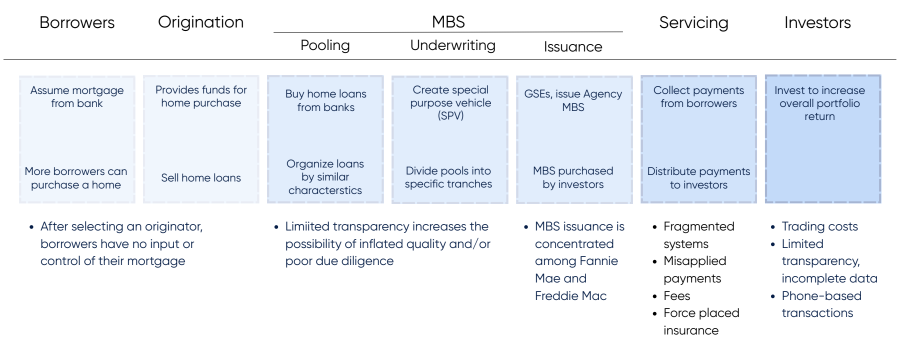
TrueScope VENTURES

Tokenization Could Be the Key to Privatizing Fannie and Freddie

The so-called “American Dream” means a lot of different things to a lot of different people, but it is rooted in the idea that, in America, upward mobility is available to everyone who wants to work hard and that anyone can attain their own version of success. Core to this ideal is the concept of home ownership, which not only represents an outward image of success but also physical ownership of a piece of the American Dream.

To help people to achieve the dream, the government established two organizations – Fannie Mae and Freddie Mac (collectively known as the GSEs, or Government-Sponsored Enterprises) – to ensure consistent, liquid home funding and enable an orderly housing market.[1] To this day, they perform several functions that are considered to be critical to have an orderly housing market.

The current process is siloed and each silo has issues.



However, much like the best laid plans of mice and men, Fannie Mae and Freddie Mac have gone awry following the losses they experienced during the 2008 housing crisis. That year, the GSEs had combined losses of over $109 billion and were placed into conservatorship, which is now approaching its 17th consecutive year.[2]

The ongoing debate surrounding the privatization of Fannie Mae and Freddie Mac, which is now a priority for the current administration, is rooted in the inherent tension between their public mission and their operational structure. While chartered to support the housing market by providing liquidity and stability, their history has been marked by periods of financial instability necessitating government intervention. The fact that they remain in conservatorship years after the 2008 financial crisis underscores the complexity of unwinding their government ties while ensuring the continued smooth functioning of the mortgage market.

Any path to privatization would need to carefully consider the potential impact on mortgage rates, the availability of credit for homebuyers, and the overall stability of the financial system. The sheer scale of their involvement in the U.S. mortgage market means that any misstep in their restructuring could have significant repercussions for consumers and the broader economy.

Conversely, the rise of blockchain and tokenization represents a technologically driven shift in how financial assets are perceived and transacted. The ability to create a digital, fractionalized representation of an asset through tokenization opens up new avenues for efficiency, accessibility, and liquidity. For instance, the tokenization of U.S. Treasuries demonstrates how blockchain can streamline processes and potentially lower barriers to entry for investors. As this technology matures and its applications broaden to include assets like global bonds, credit, and equities, the potential for a more interconnected and efficient global financial system grows. The anticipated application of tokenization to mortgage-backed securities (MBS) holds particular interest, especially when considering the future of entities like Fannie Mae and Freddie Mac.

Imagine a scenario where MBS are tokenized, potentially leading to greater transparency, liquidity, and potentially even a wider base of investors. This intersection of traditional mortgage finance with cutting-edge blockchain technology could offer novel solutions to some of the long-standing challenges within the housing finance system.

A Decentralized Solution

Effectively privatizing the GSEs could be achieved by fundamentally reimagining the mortgage process through the lens of blockchain and tokenization. This approach has the potential to reinvent the entire mortgage lifecycle, from origination to securitization and servicing.

Re-invent the mortgage lifecycle: By leveraging distributed ledger technology, numerous processes within this lifecycle could be automated, introducing significant efficiencies at multiple stages. This transformation could lead to a reduction in the concentrated market shares currently held in mortgage servicing and issuance, ultimately providing consumers with more choices that extend beyond the initial loan origination.

Enable MBS competition: Applying blockchain and tokenization could foster greater competition in the issuance of MBS. This would inherently decrease the reliance on the current GSE-dominated model, as the technology enables a more decentralized approach to MBS issuance. The lower barriers to entry associated with blockchain-based systems could empower new participants to enter the market, fostering innovation and the development of novel financial models and products within the housing finance sector.

Tap new operational benefits: Beyond market structure, the adoption of blockchain and tokenization in the mortgage ecosystem could offer substantial other benefits. The inherent transparency of blockchain technology can increase accuracy by providing an immutable and auditable record of transactions and, crucially, validate the underlying asset data. Furthermore, the efficiency gains and the distributed nature of blockchain create a greater opportunity to scale operations more effectively than traditional, centralized systems.

This technological shift could pave the way for a more resilient, transparent, and competitive housing finance market, effectively achieving the goals of privatization without necessarily replicating the structures of the past.

What the GSEs Do

But first, some background. Government-Sponsored Enterprises like Fannie Mae and Freddie Mac play a crucial role in facilitating homeownership by enabling lenders to make more mortgage loans. Their core function is to support the housing market by purchasing mortgages originated by banks and other lenders. This process allows these originators to remove the loans from their balance sheets, freeing up capital that can then be used to fund additional home loans for consumers. The creation and sale of MBS by the GSEs further enhances this process, providing another avenue for lenders to provide more home loans.

After purchasing mortgages, the GSEs pool these loans and securitize them into MBS. These securities are often categorized by loan type and further stratified into different tranches based on characteristics such as borrower credit scores. Once created, these MBS are made available for purchase by investors in the secondary market.

Broadly, MBS can be classified as either Agency or Non-Agency.[3] Agency MBS are backed by loans that meet specific criteria set by the GSEs, while Non-Agency MBS consist of loans that do not meet these GSE standards and are typically sold privately. The vast majority of the MBS market, over 91%, is comprised of Agency MBS, highlighting the significant influence of GSE standards on mortgage lending.

Investors are attracted to MBS because these securities generally offer a higher yield compared to other fixed-income investments. Importantly, Agency MBS carry a government guarantee (explicit or implicit), which provides investors with assurance that payments will be made. By investing in MBS, investors essentially absorb the statistical risk of borrower non-payment and prepayment, allowing them to potentially increase their returns and diversify their investment portfolios. The scale of this market is substantial, with over $11 trillion[4] in outstanding MBS and $1.6 trillion issued in 2024.[5] The average daily trading volume for MBS is nearly $300 billion[6], indicating a highly liquid secondary market.

Privatization Challenges

Fannie and Freddie continue to have significant financial issues, with no direct path forward.

Following the 2008 crisis, and the $109 billion in losses incurred by the GSEs, the U.S. Treasury intervened, initially providing each company with a $100 billion credit line in exchange for preferred stock. As the financial strain persisted, these credit lines had to be increased, eventually exceeding $445 billion. Now, 16 years after the initial bailout, the GSEs remain under government conservatorship.

However, privatization is proving to be a complex undertaking, in part due to the highly concentrated nature of the MBS market.

- Agency MBS, those issued by Fannie Mae, Freddie Mac, and Ginnie Mae, constitute the vast majority of all issued MBS, indicating limited competition
- There remain potential transparency issues within the market

To address these issues, various options for reforming or privatizing the GSEs have been proposed. One such option involves fostering increased competition within the "agency" MBS space by allowing multiple issuers to offer securities with an implicit government guarantee. This could potentially reduce the dominance of the current GSE structure.

A significant point of contention is the actual impact of the GSEs on homeownership rates. Independent studies, including those from the Joint Center for Housing Studies of Harvard University and the Cato Institute, suggest that the GSEs have had little to no effect on increasing the rate of homeownership in the United States. In fact, the U.S. ranks 25th among 38 OECD countries in terms of homeownership, averaging just 65.3% since 1965. This raises questions about the effectiveness of the current GSE model in achieving its stated mission of supporting the housing market.

How the Mortgage Process Currently Works

The mortgage lifecycle can be broadly divided into several key stages: origination, the creation of Mortgage-Backed Securities (including pooling, underwriting, and issuance), servicing, and trading. Each of these stages involves distinct participants, serves specific purposes, and operates with its own set of objectives.

Origination: The process begins with origination, which is when the initial mortgage loan is made to a consumer. This is a relatively broad and distributed market, with numerous banks, credit unions, and specialized mortgage companies involved in lending to homebuyers. While there are many players, the top 10 largest mortgage lenders collectively account for approximately 26% of all mortgage originations, indicating a degree of consolidation at the higher end of the market.

MBS: Following origination, the loans often enter the MBS stage, which involves pooling the mortgages together, underwriting the resulting securities, and then issuing them to investors. This is where Fannie Mae and Freddie Mac play a significant role, purchasing qualified mortgages and packaging them into MBS.

Servicing: The next stage is servicing, where the ongoing administration of the mortgage loans takes place. This includes collecting monthly payments from borrowers, managing escrow accounts for property taxes and insurance, and handling potential defaults. The mortgage servicing market is notably more concentrated than origination, with the five largest servicers holding around 80% of the market share. This concentration can sometimes lead to consumer issues, and the process itself is often relatively labor-intensive.

Trading: Finally, the trading stage involves buyside investors buying and selling the issued MBS in the secondary market. Currently, this trading can involve significant costs, often suffers from asymmetric data where not all participants have equal access to information, and a considerable amount of transactions are still conducted via phone, suggesting potential inefficiencies.

Re-Imagining the Mortgage Process

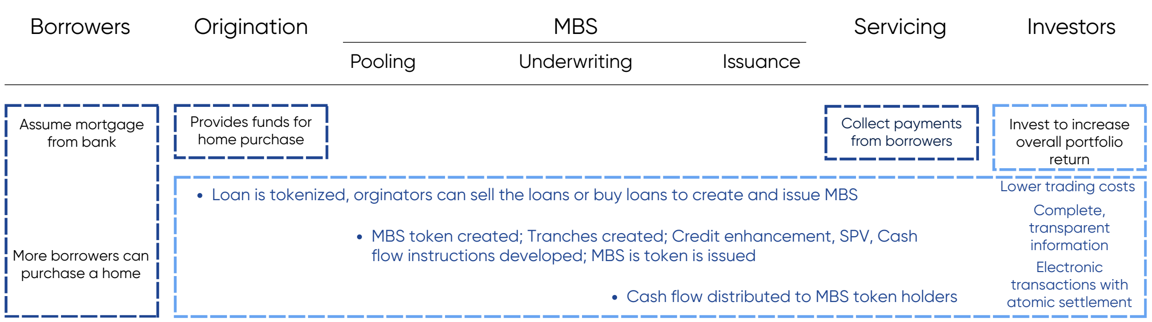
Only now does the right technology exist to bring more competition to the traditionally-closed mortgage market. The evolution of blockchain is enabling new capabilities, with tokenization standing out as particularly transformative. Tokenization, at its core, is the process of creating a digital representation of an asset on a blockchain. This digital representation unlocks a multitude of benefits, including increased liquidity, fractional ownership, and enhanced transparency. Across the broader financial services landscape, tokenization is already being actively applied to a diverse array of assets, from securities and commodities to real estate.

However, the true potential lies in applying tokenization comprehensively across each phase of the mortgage process. Imagine a future where loan origination, the creation and issuance of MBS, servicing, and even the trading of these securities are all touched by the efficiencies and transparency of tokenization. This model has the power to significantly increase competition by lowering barriers to entry, re-imagining the entire mortgage lifecycle with streamlined digital workflows, and enhancing efficiency at every step.

Another inherent advantage of blockchain technology is its ability to decentralize systems that were previously concentrated among a limited number of entities. In the context of the mortgage market, this decentralizing force could reduce the reliance on the current dominance of the GSEs and a few large servicers, fostering a more level playing field for new entrants and potentially leading to more innovative products and services for consumers.

Ultimately, the strategic goal of tokenizing mortgage-backed securities is to cultivate an environment of greater competition. This increased competition, driven by technological innovation and a more open market structure, can then pave the way for a more effective and stable housing finance system, potentially leading to a viable path for the privatization of the GSEs.

Tokenization re-invents mortgage life cycle as silos are reduced or eliminated and replaced with smart contracts.



Tokenization will re-invent the mortgage life cycle.

Tokenized Mortgage-Backed Securities (TMBS) have the potential to completely re-imagine the mortgage process as it is today. Currently, this process is often siloed, with each stage relying on its own distinct and separate procedures. This compartmentalization has contributed to the high concentration observed in certain areas, such as the exclusive issuance of Agency MBS by the GSEs and the dominance of a few large players in mortgage servicing.

Tokenization presents an opportunity to break down these silos and introduce greater efficiency and competition. A key advantage of TMBS is its ability to automate multiple processes throughout the lifecycle. This transformation begins right at the point of origination, where each underlying individual mortgage loan can be tokenized, creating a direct digital representation of the asset from its inception. This initial step lays the foundation for a more integrated and streamlined flow of information and value across all subsequent stages.

Tokenization will introduce competition in MBS issuance.

By leveraging blockchain technology and digital assets, TMBS can lower the traditional barriers to entry that currently limit the number of entities able to issue MBS. This opens the door for new participants to enter the market, fostering a more competitive landscape. TMBS can also empower participants to expand their roles within the mortgage ecosystem. The underlying technology, particularly smart contracts, offers powerful automation capabilities that can streamline multiple phases of the mortgage process.

For example, at the issuance stage, smart contracts could automate the pooling of tokenized loans based on pre-defined criteria and the creation of the TMBS. This could reduce the manual overhead and complexities associated with traditional MBS issuance. Similarly, in the servicing phase, smart contracts could automate the distribution of payments to TMBS holders based on the performance of the underlying tokenized mortgages.

By reducing barriers to entry and enabling greater automation through smart contracts, TMBS can inject much-needed competition into the mortgage industry, allowing both new entrants and existing players to participate more broadly across different stages of the mortgage lifecycle.

Tokenization will provide new operational benefits.

By its nature, TMBS offer the potential to eliminate the need for many traditional middlemen and intermediaries, streamlining workflows and reducing associated costs. The inherent efficiencies gained through automation remove the necessity for numerous manual functions that are prevalent in the current system.

The government guarantee currently enjoyed by MBS issuers like Fannie Mae and Freddie Mac, this feature could be strategically applied to TMBS if deemed necessary or required by the market to ensure investor confidence.

Furthermore, tokenization can lower the costs associated with producing mortgage-backed securities by creating a more efficient and digitally-driven production process. This efficiency also contributes to a higher quality product. A key advantage of TMBS is the enhanced transparency it offers. This increased transparency allows for more accurate loan ratings, provides clarity on the composition of the underlying loan pools and the structure of tranches, and ensures that critical information is consistently and widely distributed to all market participants.

It’s Time

The convergence of technologies, particularly in blockchain and tokenization, has created a unique opportunity to address the long-standing challenges associated with the GSEs and the MBS process. For years, discussions around GSE reform and privatization have been hampered by the complexities of maintaining market stability and ensuring continued access to affordable mortgage financing. However, the capabilities offered by these emerging technologies present a path forward.

Blockchain’s inherent transparency, security, and efficiency, coupled with the transformative potential of tokenization to digitally represent and fractionalize assets, offers a compelling framework for reimagining the entire mortgage ecosystem. This technology isn’t just about incremental improvements; it provides the foundational tools to fundamentally restructure how mortgages are originated, securitized, serviced, and traded. By leveraging these innovations, we can envision a future where the benefits of privatization can be realized alongside a more efficient, transparent, and resilient housing finance market.

Endnotes

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