Box 1

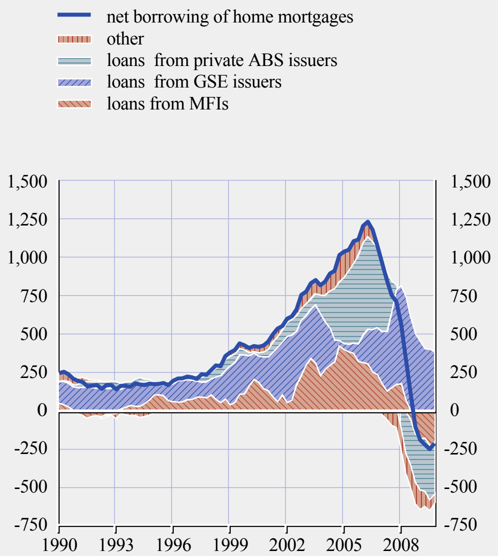
US GOVERNMENT-SPONSORED ENTERPRISES: OUTLOOK AND RISKS

The government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, which have been major providers of credit to US mortgage borrowers, have become increasingly relevant to financial stability, in particular in the recent crisis.[1] First, in September 2008, due to the systemic risks attached to these entities, Fannie Mae and Freddie Mac were placed under temporary government control to avoid insolvency. Second, the Treasury entered into a Senior Preferred Stock Purchase Agreement providing limited guaranteed capital injections, which in

1 The Federal Home Loan Bank System (FHLB), the Federal Agricultural Mortgage Corporation (Farmer Mac) and the Farm Credit System are also government-sponsored enterprises, but given their size and their role in the mortgage market, this box mainly focuses on Fannie Mae and Freddie Mac.

Chart A Net borrowing of US home mortgages

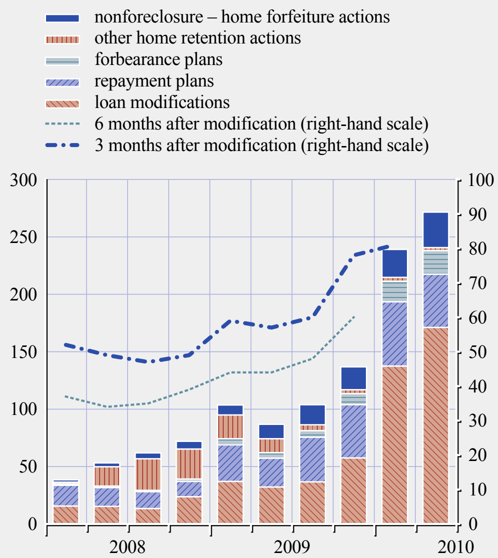
(Q1 1990 – Q2 2010; USD billions; four-quarter cumulative average flows)



Source: Board of Governors of the Federal Reserve.

Chart B Foreclosure prevention actions and current and performing loans

(Q1 2008 – Q2 2010; thousands of loans (left-hand scale); percentage (right-hand scale))



Source: Federal Housing Finance Agency.

December 2009 were extended to allow unlimited capital infusions over the next three years.[2] Against this background, this box examines the current role of the GSEs in the US housing market, their fiscal costs and the possible downside risks to the housing market and to financial stability more generally once the support is scaled back.

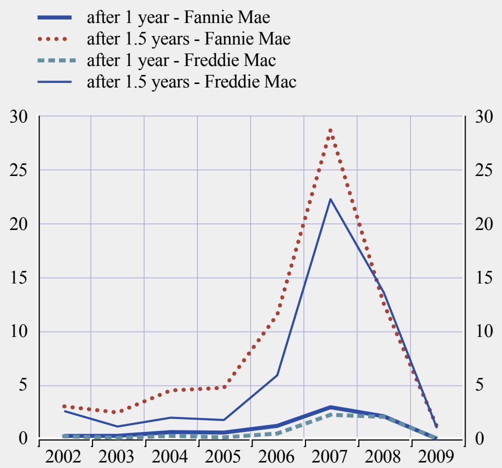
The government's involvement via the GSEs has become pivotal for the US housing market during the crisis. First, as credit from private asset-backed securities issuers dried up, the GSEs became the only source of net positive mortgage financing (see Chart A). As a result, in March 2010, the GSEs accounted for 53% of the total stock of home mortgages, compared with 40% in 2006. Second, the US Treasury and the Federal Reserve have purchased more than USD 1.4 trillion of mortgage-backed securities (MBSs) issued by GSEs, thereby contributing to historically low mortgage rates and enabling more affordable mortgage repayment refinancing. Furthermore, although the share of seriously delinquent loans remained elevated, GSEs contributed to a decrease in foreclosure rates and a decrease in excessive housing supply by foreclosure prevention actions and refinancing activity for current mortgage borrowers (see Chart B).[3]

Regarding credit risk, after the emergence of the crisis, GSEs faced significant losses on their credit portfolios, especially on mortgages which were originated in 2006 and 2007. As a result, since 2008 65% of their capital losses have been recapitalised by the Treasury to keep them solvent (see Chart C). Looking ahead, since the GSEs' underwriting standards were raised only after the government took control, there is a risk that losses from mortgages which were

2 Initially, the GSEs were allowed to draw up to USD 100 billion, which was later increased to USD 200 billion, in capital from the Treasury.
3 Two programs were introduced in this respect: the Making Home Affordable Program and the Home Affordable Refinancing Program.

Chart C Cumulative default rate by origination year for single-family conventional loans

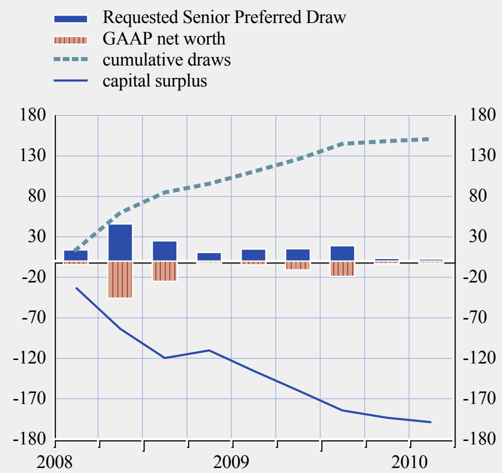
(2002-2009; basis points)



Source: Federal Housing Finance Agency.

Chart D Capital position of GSEs with Requested Senior Preferred Draw

(Sep. 2008 – June 2010; USD billions)



Source: Federal Housing Finance Agency.

originated in 2008 are yet to materialise in 2010, given the fact that cumulative default rates for mortgages issued in 2008 are higher than for those issued in 2006 (see Chart C).

As to the fiscal propagation channels, the GSEs' debt obligations have enjoyed an implicit guarantee by the federal government which, together with tax and regulatory exemptions, has resulted in sizeable federal subsidies. In January 2010 the Congressional Budget Office estimated that the subsidy costs would amount to 2.7% of 2009 GDP over the fiscal years 2009 to 2019, with the bulk of outlays occurring in 2009. Meanwhile, private sector estimates suggest even larger costs. Moreover, if the debt held by the two GSEs were to be accounted for as government debt (currently not the case), this would significantly raise current federal debt levels: the GSEs' total debt was around 10.7% of GDP at the end of 2009. Against the background of the already weak US fiscal situation, the support to the GSEs thus implies large contingent liabilities for the government, which add to the risks of further growing fiscal imbalances.

The dependence of the US mortgage market on the GSEs, as well as on other forms of government support, highlights the risks of a renewed collapse of the US housing market and a real activity drop in the event of a sudden government exit.[4] These risks could evolve into a negative feedback loop between the housing and financial sector, leading to a significant deterioration of the credit portfolio quality of small and medium-sized banks in particular. In such a scenario, there would be increased defaults on the part of several non-systemic institutions. At the same time, euro area financial institutions would also be affected: directly due to a sharp decrease in the value of their MBS holdings and indirectly due to spillover effects to equity and debt markets, tapped by the GSEs for funding purposes.

4 For more details on the impact of US housing support initiatives on recent housing market developments, see for example Box 1, ECB, *Monthly Bulletin*, September 2010.

Mounting fiscal costs and unsustainable dividend payments required from GSEs under the Senior Preferred Stock Purchase Agreement call for a reform of current GSE status.[5] Several options are being discussed and the likely outcome is that some form of government support for these entities will prevail, although the scope may be scaled back. The options include full privatisation, the transfer of key activities to the government and the re-establishment of the GSEs. From a financial stability perspective, however, several conditions must be met to avoid a renewed housing decline: the US housing market must stabilise and private mortgage origination must be revived. To achieve this, current financial sector reforms need to be implemented in such a way as to address dysfunctional aspects of securitisation markets: lack of transparency, complexity and inappropriate incentives in the originate-to-distribute model.

5 The reform is also driven by the need to target subsidies at specific groups determined by law-makers instead of providing a general subsidy.