

Freddie Mac, Fannie Mae and the Future of Mortgage Markets

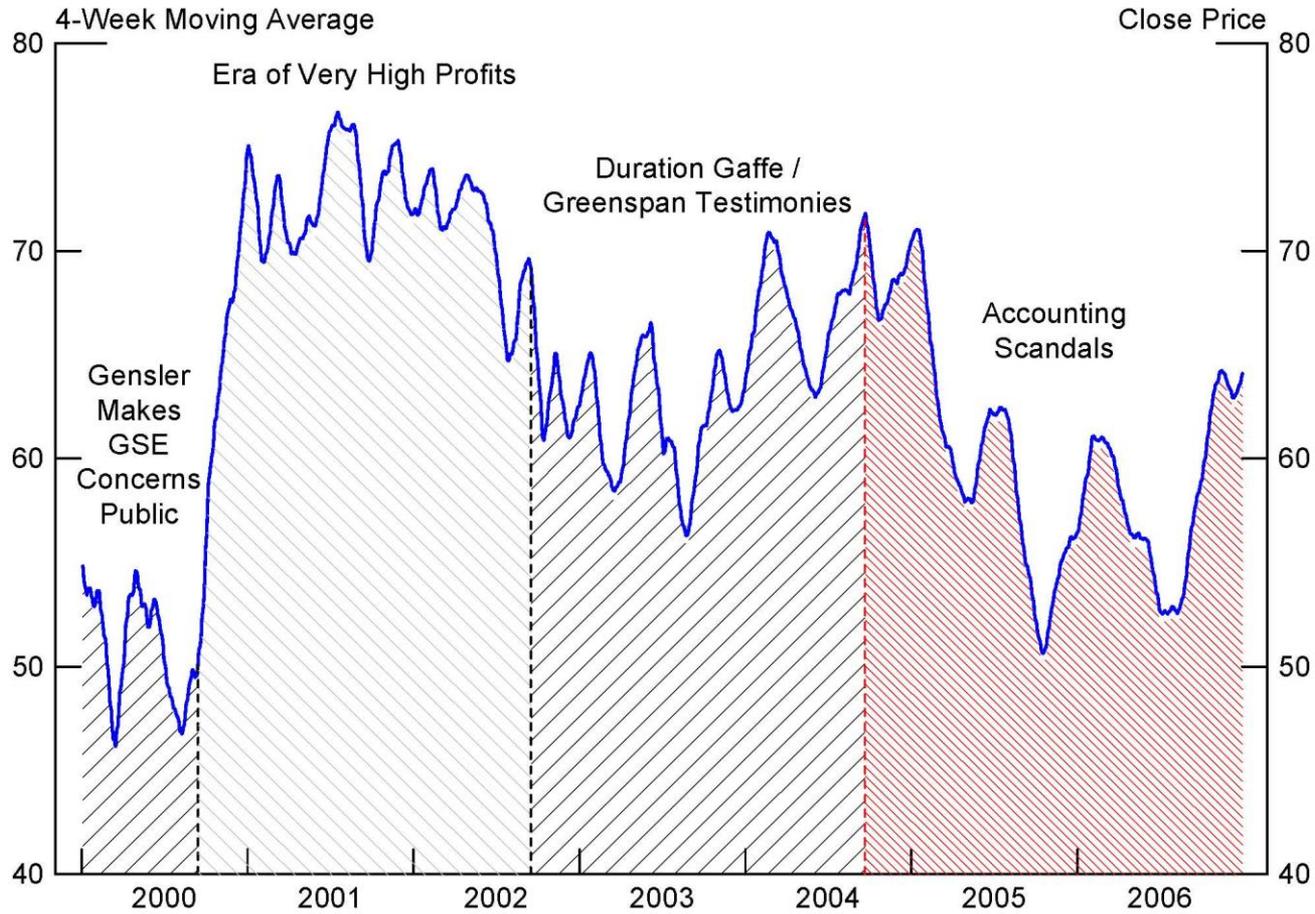
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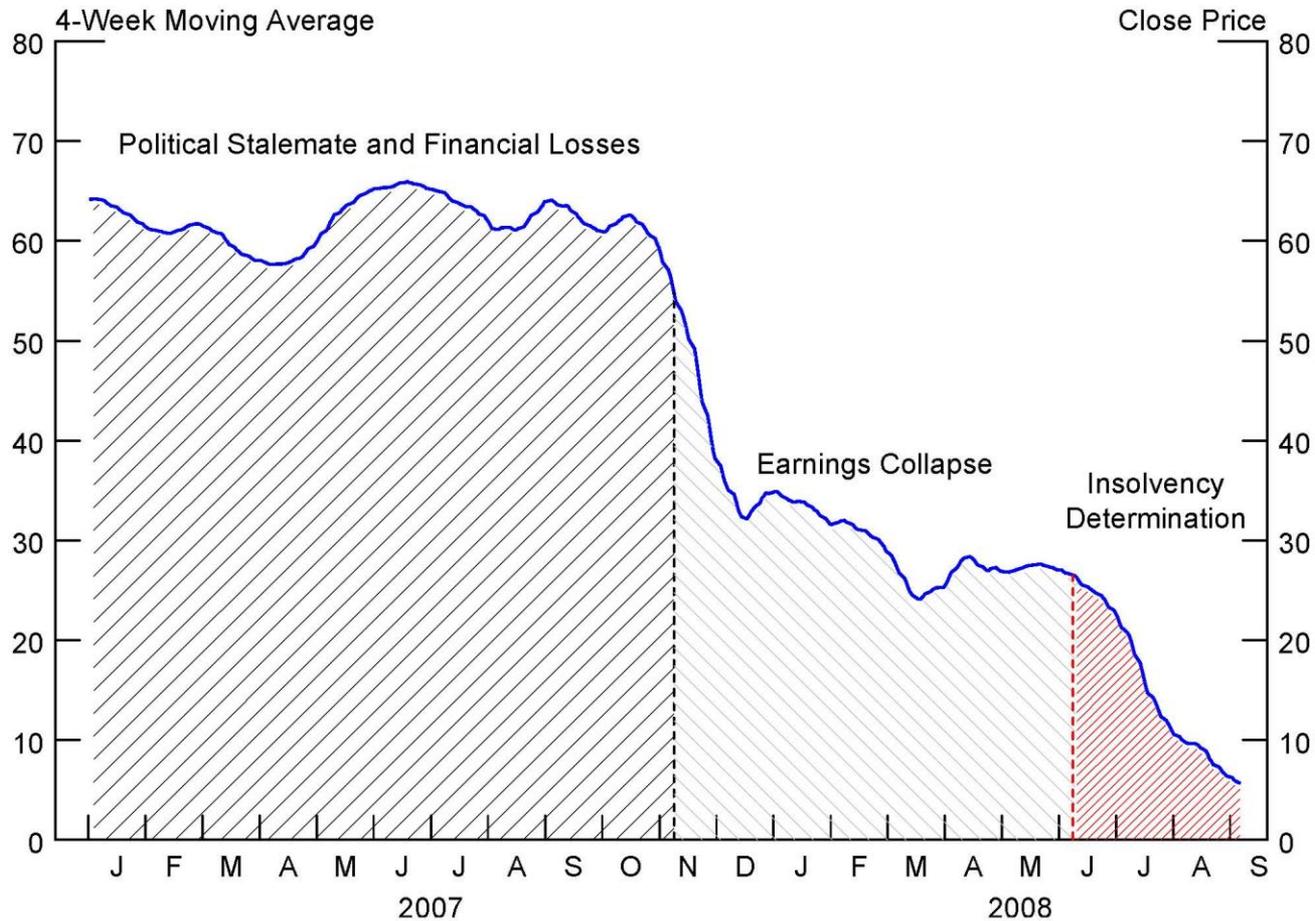
Board of Governors of the Federal Reserve System

* The views expressed do not necessarily reflect those of the Board of Governors of the Federal Reserve System, or its staff.

GSE history (2000-2006)



GSE history (2007-conservatorship)



The Federal Reserve's concerns about the GSEs Prior to Conservatorship

- Close ties to government allowed the GSEs to borrow at lower interest rates
- Private ownership and duopoly structure meant limited pass-through of benefits
- Allowed rapid portfolio growth and high profits
- Created incentives for regulatory capture
- Created systemic risk (Greenspan, February 2004)

Systemic risk: GSE portfolios, not GSE mortgage securitization

- Portfolio growth and profit pressures
 - Lowered underwriting standards
 - Accumulation of Alt-A mortgages
- Low capitalization
- Lack of ongoing market discipline
 - Accounting scandal created lack of confidence in internal controls
 - Debt costs did not rise throughout scandal
- Rollover risk
 - Debt investors fled
 - Concerns arose about credit quality of mortgage portfolio, “liquidity portfolio,” and pledging of assets for secured borrowing

What to do with Fannie Mae and Freddie Mac?

- Bernanke (2008)
- Option 1: Privatization
 - Unclear what this means; not evident that private sector would securitize mortgages without government support
 - Strong social interest in maintaining a stable source of capital market funding for mortgages
 - Suggests private firms with some form of government backstop or regulation
 - Hancock, Passmore (2008, 2009): Bond insurer

Option 2: Covered bonds

- Debt obligations are issued by financial institutions and secured by a pool of high-quality mortgages
 - Pool is actively managed by originating financial institution
 - Common method of funding mortgages in Europe
 - Relatively robust financing during financial crisis
 - Usually have some form of explicit or implicit government backing
 - Difficult to start in the United States because it competes with FHLB funding

Option 3: Government agency or public utility

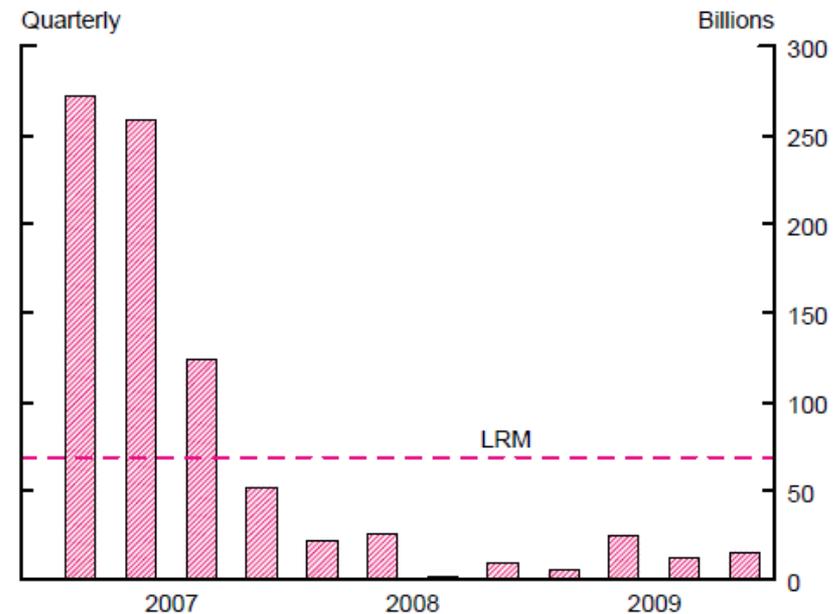
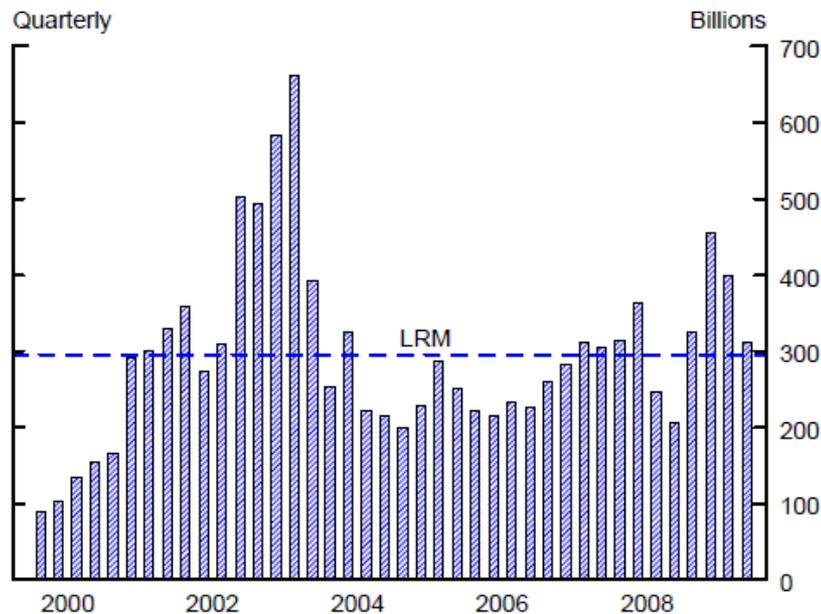
- Private shareholders overseen by utility board (Paulson)
- Consolidate FHA and GSEs into a government agency
- Cooperative structure like FHLBs (trade associations)
- Davidson

Retail Investor Runs, Asset Securitization, and an Analysis of Government Secured Bond Insurance

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Two different outcomes during the financial crisis: Agency (left-panel) and non-agency MBS Issuance (right-panel)



Policy implications of financial crisis for securitization

- Government-backed insurance for ABS: securitization ceases during a financial crisis without a credible government backstop
- Government also bears the “tail risk” associated with a systemic shock
 - Should manage this risk like an insurer
 - Would mitigate disruptions during a financial crisis if managed *ex ante*
- FINSAIF (financial institutions’ secured asset-backed insurance fund)
- Structured like FDIC:
 - Explicit risk-based insurance premiums charged to ABS originators
 - Insurance fund maintained
- Expands GSE function from securitizing mortgages to all loan types
- Provides possible role for Fannie Mae or Freddie Mac

Advantage of FINSAIF

- Explicit government guarantee fosters financial stability
- Ensures that similar risks for assets held across all FIs (big and small) are treated similarly (mitigates TBTF)
- Makes funding of longer-term assets by FIs easier
- Provides retail investors with a diversity of assets to purchase and removes their search for implicit government backing