

# SCHWARTZ *Report*

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## DON'T BET ON FANNIE AND FREDDIE YET

When we last left Fannie and Freddie they were robbing banks and sticking up candy stores. Oh, sorry that was Bonnie and Clyde, not Fannie and Freddie. So what's new with Fannie Mae and Freddie Mac? When are they going to get out of reform school? Hard as it is to believe, it's been more than a decade since the degradation of lending standards and profligate behavior of these two government sponsored enterprises (GSE's) caught up with them. Skyrocketing loan defaults nearly brought about a collapse of our nation's mortgage backed securities market and some say triggered the Great Recession of 2008.

Heedless of this chastening experience they remain today, as one eighteenth century Englishman described another government sponsored enterprise, the all-powerful British East India Company: "corporation(s) with the power to topple kings." As supposed private entities but with public backing, Fannie and Freddie today guarantee nearly half of the \$11 trillion outstanding U.S. home loans. Except that they don't, we the taxpayers do. This of course tugs at the root of what spurred the push from previous administrations towards privatizing the two GSE's. The goal was to spread the risk amongst those willing to bear it and pay investors a fair return for doing so.

Perhaps a quick review will help. Fannie and Freddie don't make loans. Rather their niche is to provide liquidity to the mortgage market. They buy loans from commercial banks, savings institutions, credit unions and other originators who issue residential mortgages to customers. They also set standards for the loans which they will buy. Fannie and Freddie provide liquidity to the mortgage market by bundling these so called "conforming loans" and selling their bundles as



mortgage backed securities to investors. This service works well and the cycle successfully repeats itself as long as investors can trust that these standards hold firm with no variance of quality or security from bundle to bundle. There is one other critical ingredient. The federal government guarantees Fannie and Freddie's products. The Feds' promise to make investors whole in case of a default operates to keep down the interest rate cost of home loans and supports the popular 30-year fixed rate mortgage. It also effectively allows the duo to undercut their private competitors and dominate the mortgage backed securities market. Up until the 2008 recession this guarantee was an "implied" guarantee. As mortgage delinquencies soared and foreclosures loomed the government effectively "nationalized" Fannie and Freddie's operations in order to stabilize the mortgage financing market.

The delinquent twins were then placed in "conservatorship" rather than bankruptcy under the auspices of the Federal Housing Finance Agency. Speculation began about the prospect that they would eventually be "privatized". However, along with the conservatorship the Treasury had to inject \$190 billion into the GSE's. Under this funding agreement the Feds received a new class of stock (senior preferred shares) with warrants to acquire up to 80% of Fannie and Freddie's common stock. Effectively the GSE's other shareholders were relegated to a decidedly junior status overnight. The Treasury changed the terms of its bailout agreement with Fannie and Freddie again in 2012 and since then has swept away Fannie and Freddie's profits as dividends on its preferred shares. It's a perfect pay-for-play situation. This is not the only reason that the present conservatorship to privatization path is quite narrow. Mostly, no one wants to do anything to cause the investment community to fear that the government will curtail its

backing of the twins. Therefore, if you follow the money like Bonnie and Clyde did, you'll conclude that any true privatization for Fannie and Freddie may be a long way off.

The rationale is quite simple. As Lawrence Yun, the National Association of Realtors (NAR) chief economist recently observed: "Low mortgage rates have been the key reason for the housing market's strong performance in the midst of the pandemic and high unemployment." The Federal Reserve continues to signal with its short term interest rate cuts and its continued bond buying programs which effect long term rates, that it will stay on course until its goals of lower unemployment and 2% inflation are achieved.

These monetary policies have been quite supportive of the housing and mortgage markets. Moreover, the new administration seems disinclined to privatize anything, quite the opposite. The Biden White House has stated that it intends to use Fannie and Freddie's unique status to "boost housing affordability and promote home ownership". The Consumer Finance Protection Bureau chimed in on December 10, 2020 with its final qualified mortgage rules replacing those set to expire a month later. NAR cheered them both on with a statement from its president hoping that the final rules will be "flexible enough to serve all communities including individuals with 'non-traditional income documentation'". Shades of 2003 to 2008, the stars are aligning for more mortgage mischief.



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