consensus on Capitol Hill. Will the next generation of housing finance entities be existing companies with a private mission? Brand-new organizations with a public mission? Or a mix of both? How many entities will there be? Will they all do the same thing? Will they be regional or national?

The right wing in Congress wants a fully private market, making affordable housing efforts the FHA's domain. Meanwhile, the left wing wants the next generation of government-chartered entities to concentrate only on affordable housing and remain largely under the government's control.

But a hybrid system incorporating elements of both is much more likely. "The biggest question mark is the transition from here to there," says Shekar Narasimhan, one of the affordable housing industry's brightest luminaries and currently a managing partner of McLean, Va.- based Beekman Advisors. "Once we agree on the form, how long does it take to go from what exists today—Fannie, Freddie, FHA, and the Home Loan Banks—to that new form? And are all of them somehow in the mix, or is it just Fannie and Freddie we're talking about?"

In analyzing the diverse proposals— from the right-wing Cato Institute; the left-wing Center for American Progress; the pro-business Mortgage Bankers Association; and the apartment industry's trade groups, the NMHC and the National Apartment Association—a way forward is beginning to emerge.

2. There will be a place for multifamily.

For most of their history, the single-family market has been the GSEs' raison d'etre. Fannie Mae was created by Congress during the Great Depression to focus on providing liquidity for the singlefamily sector, and Freddie followed more than 30 years later with the same charter. Multifamily didn't even enter their business models until the 1980s.

As a result, the multifamily divisions of Fannie and Freddie only make up about 5 percent to 6 percent of their overall businesses. Yet the GSEs now back about 80 percent of the overall multifamily market. So many in the industry fear that multifamily will get lost amidst all of the debate—even as the industry's fate hangs in the balance.

The good news? Multifamily is the GSEs' last surviving success story. It's profitable; it ensures liquidity in down times; it constitutes 30 percent of the GSEs' affordable housing goals; and the delinquency rates are so low—0.24 percent at Freddie, 0.69 percent at Fannie, as of mid-May—you'd never know they were part of a failing company.

In fact, the guarantees collected by the multifamily divisions would have covered all multifamily losses, and then some. But the reserves were drained to cover singlefamily losses instead.

Translation: Multifamily may be the tail, but it's a gorgeous tail on an extremely ugly dog. "There is more consciousness about multifamily today than I've ever seen, both within the GSEs and on Capitol Hill," says Michael Berman, chairman-elect of the Washington, D.C.-based Mortgage Bankers

expecting the GSEs to abandon their private motivations in favor of acting in a countercyclical way.

Fannie and Freddie didn't see things that way. In fact, the GSEs were shoring up their capital in anticipation of more losses due to the single-family meltdown and planned to sit on their newly raised funds and ride out the storm. "Do you think that's what Paulson wanted us to do? Hell no," says one GSE executive who spoke on the condition of anonymity. "So how do you solve that? How do you get a company that's conserving capital to stop hunkering down? You take control of them."

In short, the conservatorship was as much a matter of political expediency as it was of imminent GSE collapse. And this episode illustrates the tensions inherent in a public/private model. The GSEs decision to conserve their capital was driven by fiduciary concerns, by shareholder interests. But that was only one of the two masters the GSEs served.

The GSEs weren't exactly rolling in profits at the time. Although OFHEO said they were adequately capitalized weeks before the conservatorship, the GSEs would've needed a bailout, and a big one at that. But executives at both Freddie Mac and Fannie Mae say off the record that their current losses wouldn't be as bad had they not been forced to morph into the housing policy arm of the federal government and refinance so many underwater borrowers.

In the months leading up to the conservatorship, Mark Calabria worked as a member of the senior staff of the U.S. Senate Committee on Banking, Housing, and Urban Affairs. "One of the primary drivers behind putting them into conservatorship was an impression by Paulson and others that they were not acting in a countercyclical manner, that they were acting like private companies," says Calabria, now a policy scholar at the Cato Institute. "It's like, 'You guys made a lot of money over the years playing off of this, now it's time to pay up.'"

To Calabria, the bigger issue was that the conservatorship was driven as much by foreign policy as domestic policy. Nearly 60 percent of the funds invested in the GSEs were from overseas investors. And in Calabria's estimation, the Chinese government would've lost nearly $200 billion had the GSEs failed, since it had a lot of unsecured funds invested in the GSEs. "We basically did a back-door transfer of $200 billion from the American taxpayer to the Chinese Central Bank, without any of that being debated publicly," he says.

So was it just the GSEs' insolvency? Maybe. Maybe not. This much is true: If Fannie and Freddie held onto their capital, and if foreign investors lost confidence in MBS, credit for housing would've been virtually impossible to find. But when you go back and listen to the rhetoric surrounding the conservatorship, these points weren't made explicit, replaced instead by "insolvency."

LOOKING BACK IN ANGER

Political viewpoints will shape future proposals.

ON CAPITOL HILL, the past is as

ON CAPITOL HILL, the past is as contentious as the future. Republicans generally believe that Fannie Mae and Freddie Mac led the charge in the booming subprime market and were major drivers of the housing market's collapse. The Democratic line of thought is that the private MBS market was the main force behind the subprime explosion, and that the GSEs were lured into it long after it had blossomed.

On the multifamily side, the Democrats have a point. The GSEs didn't go down to 1.15x debt-service coverage ratios and amortizations of more than 30 years until late in 2006, when the conduit market was going gangbusters.

But if you ask Ed Pinto, Fannie Mae's former chief credit officer, the Federal Housing Enterprise Safety and Soundness Act of 1992, which freed up the GSEs to compete with the FHA on single-family housing business, was the main culprit. Within a year of the Act, the GSEs were lending at 97 percent loan-to-value (LTV), which eventually led to "no money down" loans.

"Leverage became the name of the game. They were doing 3 percent down loans, zero-down loans, and the private sector started following," Pinto says. "But what really transpired was the politicization of lending."

The Center for American Progress believes that the problem was a lack of oversight in the private market. The higher-risk, higher-profit opportunities began in the unregulated portion of the market and drew the regulated segments, the GSEs, into bad practices. "There was a cultural belief that intervention in the private label securities market would make the market less efficient and destroy wealth," says Sarah Rosen Wartell, an executive vice president at the Washington, D.C.-based Center for American Progress and a former deputy assistant to President Clinton on economic policy. "In this case, we were creating an illusion of wealth and actually destroyed far more wealth by letting it go unchecked."

One doesn't have to look too hard to find examples of an unregulated market gone awry. The fallout of aggressive CMBS loans such as the whopping $3 billion one made for New York's massive Stuyvesant Town/Peter Cooper Village complex "argues very strongly for acrossthe-board regulation," says Buzz Roberts, a senior vice president for policy at New York-based Local Initiatives Support Corp.

As such, the financial reform legislation currently being debated in Congress aims to impose stricter regulations on the private sector. And increased regulation could be very beneficial in the short term. "For the next several years, the capital markets are going to be very nervous about this kind of financing," Roberts says. "So having strong government regulation is going to be very helpful to improving both access to and cost of credit."

Association (MBA) and CEO of Needham, Mass.-based agency lender CWCapital. "It's the first time in the last 20 years of my visits to Capitol Hill where I've heard people talking about a balanced housing policy and the importance of multifamily."

But the idea of having multifamily-specifi c government-chartered entities in the future is unlikely. "Capital markets like the brand comfort of the much larger market that is single-family," says Sarah Rosen Wartell, executive vice president for the Washington, D.C.-based Center for American Progress. "So, if you take the rental market and put it in separate institutions, you actually may increase the cost of capital."

3. Common ground is emerging on a basic framework.

Amid the flurry of proposals put forth during Congressional hearings this year, a middle path is coming into focus.

The housing finance system of tomorrow will likely include several governmentchartered entities built on the ruins of the GSEs. These entities will be private companies, capitalized with private equity. As such, the entities can fail like any other private company. But a regulator modeled on the FDIC will be able to put them into conservatorship if necessary.

These chartered mortgage issuers will also have access to an explicit government guarantee for the securities they issue, much like the Ginnie Mae structure of securitizing FHA-insured loans. And they'll pay for that guarantee in the form of fees or additional basis points built into the interest rate of each loan. Those fees will be collected in a reserve to protect against losses, and some might be diverted to support affordable housing initiatives.

The guarantee will help these entities provide countercyclical liquidity to serve the market in good times and bad. When the rest of the market is healthy, the entities will see a reduced market share. And when the private market craters, the entities will scale up to pick up the slack. Importantly, the guarantee would also ensure a lower cost of capital in times of illiquidity.

In other words, the future housing finance agencies will be humbled versions of Fannie and Freddie—distant cousins with similar features. They will have very limited portfolio capacity, just enough to warehouse loans pre-securitization and to offer mortgages—such as for low-income housing tax credit deals—that don't have broad investor interest. As such, there may also be some level of government guarantee on the portfolio.

To help these entities begin life with a clean slate, the government may opt to create a "bad bank," a trust where the GSEs' most troubled loans and assets could be liquidated. There is precedent here: A liquidating trust was created when government student loan provider Sallie Mae was privatized.

This brave new world would ensure liquidity, stability, and affordability, while correcting the mistakes of the past. That's the idea anyway. Getting from here to there, with so much still up in the air, is another story.

4. There will be more than two— and as many as 12—entities.

In general, there is consensus in Congress that the country needs more than two government-chartered entities. Having multiple organizations protects against any of them being "too big to fail," or posing a systemic risk. The hope is that it would also foster competition and innovation.

But just how many is enough? Cato Institute proposes a dozen such entities, a high-water mark, while the MBA proposes starting off with just three. Both of those proposals offer flexibility: If the market needs more or less entities, the regulator can adjust the number.

"They would need to be Triple A-rated so their cost of debt would be low, and there are only so many of those you're going to have," MBA's Berman says. "The bottom line is there could be three or four or five potentially that would all compete with one another in the multifamily space."

Under Cato's proposal, if the market can't support a dozen, the entities can shift gears and apply for a bank charter. "But you need to have something to start with, and starting with just two like we have is a mistake," says Mark Calabria, director of financial regulation studies at the Washington, D.C.-based Cato Institute.

Another benefit to having many players is that it might bring more attention to underserved parts of the market, such as smaller properties. While Fannie Mae has a dedicated small loan program, Freddie Mac is less interested in small deals. Yet a large portion of the nation's multifamily stock can't support millions of dollars in debt.

"No one at the national level, neither Fannie, Freddie, nor the FHA, has been really able to address financing for smaller properties," says Buzz Roberts, a senior vice president for policy at the New Yorkbased Local Initiatives Support Corp. "It's great if Fannie can go down to $1 million, but we need more than just one way to go. Competition encourages innovation and better pricing."

The fledgling entities will be hungry to build up a market niche, Roberts says, and if an entity is a fraction of the size of Fannie Mae, small loans might look like a more attractive business line.

5. The future finance system will focus on securitization.

Securitization will be the dominant execution and as such, the entities will have much smaller portfolio capacity than in the past.

In fact, many view the size of the GSEs' portfolios as one of their tipping points. The GSEs basically played a massive arbitrage game with their portfolios—raising debt that was cheaper than the loans they put on their books—which resulted in a nice profit. Certainly, it kept the shareholders happy, but the extent to which they could act in a countercyclical nature was undermined by this profit play. [See "Whose Insolvency?".]

In the future, the portfolio's primary purpose will be to warehouse loans destined for securitization. Those securitizations will likely come wrapped in a government guarantee, much like Ginnie Mae securities. This will be an explicit guarantee on the securities, not the organizations themselves, unlike in the past where the lines were blurred. And in another sharp break from the past, the guarantee will come with a price, which will be paid for by the entities themselves.

"Over time, the form that was created slipped from an implicit guarantee to basically a government backstop, and that was not desirable," says Narasimhan of Beekman Advisors. "We have to create entities now where it is more clear where the government is, and where the government is not."

Beyond ensuring countercyclical liquidity, the government guarantee also ensures cyclical liquidity: The private sector just doesn't have the capacity to claim the market share left by the absence of the GSEs. Life insurance companies have limited allocations with which to invest in multifamily; banks continue to be saddled by bloated balance sheets; and the CMBS industry, while beginning to revive, is a shadow of its former boomtown self.

"It's possible, and almost very highly likely, that with industry support and public policy support, some kind of government guarantee for a preferred portion of the market will revive," says Wartell of the Center for American Progress.

The GSEs have a wide range of products, not all of which can be securitized. This is particularly true in the affordable housing space, where tax-exempt bond credit enhancements or forward commitments on tax-credit properties are still portfolio executions. "There should be some portfolio availability for highlystructured transactions, and specifically in the affordable multifamily sphere," Berman says. "But the total portfolio now is something like $1.5 trillion, and we don't even need a peppercorn compared to that."

In the meantime, a few industry observers have proposed covered bonds as a free-market alternative to the GSEs. But this speaks to the same problem. Covered bonds, popular in Europe, are debt securities backed by cash flows from mortgages. They're similar to mortgage-backed securities with one big difference: covered bond assets remain on the issuers' books as opposed to being passed off to investors. Given the state of most bank balance sheets, this would seem to be a nonstarter.

6. They will need to be insulated from politics to thrive.

The shifting political landscape on Capitol Hill is yet another powerful X-factor in shaping the next generation of housing finance. The Obama administration won't unveil a specific proposal for at least another seven months—an eternity in politics. "What we have today is a debate that's occurring in a bit of a vacuum," Narasimhan says.

Sen. Scott Brown's win in Massachusetts earlier this year points to a mid-term election cycle where Republicans should see significant gains in the House and Senate. And that could spell bad news for the GSEs. "A lot depends on the 2010 Congressional elections," says Alex Pollock, a fellow at Washington, D.C.-based conservative thinktank American Enterprise Institute and a former president and CEO of the Federal Home Loan Bank of Chicago. "If you have strong Republican gains in Congress, then you get a much less friendly result for Fannie and Freddie."

The administration's delay is partly driven by the fact that the housing markets are just starting to recover and are still fully dependent on the agencies. Any disruption in the flow of liquidity could have huge ramifications.

But the administration also has to line up its ducks in a row. The financial regulation legislation being debated in Congress may fundamentally alter the CMBS industry and has to be ironed out before the GSEs are dealt with. After all, how can you impose a new generation of secondary market players into a market that is, itself, undergoing vast changes?

But there is a broad consensus among trade groups and think tanks that any future government-chartered entities will need to be insulated from politics. The GSEs' lobbying efforts were ostentatious—together, they spent about $170 million from 1999 to 2008 on lobbying to help protect their empires leading up to the conservatorship.

Yet the entities will be crafted by politicians, many of whom either took large sums of money from the GSEs or from their competitors. To Narasimhan, there are a couple of ways to shield the next generation from politics. You could limit the amount each could spend on lobbying, or you can give their regulator more authority and have Congress monitor the regulator, not the entities.

In Cato's view, breaking up the GSEs into smaller multiple entities will protect against history repeating itself. "There's nothing like a huge pot of money to attract politicians," Calabria says. "If several of these entities competed with each other, they essentially make what would be a normal rate of return, so there's not that much to squeeze. You reduce the influence of politics if you reduce the excess."

Most likely, the housing finance system of tomorrow won't be much different from the borrower's perspective. "The world would have some entities, probably four or five, and you'd still be getting multiple quotes on your deal," says David Cardwell, NMHC's vice president of capital markets. "And interest rates are probably higher but not materially higher. More of the loans will be securitized, and there will be some public mission tied to it.

Yet despite all of the competing agendas and possible frameworks, despite all of the political posturing and conflictsof- interest, some people believe the next generation will just be a new coat of paint on an old house.

"They'll put a new hat on us, a smiley face, and call us new and improved," says one GSE executive who spoke on the condition of anonymity. "But when you peel all of the lipstick away from the pig, you're going to find that we'll be pretty much what we are now. Mark my words."