



Bond Market Worry Could Scuttle Paulson Fannie-Freddie Plan

Joe Light and Matt Scully

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A hedge fund proposal for freeing Fannie Mae and Freddie Mac from U.S. control is poised to face stiff opposition from investors who say it risks wrecking the mortgage-bond market.

The Moelis & Co. blueprint, which firms including Paulson & Co. and Blackstone Group LP sponsored, calls for raising tens of billions of dollars in capital for the mortgage-finance companies. The plan, released earlier this month, would also limit the amount of federal money available to offset any Fannie and Freddie losses to \$150 billion.

Fannie and Freddie package mortgages into debt securities that most investors treat as being fully guaranteed by the U.S. government, in part because the companies are currently under federal control. Some investors argue that capping taxpayer rescue funds, while releasing Fannie and Freddie to private shareholders like Paulson could upend the \$5 trillion market for the bonds they issue. By extension, that tumult might hurt homebuyers, whose low interest rates hinge on demand for the mortgage securities.

“I don’t think you could sell virtually any of this debt overseas if it wasn’t government-guaranteed,” said Scott Simon, who until 2013 managed billions of dollars in mortgage-backed securities for Pacific Investment Management Co. Some of his former foreign clients would have reacted to a limited backstop by asking him to “sell it all,” he said.

Fannie and Freddie play a pivotal role in the housing market by providing liquidity. They do so by purchasing mortgages from lenders and wrapping the loans into debt with assurances that investors will be made whole if borrowers default. U.S. regulators seized Fannie and Freddie during the financial crisis and bailed them out at least partly because of bond investors’ concerns over what would happen to their holdings if the companies collapsed.

‘Protecting Taxpayers’

Paulson and the other investors hope the Trump administration will see the plan as meeting its housing-finance objectives. “The key to protecting taxpayers and limiting the amount of a government backstop is to build sufficient private capital,” the company said in a statement. “This is what the Moelis blueprint does.”

The proposal comes as Congress revives efforts to overhaul the housing-finance system, which has been a goal of many lawmakers since the 2008 meltdown. Holders of Fannie and Freddie

legacy shares, such as Paulson, fear that such an effort could take years and possibly result in legislation that mostly wipes them out. Moelis says its plan offers a better alternative, because it could be executed quickly with support from President Donald Trump and regulators.

Pre-Crisis Perspective

Before the crisis, many investors assumed the U.S. government would make good on the guarantees even if the two companies collapsed. That wink and nod, given not only by company executives but also federal officials, drove down rates on Fannie and Freddie debt, which led to better mortgage rates for borrowers.

The government did end up standing behind the companies, ultimately injecting them with \$187.5 billion in taxpayer funds. Now, the question is what would happen if the U.S. released them with a limited backstop or none at all.

Under the current regime, Fannie and Freddie have almost no capital on their balance sheets and \$258 billion to draw on from the U.S. Treasury if needed. Under the Moelis plan, the companies would eventually have combined capital of as much as \$180 billion, plus another \$150 billion if needed from taxpayers.

Since the total funds standing behind Fannie and Freddie guarantees would be greater in the new system, bond investors should feel just as safe, the Moelis executives said.

‘Unintended Consequences’

“The unintended consequences of putting into place a full mortgage-backed guarantee are enormous,” Moelis Senior Advisor Landon Parsons said at a Cato Institute event last week. Mortgage bond investors want a full guarantee to get better capital treatment on Fannie and Freddie securities, but such a guarantee could drive up rates on other kinds of mortgages, Parsons said.

It’s unclear whether the Trump administration agrees. Treasury counselor Craig Phillips told attendees at an Urban Institute event last week that the administration believed the government should no longer implicitly guarantee Fannie and Freddie but instead explicitly guarantee mortgage bonds, according to people who attended. The change could be difficult without legislation.

Government support for housing should be explicit where it exists, Federal Reserve Vice Chairman Stanley Fischer said Tuesday during a speech in Amsterdam where he cautioned against forgetting the lessons learned from the 2008 crisis.

“An explicit guarantee would be good for mortgage investors and homeowners,” said Brian Norris, a senior portfolio manager at Invesco Ltd., which manages more than \$850 billion. A limited backstop wouldn’t be enough for many investors and an unlimited guarantee would have a side benefit of driving down mortgage rates for some borrowers, Norris said.

Unlimited Support

On the other hand, under a limited backstop many bond investors might keep the assumption that if push came to shove, the U.S. government would make available unlimited support, essentially reverting to the implicit guarantee that existed before the crisis, said Larry Penn, chief executive officer of Ellington Financial, a mortgage-bond investor.

“You are kidding yourself if you think the government is going to walk away from the companies even if they are privately owned,” said Penn, whose firm also wants to see the government offload more risk to private investors.

The Securities Industry and Financial Markets Association, whose members include some of the bond market’s biggest asset managers, has spent millions of dollars in recent years lobbying Congress on issues including housing-finance reform. One of Sifma’s longstanding goals has been to make the guarantee of Fannie and Freddie securities explicit and unlimited, which would likely raise the value of their members’ investments while making loans cheaper for borrowers.

Chris Killian, head of Sifma’s securitization group, said he believed mortgage-bond investors would react negatively to a limited backstop.

An average investor in Fannie and Freddie bonds “is not somebody who wants to ponder whether or not there’s credit risk or ponder how the government is going to react if something happens,” Killian said. Bond investors want legislation to reform Fannie and Freddie “that’s final and stable,” he said.