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Reforming Fannie Mae and Freddie Mac – A Cicero Special



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Overview

The satellite uplink vans idling outside the Brookings Institution on a bright February morning hinted that a conference on *Restructuring the U.S. Residential Mortgage Market* might see a significant story break. Inside, the politicians and wonks searched for a free seat and financial hacks tapped on Think Pads overlooked by an array of network cameras. The late news that Tim Geithner was to speak at the conference explained the packed out room.

The big announcement was the publication of a White Paper on the future of Government Sponsored Enterprises (GSEs) – finally the Administration was setting out how it might put Fannie and Freddie out of their misery. For those outside the Beltway bubble it is worth pointing out just how important an issue this had become. Once the pride of progressives, who wanted to extend homeownership to those on low incomes, Fannie and Freddie became monsters, extending finance to ever-larger sections of the population.

The spectacular implosion of the US housing market during the crisis left the GSEs massively exposed to the poor credit quality of much of its book. The US government put the GSEs into conservatorship (nationalization for European readers) making the implicit government guarantee well and truly explicit.

Dodd-Frank sidestepped Fannie and Freddie entirely, to the fury of many Republicans who hold them up as the biggest villains of the financial crisis – blaming them for sustaining a housing bubble, fueled by poorly underwritten loans to people that could not afford them. There have also been dark accusations that campaign contributions given by the GSEs made them a powerful lobby in their own right, causing a failure of oversight. The other factors in the crisis, for them, are secondary to the sub-prime crisis that the GSEs enabled.

Many Democrats and those in the Administration – including Secretary Geithner – will accept some of these criticisms. However they do not accept the GSEs are the main bogeymen of the crisis, and say that the attacks on the GSEs are in large part politically motivated.

The important point, aside from the political recriminations, is that there is finally a plan to lance the boil. Reaction to the announcement by Mr Geithner that Fannie and Freddie were being put on death row was broadly positive. Even the most vitriolic critics of Fannie and Freddie changed their line to pointing out that reform was not happening quickly enough. But unwinding Fannie and Freddie is not trivial, nor is finding a way to get the private sector to fill the yawning hole left by their loss. With so much at stake, not least a delicate economy, taking the time to do it properly is perhaps not unwise.

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History of GSEs - how did we get to here?

Fannie Mae and Freddie Mac were born out of the Great Depression, even though Freddie would not be created until the 1970s. Their original purpose was to help promote secure and sustainable homeownership for American families, and by 2008 they were the guarantor for 90 percent of all new mortgage loans in the US.

Fannie Mae, established in 1938 by the National Housing Act, was a part of President Roosevelt's New Deal. In 1968 Fannie Mae was converted into a publically held corporation, and a new entity, Ginnie Mae, was created to support insured mortgages from the Veterans Administration and the Farmers Home Administration. In 1970, Fannie Mae was authorized to purchase private mortgages, and so Freddie Mac was created at the same time to provide competition in this new arena. They began to pioneer securitization, attracting a lot of new investors.

In 1992, then President George H. Bush signed the Housing and Community Development Act that gave Fannie and Freddie an affirmative action obligation to facilitate the financing of affordable housing for low-income families. From 1999 onwards, and under increasing pressure from both the Clinton Administration and the primary mortgage lenders, Fannie Mae and Freddie Mac eased the credit requirements on the mortgages they would accept.

During the early 2000s, both Fannie and Freddie became involved in the 'sub-prime' market, in order to meet their lending targets. Increasingly, private institutions were creating mortgages that would never normally have been acceptable to the market but, since they were bought by Fannie Mae and Freddie Mac, had a guarantee of timely payment.

The shift away from regulated GSEs towards Mortgage Backed Securities (MBSs) coincided with the shift to new mortgage products which were structurally risky, and nonamortizing. The GSEs lowered their underwriting standards further in order to reclaim lost market share and keep up with the record profits experienced between 2000-2003, themselves a result of unusually low interest rates. The House of Representatives did respond in 2007 by passing legislation designed to strengthen oversight of the GSEs, spurred on by mortgage delinquency reaching a four year high at the end of 2006.

The exposure to sub-prime mortgages necessitated placing both Fannie Mae and Freddie Mac under conservatorship in September 2008, although this bailout was preceded by then Treasury Secretary Hank Paulson promising to backstop the GSEs earlier in July of that year.

The eventual bailout, in the form of the Housing and Economic Recovery Act 2008 (HERA), allowed the Federal Housing Administration to guarantee \$300bn in new 30-year fixed rate mortgages for subprime borrowers. The Bill also created the Federal Housing Finance Agency (FHFA) and the Office of Federal Housing Enterprise Oversight (OFHEO).



Next steps: a lengthy process

One thing is clear: GSE reform is not going to happen overnight. Secretary Geithner outlined both in the report and in his words that it will take at least five years to implement any meaningful reform to America's housing finance market.

Combined, Fannie and Freddie have a portfolio worth at least \$1.5tn, and this seems to be a conservative estimate. Whilst this is mandated to shrink gradually, it will remain an enormous sum of money that the government remains liable for.

While the overall intention was clear, exactly how GSE reform will look is less obvious. Other than the imperative to do so gradually, in a way that minimizes any damage to the still fragile housing market, the Treasury Secretary has essentially passed the question of how to do it to Congress.

The report intentionally did not show particular support for any of the options it outlined, leaving the door open for Congress to influence direction and timing. Once Congress has held hearings on the Treasury's proposals and there has been time for consultation, the Treasury will expand on what direction it believes should be followed. The Report does raise three potential options for reform:

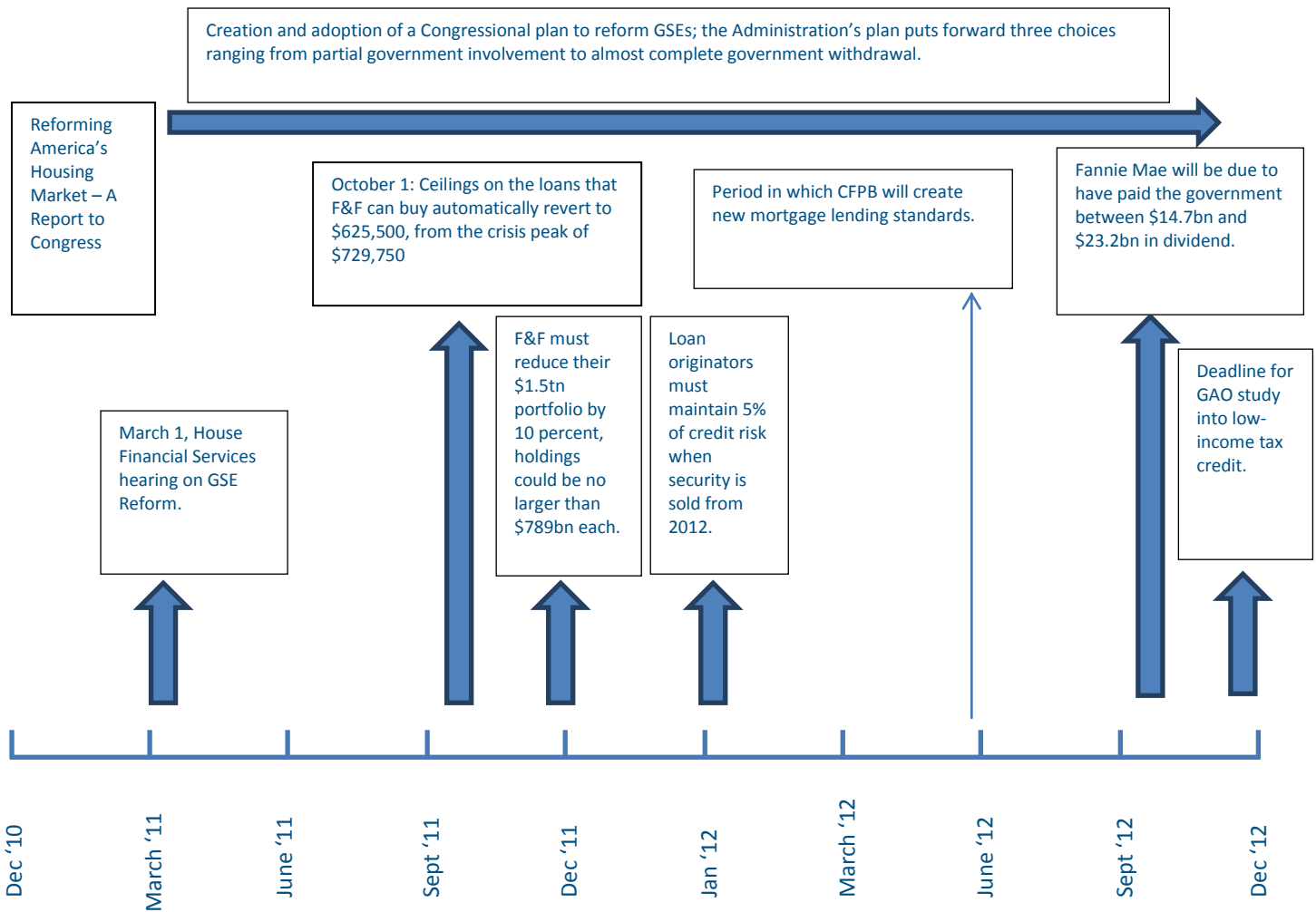
- (1)** A limited government role in housing finance, through the FHA, USDA and Department of Veterans Affairs, focused on specific target groups and rooted in an insurance role. This had the potential to reduce the government role significantly, but there are acute costs in terms of access to credit.
- (2)** A privatized system with assistance from the FHA, USDA and Department of Veterans Affairs combined with a guarantee mechanism that would provide a backstop during periods of crisis. This backstop would have a minimal presence in the market during 'normal conditions' and be ready to scale up in times of emergency. This would have the advantage of not having to rely on Congress to act during a housing crisis.
- (3)** An assistance scheme for low and medium income earners as well as government reinsurance behind significant private capital that would provide a greater spur for liquidity by protecting the private securitization of a targeted range of mortgages. The government backing would take the form of a private entity that would purchase and securitize mortgages whilst having the backing of the government; mortgages would have to meet specific criteria.

A wide-range of stakeholders will have the opportunity to comment on the report and outline what they see as the best direction for reform. The Treasury report particularly welcomed input from market participants, academic experts and consumer organizations. Ultimately, the report is seeking "a strong bi-partisan solution that results in a stronger housing finance market for all Americans", and a wide consultation that ensures all views are heard is vital to achieving this cross-party consensus.



In-line with this consultation process, both House and Senate will commence their own hearings, with the GOP-controlled House and Democrat-held Senate presenting their own opinions on where reform should focus. A long-term debate seems inevitable.

It is worth noting that during recent hearings on the Financial Crisis Inquiry Commission Report in both the House Financial Services and Senate Banking Committees, by far the main focus of disagreement was over the fate of GSEs and the role they played during the crisis. If not even the history of the crisis can be agreed upon, speedy reform for the future seems extremely unlikely.





The Geithner Plan

On 11 February 2011 Treasury Secretary Tim Geithner announced the Obama Administration's plan to wind down Fannie & Freddie and thereby reduce the government's "footprint in the housing market", a report required by the passage of Dodd-Frank. Entitled "Reforming America's Housing Market: A Report to Congress", the plan was a response to the failure to deal with GSEs in a meaningful manner with the Dodd-Frank Act, something that was certain to have been taken up by the new Republican majority in the House of Representatives. The Administration's plan consists of three main parts:

(1) Bringing private capital into the market: the plan accepts that "government had an important role to play" in the housing market, but will work to restrict the areas in which Fannie and Freddie can operate, whilst ensuring that both entities have the capital needed to meet past and future commitments.

The Administration has also committed to working with the FHFA to work out the best way to wind down both Fannie and Freddie. Among the ideas being muted are the following:

- Bringing in more private capital by increasing guarantee fees, ending the unfair capital advantage that the GSEs currently enjoy. The new guarantees will explicitly reflect risk, and will therefore level the playing field between the GSEs and private entities.
- Increasing credit-loss protection from private insurers will help to shift the ratio of capital from public to private and by increasing the down payments required so that eventually a minimum of 10 percent is achieved.
- Reduction in the conforming loan limits will further scale back the role that Fannie and Freddie are currently playing in the mortgage market. The conforming loan limits will be set in consultation with Congress, and will take into account cost-of-living differences across the US.
- Since Fannie and Freddie were allowed to operate like government sponsored hedge funds during the crisis, the investment portfolios built during this period will be wound down at a rate of *no less than 10 percent a year*.

More broadly, the Administration aims to reduce the FHA's market share from its current high of 30 percent to more historic levels of between 10-15 percent. This will be achieved by decreasing the maximum loan size that can qualify for FHA insurance (the current levels will expire on 1 October 2011) and there is a further decrease of 25 basis points in the 2012 Budget Proposal. Housing finance initiatives will also be subject to a review to ensure that they are both better coordinated and better targeted.

(2) Restoring trust in the housing market: the Administration accepts that "fundamental flaws occurred at almost every link in the housing finance chain", and aims to restore confidence whilst ensuring proper oversight. The proposal highlights several key areas:



- The Consumer Financial Protection Bureau (CFPB) will work to curb abusive practices, for example mortgage brokers will be prevented from accepting financial rewards for steering borrowers into more expensive products. The CFPB will also create a single rule book that will ensure costs and features of different products are clearly set out. Lenders will also be required to make a good faith determination about the ability of a consumer to repay their mortgage. The CFPB has been defunded as part of the ongoing budget debate, so its ability to carry out this remit is under question.
- Accepting that securitization needs to continue to play a key role in the mortgage market, the Administration nonetheless sees the need for reform to ensure that private investors are confident in their market participation. To ensure this, the Administration proposes that originators retain at least five percent of a security's risk when it is sold, and aims to have this rule finalized by 2012. Pursuant to Dodd-Frank, the SEC will impose stricter disclosure requirements and create an Office of Credit Ratings to ensure greater transparency and confidence in the mortgage market.
- The broader reforms to the financial sector, such as the Basel III capital requirements and the Financial Stability Oversight Council, will also serve to ensure greater stability in the market.
- To improve servicing and processing, the Administration supports the better alignment of incentives to create a compensation structure that ensures appropriate incentivization and helps prevent unnecessary foreclosures.

(3) Transparent and targeted support for access and affordability: The Administration accepts that not all Americans should become homeowners, but all Americans who have the credit history, financial capacity and desire to own a home should be able to take steps towards that goal. The Administration has proposed several reforms to ensure that capital is available to creditworthy borrowers in all communities and ensure that dedicated funds for homeownership remain available.



Political reaction

Reaction to the report has been largely positive, with both Democrats and Republicans welcoming the chance to formulate a clear long-term strategy for GSE reform. Particularly well-received is the assertion that the government's role in the housing finance market needs to be dramatically reduced, increasing the private sector's share of the market.

The core negative reaction has been the accusation that the report is merely an exploratory document that presents a set of options for consideration. Senior Republicans, notably **Rep. Spencer Bachus (R-AL)** and **Sen. Richard Shelby (R-AL)**, said what was really needed is a concrete plan from the Obama administration on how GSE reform will look and when it will take place.

Republican reaction:

As mentioned above, Rep. Spencer Bachus, House Financial Services Committee Chairman, and Sen. Richard Shelby, ranking Republican on the Senate Banking Committee, were both disappointed by the report. Ultimately, they said the report is a "set of options" rather than a concrete plan:

- Rep. Bachus: "What the administration offered today isn't a plan to move us forward but rather a collection of options to consider. What's needed is a real plan, and we intend to sit down with administration officials to find common ground."
- Sen. Shelby: "I am pleased that the administration admits what Congressional Democrats have long-denied, that Fannie and Freddie were poorly designed, poorly regulated, and behaved like a government-backed hedge fund. The report, however, lacks details and any sense of urgency. I join with Chairman Johnson and look forward to ending further taxpayer bailouts and establishing a more resilient housing market."

Rep. Ed Royce (R-CA), House Financial Services Committee: "Must get private capital back into the housing market in the long-term, and that's exactly what we are going to do. We now have a Treasury report that supports this. Phasing-in over time by lowering conforming loan limits and allowing private sector the space to take share of the market should be long-term goal."

Rep. Scott Garrett (R-NJ), Chairman, House Financial Services Subcommittee on Capital Markets and Government-Sponsored Enterprise: "While there are obviously going to be some differences between the administration's long-term vision and my own, I look forward to working with Secretary Geithner and President Obama to find a solution we are all amenable to."

Rep. Judy Biggert, (R-IL), Chairman, House Subcommittee on Insurance, Housing and Community Opportunity: "Democrat leaders refused to reform Fannie and Freddie last year, opting instead to wait for this report. Now that the wait is over, I hope we can move quickly



to translate this broad policy menu into a concrete plan. I am pleased that the Treasury is finally recognizing that taxpayers cannot continue to shoulder the financial risks associated with Fannie and Freddie. Our goal should be to choose a path that will quickly and prudently wind down the government's role and restore stability to the housing market."

Rep. Randy Neugebauer (R-TX), Chairman, House Subcommittee on Oversight and Investigations, welcomed the report and the acknowledgement that the private sector's share in the housing finance market needs to be substantially increased.

Rep. Shelley Moore Capito (R-WV), Chairman, House Subcommittee on Financial Institutions and Consumer Credit: "The administration's report today is a starting point on how to best wind down the GSE's. The previous business model of private gains and public losses was an injustice to the American taxpayers."

Democrat reaction:

Sen. Tim Johnson (D-SD), Chairman, Senate Banking Committee: "Maintaining a functioning housing finance system is an important part of the continuing economic recovery and one of my top priorities. I welcome the administration's white paper."

Rep. Maxine Waters (D-CA), House Financial Services Committee, appreciated the plan presented to Congress as a "report that at least provides a framework and a starting point for us to begin to fix the housing industry in this country". However, Waters outlined how she saw potential for reform to increase the cost of homeownership, something she is keen to avoid. She also stated her underlying desire to work to "end the creation of institutions that become too big to fail".

Rep. Barney Frank (D-MA), Ranking Member, House Financial Services Committee: "The administration's white paper is a thoughtful beginning that sets the stage for a constructive discussion of the future of housing finance. I hope this constructive step forward will inspire the Republican majority in the House to join us and the administration in moving concretely toward a solution to the serious problem of housing finance."

Committee Hearings: February 2011

Financial Services Oversight and Investigations Hearing: Fannie and Freddie Legal Expenses
February 16, 2011

Edward J. DeMarco, Head of the Federal Housing Finance Agency (FHFA), and Mike Williams, Fannie Mae CEO, faced a sceptical House Financial Services Committee as they attempted to justify the millions of taxpayer dollars that have been spent on legal fees in defense of Fannie Mae and, in particular, of certain Fannie Mae executives.

Committee Chairman Spencer Bachus (R-AL) cited the staggering amount of legal fees already incurred by taxpayers (\$162 million) to defend the two housing finance corporations since the government assumed them in 2008. Of this \$162 million, \$24 million went specifically to pay



for the legal expenses of three former Fannie Mae executives Franklin Raines, Tim Howard and Leanne Spencer.

Rep. Gary Miller (R-CA) added to the Chairman's remarks by insisting that at a minimum there should be more transparency for the government funds spent in Fannie and Freddie litigation.

DeMarco and Williams ultimately conceded that while they couldn't disrupt the continuation of the legal proceedings, they would review the situation to determine if they can seek reimbursement for the advances granted to the individual defendants.

House Financial Services Committee: The Final Report of the Financial Crisis Inquiry Commission

February 16, 2011

The House Financial Services Committee reacted to the Final Report of the Financial Crisis Inquiry Commission on February 16 by hearing testimonies from Phil Angelides and Bill Thomas, respectively Chairman and Vice Chairman of the Financial Crisis Inquiry Commission. Fannie Mae and Freddie Mac featured in many exchanges.

Bill Thomas made an important point that the Commission had tried to explain the root cause of the financial crisis, and that Fannie Mae and Freddie Mac had exacerbated the problem but were not the cause.

In a general point, Robert Dold (R-IL) said that looking at what governments should not be doing is the prime objective. Ranking member Barney Frank (D-MA) said the Republicans now seemed to have no idea about how to reform Fannie and Freddie.

Edward Royce (R-CA) said that the magazine *The Economist* had pointed out that American interest rates had effectively been below zero since 2002, and this caused asset bubbles in real-estate. He said that the GSEs were at the heart of the financial crisis, and the Federal Reserve had even warned Congress of this in 2005.

Patrick McHenry (R-NC) referenced excluded evidence that said 49 percent of mortgages in 2008 were subprime and guaranteed by GSEs. Mr Angelides refuted that evidence had been left out, and said that the evidence had not taken all factors into account. He said that defaults in 2008 were higher for private companies than for GSEs.



House Financial Services Hearing: Are There Government Barriers to the Housing Market Recovery

February 17, 2011

The hearing mainly focused on the effectiveness of current federal housing programs and incentives and the future of these programs. With the release of the Obama Administration's 'White Papers' the previous week, it is clear that the current trend in government policy is to reduce the footprint of institutions such as Fannie and Freddie and transition to greater involvement of private institutions in the housing market.

The main issue discussed was how this transition will take place and at what speed. The Republicans on the committee were wary of overt government influence on the market while the Democrats and members of the first panel were more concerned with the apparent weakness of current private institutions, urging caution and a slow transition.

The stakeholders on the second panel, representing the private side of the market gave their support for the type of transition outlined in the White Papers, but cautioned that there was a great deal of capacity building that needed to occur in the private sector as well as an increase in consumer confidence in private loans.

Overall, it was recognized that, although Fannie and Freddie were not the key cause of the housing market crash, the best track for future market success and growth was the gradual decrease in the footprint of government institutions in the housing market.



Conclusion

Reform of GSEs will radically change the mortgage market in the United States, a market which is almost unique in the industrialized world for its level of government involvement. Reform will be hard fought against a back drop of political division and straitened public finances. With the financial soundness of the US housing market at stake, the American people have a lot riding on the ability of the Congress and Administration to get this right.



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