GSE Activity Report November 29, 2004

Give a Little, Get a Lot?

Summary

The Friday *Washington Post* outlines what appears to be Fannie's new legislative strategy in light of its current travails. Its key demands appear to be not only control over its prospective new programs, but also – for the first time – an express federal guarantee on MBS in the event of a receivership.

Impact

We are taken by a statement in the November 26 Post piece by Jeffrey Birnbaum, which includes the following: "it [Fannie] wants to avoid limits on its ability to develop new financial products and… to be sure that the federal government would give explicit protection to mortgage-backed securities holders if Fannie Mae were ever forced into receivership." Did Birnbaum make this up? We doubt it, especially given the direct quotes elsewhere in the article from the head of Fannie PR and other clear indications of considerable feed into the article by the GSE.

The new-program issue is a long-standing one, with Fannie and Freddie doing well from their point of view, we would guess, in the Senate bill marked up in April. That legislation largely tracked current law, although it did include language broadening programs subject to prior review by the new regulator. Fannie and Freddie consistently fight toughening the current HUD prior-review system on grounds of "micro-management" and the arguable limits more extensive review would impose on their affordable-housing activities. The games next year, we would guess, will begin along these same lines.

The receivership issue is, as we noted, quite different. Receivership was, of course, the crux of the Senate bill's collapse, with the Administration taking a very hard line. It wanted the new regulator to have authority to put GSEs into receivership comparable to that granted the banking agencies – power that protects holders of "qualified financial contracts" (i.e., derivatives), but requires shareholders and creditors to fend for themselves when the government starts to run the failed bank.

Federal Financial Analytics, Inc.
(202) 296-5240
fax: (202) 452-6816

900 Seventeenth Street, N.W.
Washington, D.C. 20006
www.fedfin.com

Only insured depositors get an express guarantee – is that now what Fannie has in mind for MBS holders?

If so, a major shift in what a GSE is would occur and, perhaps with it, how it is regulated and governed. Both Fannie and Freddie have long fought suggestions that they are subsidized on grounds that banks are too – avoiding all the substantial differences between banks (for starts, there are more than two) and their regulatory framework. Fannie may now be turning the tables in the face of ineluctable pressure from a strengthened Administration determined to push through legislation tougher than the bill scuttled last year. In essence, it could be saying, "OK, regulate us like banks – with the signal exception of how new programs receive prior approval – but then give us what banks have: an express guarantee."

What if MBS holders in fact got what Fannie now suggests: an express federal guarantee backstop behind Fannie and Freddie (and/or the Home Loan Banks). Would this be free? That is, would the federal backstop just be there to make MBS holders happy – so happy that they might drop their demands a bit and thus, buttress GSE securitization profits? Or, as is the case with FDIC insurance, would the GSEs pay for it? If so, how? A scheme like the one now in place for banks would make the backstop essentially free for a well-rated GSE, even though a weaker one might be charged something along the lines now in place for FDIC risk-based premiums.

Under this model, the federal government could charge something for the express guarantee – possibly putting a few dollars into the federal treasury in a way that reduces the deficit a bit. Could this offset budgetary pressures for user fees? Would the GSEs then be free, like banks, to charge what they want to lenders for g-fees and MBS holders after paying whatever premium the government requires for the backstop? Or, would the government then step in and regulate g-fees, taking up the issue already under consideration by Richard Baker on the appropriateness of GSE g-fee pricing? Or, would the government regulate g-fees altogether in the fashion now imposed on Ginnie Mae, putting a g-fee into law for the housing GSEs and leaving what's left for lenders?

Outlook

In essence, an explicit federal guarantee of MBS is a clever counter to all the demands that GSEs be regulated like banks. In essence, Fannie is saying, "OK, but then we get what banks have – an express guarantee that we sort of pay for." The argument for deposit insurance, however, is quite different than that likely offered in defense of an express MBS guarantee. Retail depositors – the only ones granted clear FDIC insurance – are presumed too unsophisticated to make rigorous risk judgments. Deposit insurance is limited in consequence, although there is of course an implicit too-big-to-fail backstop behind the biggest banks that gives big depositors considerable comfort. Depositor protection is intended to limit contagion risk through bank runs, but most analysts expect that GSE systemic risk would come from panicky debtholders, not MBS investors. Still, quieting the MBS side with an express guarantee would go a long way towards addressing systemic risk –at considerable potential cost to taxpayers, of course – while doing more than a little for GSE profits along the way.

Federal Financial Analytics, Inc.
(202) 296-5240
fax: (202) 452-6816
900 Seventeenth Street, N.W.
Washington, D.C. 20006
www.fedfin.com