

Harnessing Fannie and Freddie

How does the government's conservatorship of Fannie Mae and Freddie Mac impact you and your clients?

By **Gibran Nicholas**, founder and chairman, CMPS Institute. Illustration: Keith Negley

This past September, the U.S. government placed government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac under conservatorship. The Federal Housing Finance Agency, created by July's Housing and Economic Recovery Act of 2008 as the companies' regulator, will now oversee them until the agency's director determines that they have returned to a solvent condition.

This takeover will have many short-term and long-term consequences for the mortgage industry, as well as for the homeowners and homebuyers mortgage professionals serve. Here's what you need to know about what brought Fannie Mae and Freddie Mac to this point, as well as how the conservatorship will affect you and your clients.



Before understanding the current state of Fannie Mae and Freddie Mac, it helps to understand their origins.

The U.S. government created the Federal National Mortgage Association — better known as Fannie Mae, a pronunciation of its acronym — in 1938. Its mission was to purchase mortgages from banks and issue bonds using those mortgages as collateral.

The purpose was to encourage homeownership by adding liquidity to the marketplace and giving banks more funds so they could make more loans and allow more people to purchase homes. In 1968, Fannie Mae became a private, shareholder-owned company while retaining its ties to the government as a GSE.

To create competition for Fannie Mae and to provide further liquidity, stability and affordability to the marketplace, the government chartered the Federal Home Loan Mortgage Corp. — aka,

Freddie Mac — as another private, shareholder-owned GSE in 1970.

Their GSE status allowed Fannie and Freddie to retain their ties to the government, rather than becoming truly private companies. In a nutshell, this status was equivalent to parents giving their children the freedom to go out and open a charge card with the tacit understanding that the children can always go back to mom and dad for help if they run into financial trouble.

Analysts have said the GSE idea might have worked better had the government given the companies some enforceable rules and boundaries. Few were given, however, and those that were proved ineffective.

Much like children testing their limits, Fannie and Freddie piled on leverage, trading positions and business strategies that assumed home values would never decline on a national level. Likewise, much like parents who fail to discipline

their wayward children, the government failed in its oversight of Fannie and Freddie.

After a 38-year winning streak, Fannie and Freddie started running into trouble at the gambling tables. The financial markets — the casino bosses — were getting nervous because these were the biggest high-rollers in town, representing 50 percent of all mortgages outstanding and nearly 80 percent of all new mortgages made in 2008.

Essentially, beginning this past June, the financial markets became spooked that Fannie and Freddie were too overleveraged and that they would have to raise new capital to cover the widening losses from defaulting mortgages in their combined \$5.2 trillion portfolio.

Then this past September, mom and dad were called upon to formally co-sign on their kids' overextended credit cards and to reassure the market that Fannie and Freddie will be good for

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the money.

The government takeover has averted the short-term fear of panic, crisis and a classic Wall Street “run” on Fannie and Freddie. By placing the two companies under conservatorship, the government is now the biggest player in the mortgage business, however.

As of press time, this major development will impact the mortgage industry in three major ways:

1. **Lower interest rates on conforming loans, for now;**
2. **Less-restrictive lending guidelines on conforming loans, for now; and**
3. **Higher rates and restrictive guidelines for jumbo and nonconforming loans.**

Lower interest rates

Through this conservatorship, the U.S. Department of the Treasury will purchase Fannie Mae and Freddie Mac mortgage bonds directly. For loans that conform to Fannie and Freddie lending standards, this will keep interest rates low.

Before the government takeover, demand for Fannie and Freddie mortgage bonds began eroding as many investors slowed down their purchasing of these bonds. This drove mortgage rates higher.

Now that the government has created more demand in the marketplace by purchasing Fannie and Freddie mortgage bonds, homeowners and buyers should start seeing lower mortgage rates and enhanced mortgage options.

The Department of the Treasury will use borrowed funds to invest in Fannie and Freddie bonds, and this will add to the federal budget deficit. Taxpayers potentially may profit from the spread between U.S. government debt and debt issued by Fannie and Freddie, however.

The government currently pays around 4 percent when it borrows money. If it invests these borrowed funds by purchasing Fannie and Freddie bonds at, say, 6 percent, it will earn a 2-percent profit on the difference between its cost of funds and the return on investment.

Therefore, consumers benefit twice from this plan: first from lower mortgage rates and then from the government making a profit on its investment.

Less-restrictive guidelines

Before being placed under conservatorship, Fannie Mae and Freddie Mac announced that they would scale back their mortgage purchases to preserve capital. This was necessary to help them prepare for the expected losses from the

large wave of defaults and foreclosures in their mortgage portfolios.

Scaling back would have essentially meant tighter and more-restrictive lending guidelines. For borrowers, this would mean larger downpayments and more-restrictive credit-score requirements to get loans. As a result, more of these borrowers would have been priced out of the homeownership market — not because of borrowers’ higher risk but because Fannie and Freddie did not have the capital to continue buying as many mortgages.

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The government-takeover plan empowers the Treasury Department to inject as much as \$200 billion of capital in the companies — or \$100 billion investment in each. This means that Fannie Mae and Freddie Mac are no longer forced to slow down their mortgage-buying activities and further restrict lending guidelines.

Therefore, although guidelines probably won’t get looser, at least Fannie and Freddie are not forced to tighten their lending guidelines because of lack of capital.

Higher rates and restrictive guidelines

A big issue with the government’s plan in placing Fannie Mae and Freddie Mac under conservatorship is that it does not have an exit plan or a schedule for potentially breaking up and re-privatizing the companies. It is thought that continued government involvement in these companies will only serve to harm consumers who don’t meet conventional-lending guidelines. For borrowers who need a jumbo or nonconforming loan — a large segment of the marketplace — this will contribute to increased interest rates and a limit on mortgage and homebuying options.

Certainly, homeownership is a noble cause, and Fannie Mae and Freddie Mac have helped promote that cause. But just because their business benefits the public doesn’t mean that they deserve to be backed by taxpayers and the federal government in the long term. After all, many other businesses also benefit the public, such as food-service companies, energy companies, technology companies, and auto and

transportation businesses. Just as it is not the government’s mission to be the biggest player in those businesses, it likely should not be the biggest player in the mortgage business.

What makes today different from the Great Depression era, which gave birth to direct government involvement in the mortgage business, is that financial markets are more sophisticated. Money for U.S. mortgages comes from all over the world, with foreign investors, central banks and sovereign wealth funds clamoring for places to invest their funds. In fact, covered bonds have recently been cited as one way to attract capital to the U.S. mortgage markets and replace the collateral debt obligations and other complex investment vehicles of the past. With covered bonds, banks keep the mortgages on their balance sheets and must replace any loans that default.

But privately issued mortgage-backed securities and covered bonds that do not have government backing will have a difficult time competing with the Fannie- and Freddie-issued securities that do have the government’s full faith and backing.

These issues and risks can best be addressed by breaking up and completely privatizing Fannie Mae and Freddie Mac, removing their GSE status permanently and cutting off their lifeline to the federal government. In other words, it is time for the parents to let go and allow their children to be responsible adults and functioning members of society.

Under a full-scale privatization scenario, the government’s role would be to create a regulatory environment in which Fannie’s and Freddie’s independent, smaller components, along with all other financial-market participants, can compete with one another and operate responsibly on their own without creating unnecessary risks for all other market participants. This can serve to bring long-term stability to the U.S. mortgage, real estate and financial markets. **!**



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