

# What to Do About the GSEs?

## Know When to Fold'em

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The primary function of the two government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, is to purchase and securitize mortgages. Within this function, the securitized mortgages are sold off to outside investors with a guarantee of full payment of principal and interest. In addition, the GSEs hold some of the purchased mortgages as investments, and, in theory, help provide liquidity to the secondary market by repurchasing the mortgage-backed securities. Their size and importance for the market for residential mortgages is without question. With the residential mortgage market approximately 10 trillion dollars in size, 55% of which is securitized, the GSEs retain a mortgage portfolio of \$1.5 trillion and have securitized (and thus guaranteed the defaults of) \$3.8 trillion of existing mortgages. Though a private institution, the GSEs accept some regulatory oversight in return for an implicit government guarantee of support. As a result, the GSEs' activities are funded through "cheap" credit made available in capital markets under the presumed guarantee. The structure of the GSEs leads to the classic moral hazard problem in which the lack of capital market discipline and cheap credit provided the incentive for excessive risk taking. In fact, even though the GSEs' portfolio contained a variety of risks, including nonprime mortgages and long-maturity prime ones, the GSEs had leverage ratios on the order of 25 to 1.

The GSEs had two clear, negative influences on the financial system during the current crisis. The first was their investments into the subprime and Alt-A areas. By 2007, as a percentage of their own outstanding mortgage portfolio, over 15% was invested in non-prime assets. This amount represented 10% of the entire market for these assets. While not the only institutional culprit here, it is reasonable to assume that the mere size of the GSEs created "froth" and "excess" liquidity in the market. The moral hazard gave the GSEs the incentive to purchase nonprime collateralized debt obligations (CDOs) even if other investors were less willing to do so. The second, and more important, effect was to introduce systemic risk into the system and therefore add to the growing financial crisis. This systemic risk came in three forms. First, by owning such a large (and levered) portfolio of relatively illiquid MBSs, failure of the GSEs would have led to a fire sale of these assets that would infect the rest of the financial system, holding similar assets. Second, as one of the largest investors in capital markets with notional amount positions of \$1.38 trillion and \$523 billion in interest rate swaps and OTC derivatives respectively, the GSEs presented considerable counterparty risk to the system, similar in spirit to LTCM in the Fall of 1998. Third, the failure of the GSEs would have disrupted the firms' ongoing MBS issue/guarantee business, with major consequences for the US mortgage markets and obvious dire consequences for the real economy. As a result of losses in their subprime and Alt-A holdings, the GSEs soon would have violated their capital requirements, and, with no likely prospect to raise capital, would have gone bankrupt. Given the aforementioned systemic risk, the government had no choice but to place the firms in conservatorship on September 7, 2008.

Regulatory reform of the GSEs has been a continuing quest for most of the firms' history, and with a notable, even remarkable, lack of success. The primary case for regulatory reform has always been based on the systemic risks that the firms pose for the US mortgage and financial markets due to the severe moral hazard problem that exists. But in the absence of an actual crisis, the firms always deterred any serious action. The lobbying power of the GSEs in this regard is legendary. It is now clear, of course, that the fears of a systemic meltdown were all too accurate, and that the GSE model--combining a public mission with an implicit guarantee and a profit maximizing strategy--is untenable. In thinking about the appropriate reform of the GSEs in light of the above statement, it is useful to consider the possible path a mortgage might take to reach outside investors. Once the mortgage is originated, consider the following series of questions: (i) should it be securitized or not?, (ii) if securitized, should the principal and interest be guaranteed?, and (iii) if guaranteed, should the guarantor be the government or a private institution? Answers to these questions help suggest the appropriate reform.

With respect to (i), a majority of the current outstanding mortgages are securitized, being spread throughout the worldwide investment community. It seems hard to believe that this quantity of assets could be placed as whole loans within the banking and mortgage lending sectors. With respect to (ii), while there is room for securitization both with and without guarantees, approximately 68% of the MBS market is agency-backed whereas 32% is non-agency, some of which is also privately insured. There exists a \$4 trillion investment community that has been built over the last 40 years which focuses on interest rate and prepayment risk as opposed to default risk. A substantial amount of human capital (i.e., knowledge and training) and investment networks are devoted to this product. Taking guarantees away would cause a deadweight loss to all this invested capital so far. With respect to (iii), there are several obstacles for complete privatization of the guarantee function. Generally, private institutions are not good insurers against systemic risk because, by definition, systemic risk occurs very infrequently yet requires large amounts of capital on hand in the rare case. Moreover, even if a party were willing, who will insure the insurers? Is there any way to credibly signal that the government would not bailout these private institutions in times of a crisis?

The obvious solution is for the GSE firms to continue the mortgage guarantee and securitization programs for conforming mortgage loans. To reduce the moral hazard problem, the programs, however, would now operate within government agencies, in a format parallel to the current Federal Housing Administration (FHA) and successful GNMA programs. This way, the securitization of guaranteed mortgages, with all its investors already in place, would run almost as is yet without systemic risk. Parallel to the government market, there would exist a private market. Specifically, much like there is now, there will be three distinct securitization markets, consisting of "jumbo", Alt-A and subprime mortgages, respectively. These mortgages may or may not be guaranteed by the private firm. This will involve a tradeoff between the benefit of offering investors their preferred guaranteed mortgage pools versus the cost of stringent regulatory capital requirements being placed on firms offering these guarantees.

The final action will be to essentially shutdown the investor function of the GSEs. As discussed earlier, the current setup leads to "froth" in the marketplace such as the support for weak Alt-A and subprime loans, and, even more serious, systemic risk due to the moral hazard problem of the GSEs taking risky bets. The obvious solution is to spin off the retained mortgage portfolios to the GSE shareholders, and to transform these entities into the equivalent of mortgage REITs or hedge funds. These entities would also receive the intellectual capital of the GSEs, covering their proprietary software for evaluating loan quality, techniques for hedging interest rate risk, and so forth. The spinoff would thus fully respect the property rights of the GSE investors. The new private sector entities, however, would have no links in any form to the federal government and be at the mercy of capital market discipline.