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Fannie Mae and Freddie Mac: A Fall from Grace

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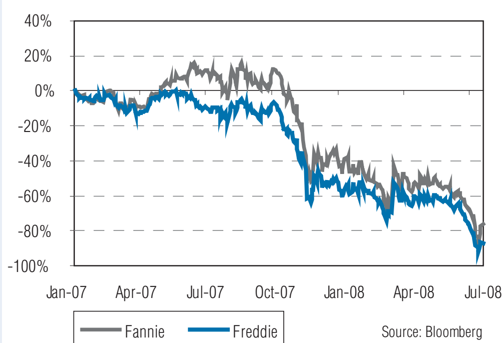
A Fall from Grace

The recent collapse in the stock prices of Fannie Mae and Freddie Mac (F&F) is just one in a series of blows to the stability of U.S. financial markets. The threat created by the failure of these two institutions, however, could be even greater than that posed by the collapse of Bear Stearns earlier in the year.

Indeed, one could argue that F&F have now become two of a dwindling number of providers of liquidity for lenders looking to secure new mortgage loans, and that the availability of mortgages would dry up almost entirely if they were allowed to fail. That marks a sharp contrast to the situation just a few years ago, when many, including former Fed Chair Alan Greenspan, were trying to limit the role that F&F were playing in the market for mortgage backed securities. The excesses being created by the implicit government guarantees that these institutions enjoyed on their debt was of particular concern to policy makers.

CHART 1



> "Investors remained fairly confident that the government would honor the GSE's [Fannie's and Freddie's] debt, but less confident that they would protect stockholders from the decline in the relative health of their balance sheets."

This report explains the role that F&F have historically played in the housing and mortgage markets, why they were able to grow so large (and out of control), and what risk their failure would pose to the economy today. The report will also discuss a few ideas about the most likely scenario for their bail-out proposed by the Federal Reserve, Treasury, and Congress. While the details are still a bit of a work-in-progress, there is little doubt that some sort of deal will be done. The consensus is that we have little choice but to keep Fannie and Freddie in the game near-term. How we deal with those agencies today, however, could limit our reliance on them in the future.

Fannie and Freddie: A Privileged Position

The Federal National Mortgage Association, known as Fannie Mae, was originally created by the U.S. Congress during the Great Depression in order to provide liquidity to the mortgage market. In 1968, Fannie was transformed into a shareholder-owned corporation, and parts of its operations were spun off into the Federal Home Loan Mortgage Corporation, or Freddie Mac.

Since their inception, the nature of the two companies has remained ambiguous. They are public companies, owned by private shareholders and, as such, their profits are fully private. Yet, since they were chartered by the federal government, markets have looked at them with different eyes.

"Government-sponsored enterprises" (GSEs) do in fact enjoy a special status, being the subject of special federal oversight – but also the recipient of special federal privileges. Over the years, Congress and administrations did little or nothing to dispel the notion that F&F would be backed by the federal authorities in case of difficulties.

Fannie Mae's and Freddie Mac's business is in the secondary mortgage market. They buy mortgages from original lenders (commercial and mortgage banks, thrifts, etc.), bundle these mortgages into pools, and in turn sell the re-packaged pools (the so-called mortgage-backed securities, or MBS) to investors all around the world. In order to fund their operation, F&F borrow heavily, mostly in the fixed income market through issuance of bond and paper known as "agency debt."

Too Good to Be True

On paper, this market structure appears to be a win-win proposition for all parties involved. Lenders receive liquidity for

mortgages, thus relieving their balance sheet of the risk associated with holding these assets; private investors receive a premium over more traditional risk-free investments like treasuries when investing in a well-diversified MBS pool; and homebuyers benefit from the cheaper credit and increased availability of mortgages that this securitization provides.

In return, F&F receive above-average returns thanks to their hybrid nature: they earn market spreads on their assets, but pay their funds at a discount because of the implicit guarantee by the federal government. In fact, thanks to their special relationship with Washington (carefully protected, we should add, by vigorous lobbying), debt issued by F&F is *considered* to be as reliable as the bills issued by the U.S. Treasury.

The problem, of course, is that these quasi-government agencies are just that "quasi." There are no explicit laws that require the U.S. government to make good on their debts should these agencies fail. But because F&F were considered actual government agencies, with an explicit guarantee on their debt, they were able to tap capital at much cheaper costs than the market would otherwise dictate.

Over-leveraged/Under-capitalized

As of December 31, F&F had a combined "book of business" (their mortgage portfolio plus all the MBS they issued) of more than $4.9 trillion, which is fairly substantial even in a $14.2 trillion economy. Substantial obligations were in off-balance sheet commitments used to secure payments for the MBS that they previously sold.

According to the latest filings, Fannie Mae had $843 billion in assets and only $38 billion in stockholder equity. That means its equity-to-asset ratio was 5% - less than half the average for FDIC-insured financial institutions. The situation at Freddie Mac was even worse. It held $802 billion in assets and only $16 billion in stockholder equity, which gave it an equity-to-asset ratio of 2%.

An Accident Waiting to Happen

In recent weeks, the reality of F&F's situation began to set in. Investors remained fairly confident that the government would honor the GSE's debt, but less confident that it would protect stockholders from the decline in the relative health of their balance sheets. Hence, the panic selling in F&F stock relative to their bonds.

By July 12, stockholder equity in Fannie Mae and Freddie Mac dropped even further, following the collapse of their stock prices *(see Chart 1.)*

Too Big to Fail?

Moral hazard and the implicit risks associated with repeated bailouts are the primary arguments against the government intervening on behalf of F&F. Making the implicit guarantees of F&F's debt explicit would only exacerbate the market's mispricing of risk of these and other large financial institutions.

That said, these are not normal times, and the consequences of letting these institutions fail are significantly greater than the moral hazard associated with bailing them out. The collateral damage associated with a failure of the GSEs, in particular, would be substantial:

- The number of bank failures would surge and credit conditions would further tighten, as banks struggle to conserve their capital in a market where they could no longer raise capital with the sale of their mortgages. (Fannie's and Freddie's "book of business" accounts for more than 40% of the total outstanding residential mortgage debt in the U.S.)
- Pension funds for public workers would suffer heavy losses, as they invested heavily in F&F debt thinking it was almost as safe as treasuries. The result would be an unbearable burden to government, and a major loss of income to current and future retirees.
- The dollar would depreciate and push oil prices even higher, as foreign governments also invested heavily in F&F debt, thinking it was similar in risk to the treasury market.

Getting the Bailout Right

This has left the government with the dilemma of having to bail F&F out of their current situation while, at the same time, discouraging such mismanagement of risk by financial markets in the future. An ideal solution would consist of:

- penalizing shareholders with a dilution of their equity positions;
- protecting current bondholders and other creditors, in order to preserve the orderly functioning of credit markets;
- forcing future creditors to better price the risk associated with such bonds by limiting the time horizon over which the bailout is conducted.

Unfortunately, Congress is moving toward a rescue package that does not punish shareholders or the management, and it fails to sever the political ties between F&F and Capital Hill. Furthermore, the injection of capital into F&F will come from taxpayers' pockets: current estimates by the Congressional Budget Office suggest that a bailout may cost about $25 billion, but this figure is uncertain. There is a 50% chance that no funds will be needed if the promise of a bailout boosts investor confidence. Nevertheless, in a worst case scenario, the final bill may top $100 billion.

One would hope that policymakers will use the current crisis to avert a repeat in the future. We may not be that lucky. Congress is pushing to increase the regulation of financial markets without weighing the consequences of those regulations, and without forcing more accountability on F&F. Indeed, the risk is that the government, and politics, will play too large instead of too small a role in financial markets as we struggle to deal with this crisis in an election year.

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