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Discussion of Tom Stanton's GSE Privatization Proposal

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The current energized attention being paid to Fannie Mae's accounting and related issues may give us the opportunity for serious consideration of fundamental, structural reform. While issues of proper accounting, including the appropriate recognition of realized losses on derivatives, are of course very important, they are still relatively surface phenomena. The underlying foundational question is whether we should have a \$4.8 trillion sector of very large government-sponsored corporations which benefit from special privileges and correspondingly very large economic rents. For those of us who think the answer is that these corporations should be privatized, we are still faced with challenging questions of how to do it, given the present realities.

Tom Stanton has done us the great favor of proposing a specific way to achieve such a privatization of Fannie Mae, Freddie Mac and the Federal Home Loan Banks (FHLBs). This requires, as the title of his presentation has indicated, a transition process of removing government sponsorship—which I refer to as “de-GSEification.”

In general, it is my opinion that the structural steps Tom proposes would work, legally speaking. I also believe he is correct that to make policy sense, privatization must proceed simultaneously for all three GSEs, including the FHLBs. It is obvious that the politics of the matter would be complex and contentious, especially given the possible effects on the holders of GSE securities, particularly the equities but also the bonds and MBS. However, Tom's objective, and ours today, is not to begin with the political compromises which might be entailed, but to seek the right answer on the economic and competitive merits. In doing so, I will suggest a number of possible variations on Tom's themes, but will begin with a point of complete agreement.

Tom's starting point is that one GSE regulator should be established for all three housing GSEs and that this regulator is headed by a Director (not a board). This is the position of Chairman Shelby of the Senate Banking Committee and of the Administration. In my opinion, it is an essential prerequisite for the rest of the program.

It is important to understand that in the structures Tom proposes, this regulator has responsibility only for the GSE subsidiaries, which will become liquidating entities, not for the private corporations which will be the ongoing competitive businesses. Part of this responsibility is to insure the “firewalls” between the GSE subsidiaries and their private affiliates. When the GSEs ultimately terminate, there will be no GSE left to regulate, no firewall will exist, and the GSE regulator will also terminate.

President Bush has already declined to appoint directors to the boards of Fannie and Freddie. Under Tom’s plan, there would be no government-appointed directors to any of the GSEs as an immediate and permanent statutory change. Thus the curious situation in which the regulator appoints directors to the boards of the FHLBs would also cease. These changes would be a good idea with or without full privatization.

A key objective in Tom’s plan is to ensure that the resulting private companies which inherit Fannie’s and Freddie’s business operations are not too powerful, so that even with de-GSEification they could continue to dominate the market. I worry much less about this. It seems to me that these companies, while having high class human capital, important technological assets and information, valuable customer relationships and brand equity, would be much less powerful and fully subject to market and competitive discipline. As approximately (I estimate) single-A credits, they would not be in a position to dominate either mortgage securitization or debt issuance. Without the benefits or the restraints of GSE status, their freedom in private status would be a freedom to compete, not to dominate.

Thus, it seems to me unnecessary to require that they spin off their automated underwriting systems and data bases into a separate company, which must share them with others. Eliminating this provision would be a simplification of the plan, and would avoid the problems of taking intangible assets from the shareholders.

Essential to Tom’s proposal is that GSE assets be put on a liquidating basis without excessive delay. However, it might not be necessary to force interim sales of assets, since mortgage loans or MBS will naturally run off due to prepayments, and the vast majority of FHLB advances have maturities of less than five years, with most being much shorter than that. Suppose following the transition periods all GSEs simply were put on an asset liquidation program—no new asset acquisition—the run-off in five years would be very substantial. At a not very distant year the remaining assets would be small enough relative to the then market size to be able to be sold without disruption.

Remaining MBS with GSE guarantees which are owned by other investors seem to me a more difficult problem. Tom’s plan suggests restructuring the securities to replace the GSE guarantees with a subordinated position, but how do you take an existing credit enhancement away from investors who bought the original securities in good faith? If GSE-guaranteed MBS are still to be issued for three years of transition, there will be a lot of them still outstanding only two years later when the plan calls for GSE sunset. I don’t know that I have a good solution here, but maybe a pure guarantee function, on a liquidating basis, could be merged into Ginnie Mae.

In order to ensure sufficient financial substance to the liquidating GSEs, Tom's plan requires that they receive a "stand-alone" credit rating of AA and that to pay dividends the Director of the regulator would have to conclude that this rating would be maintained. The problem I have with this is that a credit rating which has to assume that a GSE does not have GSE benefits or any connection to the government is in fact a rating of an imaginary entity, not the actual entity. It seems to me the essential purposes would be served in a much simpler and less ambiguous way by having continuing minimum capital requirements for the GSEs.

I see three technical questions with regard to the FHLBs.

First, Tom slips in a change, albeit an upgrade, in FHLB collateral requirements for advances. Since there has never been a credit loss on an FHLB advance since 1932, I would suggest as a simplifying matter this provision could be left out.

Second, and trickier to deal with, is the issue of FHLB capital after the formation of holding companies as it relates to FHLB advances. Historically and at present, FHLB member institutions repaying advances have often been able to redeem their FHLB stock. This is stock of a GSE, the unusual characteristics of which are defined by the FHLB Act. But under Tom's plan, all the stock of the GSE would be owned by the holding company, and the financial institutions would own stock of the holding company, a normal private corporation. How would stock redemption work with this structure? Perhaps the GSE subsidiary could have a redeemable preferred stock owned by the members and a common stock owned by the holding company?

Third, there is the question of the Affordable Housing Program. Tom's plan has a reasonable approach to funding an Affordable Housing Reserve Fund. A possible alternative would be to give such a fund warrants for the stock of the privatized company, analogous to the warrants given in the Sallie Mae privatization to benefit Washington, D.C.

Would the American housing finance system function effectively in privatized form? In my opinion, there is no doubt that it would.

All in all, I want to congratulate Tom (and Peter and Bert) for developing specific and careful proposals which, as current events show, are more and more relevant and timely.