Newsletter

Written by Bruce Jordan

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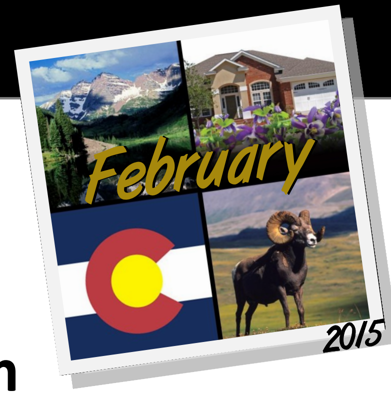


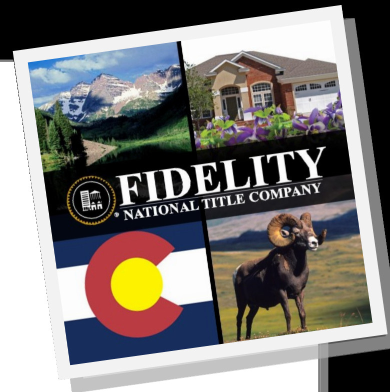
Keep - Start - Stop…
The Fannie and Freddie Conundrum

With the close of the old year and the start of the new, thoughts frequently turn to business planning and strategies for the New Year. In this arena, a common theme is the notion of **“Keep - Stop - Start”** and that it is to say, “What are the things we are going to **Keep** doing for the new year; What are the things we are going to **Stop** doing in the new year; and what are the things we should **Start** doing in the new year?” When it comes to mortgage financing, and the various stakeholders affected by the status quo, a similar dialogue has been going on and will likely be continuing for some time to assess the future role of Fannie and Freddie as the controlling influences for liquidity in the mortgage marketplace.

Just before Christmas, the agency which provides budget and economic information to Congress (CBO) released a 67 page report, “Transitioning to Alternative Structures for Housing Finance”. [See, ww.cbo.gov/publications/49765]. The purpose of that report was to look at various options to attract more private capital to finance mortgages in the secondary market, gradually moving away from, if not eliminating, the traditional mortgage giants. Currently, Fannie Mae and Freddie Mac are offering guarantees on a much greater share of all residential mortgages, far in excess of their involvement in the years preceding the onset of the financial crisis. When the federal government jumped in to bail out these two mortgage agencies, essentially it became the guarantor of their mortgages, placing the American taxpayer on the hook to make good that guarantee. As the financial crisis has ebbed, and the housing market improved, the discussion of what to do with Fannie and Freddie is back in the forefront of the marketplace and shifting political landscape.

The interested reader, seeking to be well informed, would do well to study the entire report. However, in keeping with our theme for the New Year, and for those who do not have the inclination to wade through 67 pages of complicated analysis, the issues boil down to these:

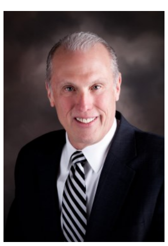
- **Keep:** Fannie Mae and Freddie Mac have been the structures supporting the mortgage market for decades, in varying degrees, and they provide a platform for liquidity that is well understood and relied upon by beneficiaries of a stable housing market. Some advocates will continue to defend a system which has been basically reliable and has worked to promote homeownership across the country. This view is based upon the assumption that changing the underpinnings of the mortgage marketplace might be ill-conceived when the recovery is still fragile at best.
- **Stop:** Stakeholders on the other side of the spectrum would urge Congress to dismantle the mortgage agencies altogether, arguing that the potential risk to the taxpayer is just too great. After all, the experiences with the unraveling of the marketplace starting in 2007 suggest that Fannie and Freddie’s relationship to the Federal government promote risk-taking and reckless behavior, which ultimately creates a financial burden to the taxpayer who pays the bill when the bail-out dollars have to start flowing. While the market is improving, the argument goes, it is the perfect time to put the brakes on the existing model, before more risk-taking resumes.



- **Start:** It is well known and widely reported that there are substantial sources of private capital waiting on the sidelines, ready to come into a mortgage market substantially, if not almost completely funded by private investors. The suggestion is that once Fannie Mae and Freddie Mac get out of the way, the opportunity for private capital to come in would restore a more normal market, one which would appropriately provide for reasonable risk assumptions in both guidelines and pricing. Those who align with the private capital approach suggest that it is time to start moving in this direction, emulating models that have worked well in other places, and to some extent have worked well here in the US in the two decades preceding the onset of the financial crisis.

The government report includes detailed analysis of various degrees of the foregoing approaches, as well as a discussion of 'phasing' in or out of each one. What the outcome of this renewed discussion will be, remains to be seen. But, as the wrangling continues, we will hear much more on subjects, such as: (i) If Fannie and Freddie are phased out, won't that necessarily result in higher interests rates and costs, when private sources of capital rush in to fill the void? (ii) If interest rates and costs trend upward, are we prepared to bear the risk that housing prices will decline as the already inflated home prices become less affordable? and (iii) Given the known financial challenges facing the American taxpayer, isn't it time, at last, to move away from exposing them to the systemic risks of the Fannie & Freddie model and try something different?

Get ready for a passionate and sustained discourse fueled by politicians, their constituents and the competing stakeholders, each hoping to advance their respective interests in the outcome.



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