

What the Fannie and Freddie Bailout Means

By Elaine Floyd, CFP
Sept. 18, 2008

The government takeover of Fannie and Freddie is a momentous, historic event. It's imperative that you can explain what transpired and what it means for your clients' portfolios and psyche. Use this overview to help them understand the back story and make decisions going forward.

The government bailout of Fannie Mae and Freddie Mac is old news after all that's happened this week. But because the bailout has such far-reaching implications for the global economy, the U.S. housing market, and all American taxpayers—not to mention your clients' portfolios—it is worth a more detailed discussion now that the dust has settled a bit. Use this information to help your clients understand the back story of the bailout and what it might mean for them.

In his announcement on Sept. 7, Treasury secretary Henry Paulson reiterated the government's three key objectives: providing stability to financial markets, supporting the availability of mortgage finance, and protecting taxpayers.

It is easy to get sidetracked by personal concerns and philosophies, such as the bailout's effect on individual portfolios, the terrible mismanagement and flawed business model of the two government-sponsored enterprises, or even the idea of government intervention in a free-market system. But the important thing now is to understand the rationale behind the bailout and how it is expected to solve the current crisis.

Providing stability to the financial markets

Why didn't the government just let Fannie Mae and Freddie Mac fail? The answer lies partially in the strange connectedness between these two shareholder-owned corporations and the U.S. government. In 1938, the Federal National Mortgage Association (Fannie Mae) was established as an agency of the government to guarantee mortgages issued by private lenders. This was done to remove some of the risks of mortgage lending and encourage banks to help people buy homes. Eventually Fannie Mae moved into the business of buying, packaging, and selling mortgages in the secondary market. This gave banks more cash to originate more new mortgages and facilitated home ownership for millions of Americans.

In 1968, FNMA was rechartered by Congress to become a shareholder-owned company, but it carried the term "government-sponsored enterprise," or GSE. Most of the mortgages it packaged were backed by the Federal Housing Administration, a federally sponsored agency. In 1970 the Federal Home Loan Mortgage Corporation (Freddie Mac) was created to introduce competition to the market, and it too started out packaging mortgages backed by government agencies.

Because of Fannie and Freddie's long-standing affiliation with the U.S. government, investors have always seen their securities—both mortgage-backed securities packaged for investors and the debt and equity securities of the companies themselves—as having the backing of the U.S. government, even though such backing has always been "implicit."

Investors around the world, including foreign governments, regional and money center banks, and ordinary Americans, have long believed that the creditworthiness of Fannie and Freddie securities is second only to that of U.S. Treasury securities—and a close second at that. Investors believed that if problems were to arise, the government would come to the rescue.

Thanks in part to the perception of these government guarantees, business has boomed for Fannie and Freddie. Even when defaults on subprime mortgages started rising in the summer of 2007, setting off a downward spiral of foreclosures and falling home prices, Fannie and Freddie stepped up to the plate and purchased or guaranteed even more mortgages in an effort to prop up the housing market. They both used leverage to vastly expand their lending capabilities, and were responsible for more than 80% of new mortgages made in 2008. Together they own or guarantee about half the United States' \$12 trillion mortgage market.

But as the housing slump wore on, Fannie and Freddie reported combined net losses of \$14.9 billion, eating into their capital. Initially, they resisted raising capital to provide a cushion for potential defaults. Their former regulator, the Office of Federal

Housing Enterprise Oversight, lowered their capital requirements to 15% from 20%. So even as losses were mounting, they could say they were adequately capitalized.

In July, Secretary Paulson hired Morgan Stanley to look at Fannie's and Freddie's finances. When it was determined that as much as \$50 billion would be required to offset the companies' combined losses, Paulson concluded that government intervention was necessary to preserve the strong credit rating of the U.S. government. The fear was that if foreign governments and banks were to lose money in Fannie and Freddie, they might shun our Treasury securities and maybe even dump all their dollar-denominated assets.

We depend on global capital to finance half of our nearly \$10 trillion national debt (the remaining \$5 trillion in Treasury securities is held by agencies such as Social Security and the Federal Reserve). If Treasury borrowings were to dry up or become more expensive because of a cut in our credit rating, the solvency of our entire nation could be at risk. One blogger noted that the unhappy taxpayer would be even more unhappy—he would have to finance all the debt of the U.S., not just that of Fannie and Freddie.

To keep Fannie and Freddie solvent and ensure that each company maintains a positive net worth, the government has established preferred stock purchase agreements whereby the Treasury can inject up to \$2 billion into the two companies in exchange for \$1 billion worth of senior preferred stock and warrants representing ownership stakes of 79.9% of each company. The government will receive annual interest of 10% on its stake.

Paulson says that these agreements prove to the holders of Fannie's and Freddie's senior and subordinated debt that the conserved entities have the ability to fulfill their financial obligations. In other words, financial Armageddon has been averted.

Supporting the availability of mortgage finance

Paulson's second objective was to keep mortgage money flowing and to keep it reasonably priced. Fannie and Freddie are crucial players in the mortgage market, especially now that banks and other mortgage lenders are cutting back or even pulling out of the market. In guaranteeing a mortgage, Fannie and Freddie essentially promise to make any payments that the borrower misses and also to make up for any loss if the loan is not fully repaid. This transfer of risk encourages the private sector to lend money to homeowners and is worth the small fee it costs lenders.

In addition to guaranteeing loans, Fannie and Freddie also use borrowed funds to buy mortgages outright. Some of these are packaged into mortgage-backed securities, which are sold to investors around the world. Others are retained by the firms. Revenues come from the fees they charge for guaranteeing mortgages and the interest rate spread between the rate paid to fund the purchase of mortgages and the return it earns on retained mortgages. At the end of July, Fannie Mae's portfolio was \$758 billion; Freddie Mac's was \$798 billion.

Without Fannie and Freddie, mortgages would be much harder to get, and they would probably be more expensive. Home buyers would qualify for smaller mortgages, which could cause house prices to drop another 10% or 20% or more.

Paulson feels that Fannie and Freddie are critical to turning the corner on housing. His plan therefore calls for them to modestly increase their mortgage-backed securities portfolios to \$850 billion through the end of 2009 in order to promote stability in the secondary mortgage market and lower the cost of funding.

Then, to address systemic risk, in 2010 their portfolios will begin to be gradually reduced at the rate of 10% per year—largely through natural runoff—eventually stabilizing at a lower, less risky size of around \$250 billion each. A new secured lending credit facility will be available to Fannie Mae and Freddie Mac as well as the 12 Federal Home Loan banks.

In addition, the U.S. Treasury will start buying mortgage-backed securities itself. Such purchases will begin this month and continue through the end of 2009. Given that the Treasury can hold the securities to maturity—and that the spreads are positive between the rates paid on Treasury securities and the rates earned on mortgage-backed securities—taxpayers might even make some money on the deal.

The credit markets reacted positively to the news. Mortgage rates have fallen about 75 basis points, bringing the 30-year fixed-rate mortgage down to 5.78%, according to Bankrate. And spreads between Treasuries and mortgage-backed securities have narrowed, which will allow banks to sell the loans they make more easily to investors in the mortgage bond market.

Protecting taxpayers

Paulson chose not to use taxpayers' money to bail out common and preferred shareholders, citing "moral hazard"—that is, desensitizing investors to risk because they believe the government will bail them out. Although these securities have not been eliminated, they are last in line for claims on the companies' assets. Dividends on the preferreds have been suspended.

Of all the aspects of the bailout, this is causing the most consternation among advisors and clients. One advisor said that as recently as April, he and his clients were led to believe that the companies were solvent and the dividends secure. A few short months later, they found out otherwise.

Many, many investors are affected by this: together the companies sold over \$20 billion in securities since November, and many people don't understand why the government is protecting foreign bond holders but not the tax-paying Americans who invested in Fannie and Freddie preferreds to help finance their own retirement.

There is some concern about the many regional banks that invested in Fannie and Freddie's preferred securities and whose capital positions may now be in jeopardy. The Treasury has indicated it will work with any bank that has significant exposure as long as it is otherwise healthy.

The bailout plan was designed to give Fannie Mae and Freddie Mac breathing space but not decide on their ultimate disposition. That will be up to Congress and the new administration. It is therefore unknown how much, if anything, this will cost American taxpayers. It is conceivable that the two companies could deleverage in an orderly manner and wind up in the black.

For now, the authority of the U.S. Treasury to advance funds for the purpose of stabilizing Fannie Mae or Freddie Mac is limited by the amount of debt that the entire federal government is permitted by law to commit to. The July 30, 2008, law enabling expanded regulatory authority over Fannie and Freddie increased the national debt ceiling by \$800 billion, to a total of \$10.7 trillion.

Evan Newmark of *The Wall Street Journal* praised Paulson's plan. "It is just good deal making," he said. "And it will end up working just fine for the people who matter. In this case that would be the holders of Fannie and Freddie's debt, mortgage applicants throughout the U.S., and the U.S. taxpayer."