

Chapter 4: Executive Summary

What to Do About the Government Sponsored Enterprises

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Background

The primary function of the two government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, is to purchase and securitize mortgages. 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 (MBS). They are major enterprises and play an unquestionably important role in the market for residential mortgages. The residential mortgage market is 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 private institutions, 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 provides an incentive for excessive risk taking. In fact, even though the GSEs' portfolio contained a variety of risks, including non-prime mortgages and long-maturity prime ones, the GSEs had leverage ratios in 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 investment in the subprime and Alt-A areas. By 2007, over 15% of their own outstanding mortgage portfolio was invested in non-prime assets, an amount representing 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 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, the failure of the GSEs would have led to a fire sale of these assets that would in turn have infected other parties in 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.

The Issues

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. Given that the GSE model itself is flawed, what is the appropriate reform to be followed? Consider the following series of questions and answers regarding mortgages:

1. Should mortgages be securitized or not?

A majority of the current outstanding mortgages are securitized and 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.

2. If securitized, should the principal and interest be guaranteed?

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. Over the past forty years, a \$4 trillion investment community has arisen which focuses on interest rate and prepayment risk as opposed to default risk. Substantial amounts of human capital (i.e., knowledge and training) and investment networks are devoted to this product. Removing guarantees would cause a deadweight loss to all the human capital invested thus far.

3. If guaranteed, should the guarantor be the government or a private institution?

There are several obstacles to 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 to address that rare eventuality. Moreover, even if a party were willing, who will insure the insurers? Is there any way to credibly signal that the government would not bail out these private institutions in times of a crisis?

Policy Recommendations

1. The GSE firms should continue their mortgage guarantee and securitization programs for conforming mortgage loans. But in order to reduce the moral hazard problem the programs should now operate within government

agencies, in a format parallel to the current Federal Housing Administration (FHA) and successful GNMA programs.

2. The investor function of the GSEs should be discontinued. 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.

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