Agency Mortgage-Backed Securities

Fannie and Freddie Private Again Under Trump 2.0?

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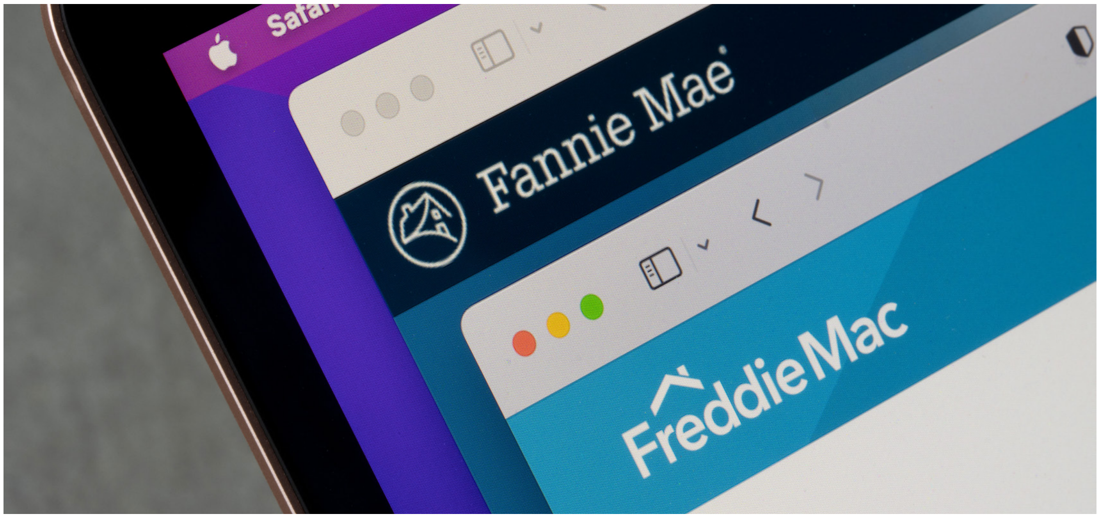

After President-elect Donald Trump's victory in November, markets have been anxiously awaiting how campaign policy topics such as immigration, tariffs, regulation and tax cuts will be addressed post-inauguration. One topic that did not generate much discussion during the campaign but could have significant impact on the mortgage market is the future of Fannie Mae and Freddie Mac. Specifically, whether these two government-sponsored enterprises (GSEs) will be taken out of conservatorship – where they've been since September 2008 – and privatized. The first Trump administration made its intention to privatize the GSEs public and clear, so we expect the incoming administration to make another push to end conservatorship. However, the task would be a complex undertaking, with possibly limited political and consumer upside.

Even if Trump 2.0 is able to end conservatorship, it's hard to see how GSE privatization would lead to lower mortgage rates that benefit the consumer. Further, privatization would carry significant execution risks and could adversely affect the secondary mortgage market, which could drive primary mortgage rates much higher. Thus, the risk-reward balance is certainly a tenuous one. However, it would not be surprising if the new administration takes on some sort of effort at privatizing the GSEs, as conservatorship is not a permanent solution. Thus, it is helpful to highlight the history of the conservatorship, the status quo and what might need to be done if Fannie and Freddie were to be privatized.

In response to the Global Financial Crisis (GFC), the U.S. Treasury in concert with the Federal Housing Finance Agency (FHFA), under new powers granted to it by the Housing and Economic Recovery Act of 2008, placed Fannie Mae and Freddie Mac into conservatorship. The conservatorship was meant to shore up the balance sheets of both entities, restore confidence and stabilize the mortgage market. While the conservatorship was never meant to be permanent, the path to restoring the GSEs to fully private entities would be beset with challenges, especially as outstanding mortgage debt backed by both GSEs has increased since the GFC.

While under conservatorship, the Treasury has committed to supporting the GSEs to ensure they maintain a positive net worth. In exchange, the Treasury obtained approximately $190 billion of senior preferred shares and warrants to buy up to 79.9% of common stock, which will expire in September 2028. Due to unpaid dividends and retained capital, the Treasury had amassed a liquidation preference of approximately $310 billion as of Sept. 30, 2023.[1]

Since conservatorship started, the Treasury has provided the GSEs with approximately $190 billion (and a total commitment of approximately $446 billion, of which $256 billion remains) while the GSEs have paid the Treasury approximately $301 billion in dividend payments.[2] In January 2021, the Treasury amended its agreement with the GSEs and paused subsequent dividend payments until the GSEs reached higher capitalization levels, at which point dividend payments – and periodic "commitment fees" – would resume. To ensure that higher capitalization accrues to the Treasury, the senior preferred liquidation preference would increase dollar for dollar with the increased capitalization. Overall, the Treasury has collected back more than it has provided, although less than it has committed. It is important to note that the dividends paid have not decreased the size of the senior preferred equity stake of the Treasury.

Recapitalizing the GSEs will be a lengthy process, but the Treasury can influence the timeline by amending rules such as capital retention requirements, and act based on its views and valuation of the senior preferred shares. Further, any privatization effort will most likely need to include both administrative and legislative components. While the former could be done by GSE regulators directly, the latter would need congressional action. It is unclear how straightforward the path of administrative action would be within this context, especially after the Supreme Court overturned Chevron deference in June 2024. Getting Congress, as it is currently composed with a slim Republican majority in both chambers, to agree on legislation related to GSE privatization also seems like a Herculean task.

And the big question will need to be carefully addressed: What happens to the implicit guarantee of the GSEs by the U.S. government in privatization? Uncertainty around GSE support by the government would most likely have a significant adverse effect on primary mortgage rates, hurting consumers. In addition, any kind of guarantee beyond what is currently offered by the Treasury – the $256 billion as per the conservatorship agreement would presumably end once conservatorship ends – would need congressional approval. Uncertainty around a guarantee could also trigger rating downgrades of GSE-backed bonds and impact their capital treatment on bank balance sheets – either or both would be very disruptive to the overall mortgage market. Further, we could see a significant shift to Ginnie Mae-guaranteed mortgages in such a scenario, as these mortgages are explicitly guaranteed by the U.S. government, which would increase taxpayer exposure to adverse housing downturns.

In 2019, the first Trump administration published a Housing Reform Plan that outlined various administrative and legislative actions toward privatizing the GSEs.[3] While the plan recommends an explicit guarantee, it is unclear how such a guarantee would work – presumably this would be tied to commitment fees that GSEs would pay to the Treasury. Any serious attempt at GSE privatization will need to offer a credible answer to this question. Indeed, as the Housing Reform Plan states, "Stability in the housing finance system is crucial, and generally counsels in favor of *preserving what works in the current system, including the longstanding support of the 30-year fixed rate mortgage loan.*"[4] Further, privatization of both Fannie and Freddie would need to be executed nearly simultaneously and in such a way that preserves the functionality, nature, and standards behind Uniform Mortgage-Backed Securities.

In 2020, the Congressional Budget Office (CBO) published an analysis modeling various recapitalization approaches of the GSEs, which concluded that in scenarios guided by moderate expectations, the Treasury would be fully compensated for its initial $190 billion senior preferred stake in 12% of modeled scenarios.[5] In 2024, the CBO updated the same analysis and found that – due to higher starting capital and earnings of the GSEs – the Treasury would be fully compensated in 60% of the modeled scenarios.[6] The CBO only analyzed potential scenarios for recapitalization, and explicitly warned that the impact to primary mortgage rates could be significant if "investors believed that the federal government would not support the recapitalized GSEs when needed," while noting that investors effectively have such a guarantee under the current agreement while under conservatorship.[7]

On Jan. 2, 2025, the Treasury and FHFA released a joint statement outlining changes to the conservatorship agreement that restore the Treasury's right to consent to an end of conservatorship for the GSEs.[8] Additionally, the FHFA has written the Treasury a side letter committing to a transparent process for ending conservatorship, including public request for comments on termination options and housing market impact. The FHFA plans to provide the Treasury with a plan and recommended approach, including presenting the public comments to the Financial Stability Oversight Council at the Treasury. While this might not be binding on the incoming administration, it reflects the degree of seriousness that Treasury and FHFA officials are placing on the potential market impact of ending GSE conservatorship.

Privatizing the GSEs, if pursued, would be a massive and complex project that would take multiple years and likely require coordination among all three branches of government. President-elect Trump's pick for director of the FHFA should offer clues as to the relative priority of this effort. While privatization has significant risks and unclear political or economic upside relative to the status quo, it is certainly possible, and there is a good chance parts of it will be attempted at some point by the incoming administration, which might be a catalyst for sporadic volatility in the Agency mortgage-backed securities market. ■

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Endnotes

[1] https://fiscal.treasury.gov/files/reports-statements/financial-report/2023/notes-to-the-financial-statements8.pdf

[2] As of Dec. 31, 2023, https://www.whitehouse.gov/wp-content/uploads/2024/03/gov_fy2025.pdf

[3] https://home.treasury.gov/system/files/136/Treasury-Housing-Finance-Reform-Plan.pdf

[4] Ibid, emphasis ours

[5] https://www.cbo.gov/system/files/2020-08/56496-GSE.pdf

[6] https://www.cbo.gov/system/files/2024-12/60810-GSEs.pdf

[7] Ibid (6)

[8] See https://home.treasury.gov/news/press-releases/jy2767 and https://www.fhfa.gov/news/news-release/fhfa-and-u.s.-treasury-announce-amendments-to-the-preferred-stock-purchase-agreements-pspas

Definitions

Agency – Refers to mortgage-backed securities (MBS) whose principal and interest are guaranteed by a U.S. government agency such as Fannie Mae (FNMA) or Freddie Mac (FHLMC).

Fannie Mae (FNMA) – The Federal National Mortgage Association (Fannie Mae) is a government-sponsored enterprise (GSE) chartered by Congress in 1938 during the Depression to stimulate home ownership and provide liquidity to the mortgage market. Its purpose is to help moderate- to low-income borrowers obtain financing for a home.

Freddie Mac (FHLMC) – The Federal Home Loan Mortgage Corp. (Freddie Mac) is a stockholder-owned, government-sponsored enterprise (GSE) chartered by Congress in 1970 to keep money flowing to mortgage lenders in support of homeownership and rental housing for middle-income Americans. Freddie Mac, purchases, guarantees and securitizes mortgages to form mortgage-backed securities (MBS).

Ginnie Mae (GNMA) – The Government National Mortgage Association (Ginnie Mae) is a federal government corporation that guarantees the timely payment of principal and interest on mortgage-backed securities (MBS) issued by approved lenders. Ginnie Mae's guarantee allows mortgage lenders to obtain a better price for MBS in the capital markets.

Government-Sponsored Enterprise (GSE) – Quasi-governmental entity established to enhance the flow of credit to specific sectors of the American economy. Created by acts of Congress, these agencies – although they are privately held – provide public financial services. GSEs help to facilitate borrowing for a variety of individuals, including students, farmers and homeowners.

Mortgage-Backed Securities (MBS) – Investment similar to a bond that is made up of a mortgage or bundle of mortgages bought from the banks that issued them. Investors in MBS receive periodic payments similar to bond coupon payments.

Pass-Through Security – Pool of fixed income securities backed by a package of assets. A servicing intermediary collects the monthly payments from issuers and, after deducting a fee, remits or passes them through to the holders of the pass-through security (that is, people or entities who have invested in it).

Uniform Mortgage-Backed Securities (UMBS) – Pass-through securities, each representing an undivided interest in a pool of residential mortgages, offered by Fannie Mae and Freddie Mac.

You cannot invest directly in an index.

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