Fannie Mae & Freddie Mac

Summary

On September 7, 2008, the director of the Federal Housing Finance Agency (FHFA), James B. Lockhart III, announced his decision to place two Government sponsored enterprises (GSEs), Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation), into conservatorship run by the FHFA. There were no plans to liquidate the companies. The action is "one of the most sweeping government interventions in private financial markets in decades" (Statement of FHFA Director James B. Lockhart III - 2008-09-07). It was one financial disaster among many in the 2008 and following years subprime mortgage crisis and since the US financial system and the world economies are linked to these two companies, the US government had little choice but to bail them out.

Fannie Mae and Freddie Mac, historically established to support the US home market after the Great Depression of 1930s, have in turn contributed to the housing crisis of 2008 and ironically had to be rescued by the Federal government.

Background

Established in 1938, to make mortgages more available to low-income families, Fannie Mae was added to the Federal Home Mortgage Association, a US government agency in the aftermath of the Great Depression, as part of Franklin Roosevelt's New Deal in order to facilitate liquidity within the mortgage market.

In 1968, the US government converted Fannie Mae into a private shareholder-owned corporation (GSE – government sponsored enterprise) in order to remove its accounts from the annual balance sheet of the federal budget as a consequence of the Vietnam War. Thus, Fannie Mae ceased to be the guarantor of government-issued mortgages, which was now the responsibility of the new Government National Mortgage Association (Ginnie Mae).

In 1970, the government created the Federal Home Loan Mortgage Corporation (FHLMC), commonly known as Freddie Mac, to introduce competition to Fannie Mae and, thus, create a stronger and more efficient secondary mortgage market. Since the creation of the two GSEs, there have been questions about their role in the mortgage market, debates about their relationship with the government, and whether or not they are indeed necessary at all. These issues came to a head at the start of the collapse of the US housing market and subprime mortgage crisis that began in 2007. However, it is widely accepted that Fannie Mae, as well as Ginnie Mae and later Freddie Mac, have played an integral part in the development of what was considered the most successful mortgage market in the world (and some may argue still is) which allows US citizens, specifically those on lower incomes, to benefit from one of the highest home ownership percentages in the world.

Timeline of events that led to the bail-out

In **1977**, the Carter Administration and the United States Congress passed the Community Reinvestment Act of 1977, or CRA, designed to increase lending in inner cities particularly in very poor areas by forcing banks to open new branches in these areas and to have a certain percentage of their lending portfolio of small business loans and home mortgages located there. The banks were prevented from opening branches in other areas that were not troubled if they failed to maintain this ratio.

Fannie Mae was pressured by the Clinton administration in **1999** to expand mortgage loans to low and medium income borrowers by increasing the ratios of their loan portfolios in poverty-stricken inner city areas set out in the CRA of 1977. Because of these increased ratio requirements, institutions in the primary mortgage market demanded that Fannie Mae eased its credit requirements on the mortgages it purchased, which enabled them to make loans to subprime borrowers at interest rates higher than conventional loans. Fannie Mae was also pressured by its shareholders to maintain its record profits.

Fannie Mae never actually made loans directly to the consumer. It was essentially a powerful middleman, buying mortgages from approved mortgage sellers, either for cash or in exchange for a mortgage-backed security (MBS) that comprises those loans and that, for a fee, carries Fannie Mae's guarantee of timely payment of interest and principal. Fannie Mae keeps some but resells most to investors guaranteeing (for the above fee) to pay off a loan if the borrower defaults. By purchasing the mortgages, Fannie Mae and Freddie Mac provide banks and other financial institutions with fresh money to make even more new loans, thus increasing the pool of homeowners and allowing Fannie Mae to continue making large profits.

This political pressure to expand home ownership to lower-income families led to riskier mortgages being issued, with which Fannie Mae and Freddie Mac issued riskier MBSs, and there was the real risk was that Fannie Mae might guarantee questionable mortgages and lose out when large numbers of borrowers were unable to fulfil their obligations.

With this in mind Fannie Mae built a vast network of computer programs and devised mathematical formulae and models that analysed its millions of daily transactions and ranked borrowers according to their risk profiles.

Those computer programs were seemingly capable of separating pools of similar-seeming borrowers into safe and risky bets grouped by credit quality. The riskier the loan, the more Fannie Mae charged to handle it, on the basis that the income from the higher fees would offset any losses. Fannie Mae was thus issuing MBS backed by pools of mortgages which were grouped by credit quality, such as its riskier single-family mortgage loans, increasing the fees in relation to poor credit mortgage pools. Investors, or purchasers of Fannie Mae MBSs let Fannie Mae keep this fee in exchange for assuming the credit risk; that is, Fannie Mae's guarantee that the scheduled principal and interest on the underlying loan will be paid even if the borrower defaults.

On September 30, 1999, the New York Times reported that with the corporation's move towards the subprime market "Fannie Mae is taking on significantly more risk, which may not pose any difficulties during flush economic times. But the government-subsidized corporation may run into trouble in an economic downturn, prompting a government rescue similar to that of the savings and loan industry in the 1980s."

In **2000**, rules were put into place that disallowed risky, high-cost loans from being credited toward affordable housing goals, due to a re-assessment of the housing market by Housing and Urban Development (HUD).

In **2002**, President George W. Bush signed the Single-Family Affordable Housing Tax Credit Act. The "Renewing the Dream" program would give nearly $2.4 billion in tax credits over the next five years to investors and builders who developed affordable single-family housing in poor and distressed areas.

Then in **2003**, the Bush Administration recommended the most significant regulatory overhaul in the housing finance industry since the savings and loan crisis in the late 1980s. A new agency would be created within the Treasury Department to assume supervision of Fannie Mae, to set capital-reserve requirements for the company and to determine whether Fannie Mae is adequately managing the risks of its expanding portfolios.

On September 31, 2003, the New York Times reported that the plan is an acknowledgment by the administration that oversight of Fannie Mae and Freddie Mac was broken. The Times also reported Democratic opposition to Bush's plan: "These two entities -- Fannie Mae and Freddie Mac -- are not facing any kind of financial crisis," said Representative Barney Frank of Massachusetts, the ranking Democrat on the Financial Services Committee. "The more people exaggerate these problems, the more pressure there is on these companies, the less we will see in terms of affordable housing."

Later that year, President George W. Bush signed the American Dream Downpayment Act, a new program that provided grants to help home buyers with downpayment and closing costs. The act authorised $200 million dollars per year for 2004-2007.

In **2004**, the 2000 rules were dropped and high-risk loans were again counted toward affordable housing goals.

This was in the assumption that Fannie Mae's enforcement of their underwriting standards for standard conforming mortgages would also provide safe and stable means of lending to buyers who lacked a prime credit rating. The market continued to perceive that Fannie Mae and Freddie Mac had an implicit government guarantee which gave them the ability to issue debt at lower rates than would otherwise have been possible.

But Fannie Mae's computer systems could not fully analyze many of the risky loans that customers, investors and lawmakers wanted them to buy. Many of these products were so new that unsafe bets could not be identified by the mathematical models and computer programmes correctly. "We didn't really know what we were buying," said Marc Gott, a former director in Fannie's loan servicing department in the New York Times on October 5, 2008. "This system was designed for plain vanilla loans, and we were trying to push chocolate sundaes through the gears".

"We also set conservative underwriting standards for loans we finance to ensure the homebuyers can afford their loans over the long term. We sought to bring the standards we apply to the prime space to the subprime market with our industry partners primarily to expand our services to underserved families. Unfortunately, Fannie Mae-quality, safe loans in the subprime market did not become the standard, and the lending market moved away from us. Borrowers were offered a range of loans that layered teaser rates, interest-only, negative amortization and payment options and low-documentation requirements on top of floating-rate loans. In early 2005 we began sounding our concerns about this "layered-risk" lending. For example, Tom Lund, the head of our single-family mortgage business, publicly stated, "One of the things we don't feel good about right now as we look into this marketplace is more homebuyers being put into programs that have more risk. Those products are for more sophisticated buyers. Does it make sense for borrowers to take on risk they may not be aware of? Are we setting them up for failure?" As a result, we gave up significant market share to our competitors." - Daniel Mudd, then President and CEO of Fannie Mae, states in the "Opening Statement as Submitted to the U.S. House Committee on Financial Services", April 17, 2007.

Then in **2007**, the subprime mortgage crisis began. An increasing number of borrowers, usually with poor credit ratings that were unable to continue to pay their mortgages - particularly with adjustable rate mortgages (ARM), caused a steep rise in home foreclosures. Consequently, house prices fell as more and more foreclosures added to the already large inventory of homes and stricter lending standards made it increasingly hard for potential borrowers to secure new mortgages. This fall in house prices led to mounting losses for Fannie Mae and Freddie Mac, which back the majority of US mortgages.

The US government attempted to calm the market in July **2008** by repeating their belief that "Fannie Mae and Freddie Mac play a central role in the US housing finance system". The Treasury Department and the Federal Reserve took steps to boost confidence in the companies, including granting both corporations access to Federal Reserve discount window and removing the prohibition on the Treasury Department to purchase Fannie Mae's and Freddie Mac's stock.

In August **2008**, in spite of the US governments efforts, shares of both Fannie Mae and Freddie Mac, both of which at this time guaranteed half of the $12billion US mortgage market, had plummeted more than 90% from their one-year prior levels.

At the same time, their investments in other financial institutions reported losses. Their capital adequacy ratio of 0.5% was unable to meet the consequences of subprime lending crisis.

To summarise, initially the market perceived Fannie Mae and Freddie Mac as having an implicit government guarantee which gave them the ability to issue debt at lower rates than would otherwise have been possible. There was political pressure over an extended period described above to expand home ownership to lower-income families, and this led to the issuance of riskier mortgages, which Fannie and Freddie pooled into riskier MBS.

Fannie and Freddie developed strong political influence to protect their special status and avoid scrutiny.

Eventually longstanding concerns about whether they had adequate capital for the risk they were taking were confirmed when the housing market and MBS market collapsed.

The Federal take over

Creditors and alarmed investors reacted by limiting the credit supply and selling the shares. The foreign investors (mainly Asian central banks), who held 35%–40% of the debt issued by Fannie Mae and Freddie Mac started to sell. The market capitalisation of Fannie Mae by the end of August 2008 was $7.6 billion compared to $38.9 billion at the end of 2007 and Freddie Mac was $3.3 billion compared to $22 billion of the last year.

These losses endangered the whole financial system of the US, which was already struggling with deteriorating housing markets, and it could have collapsed if Fannie Mae and Freddie Mac had failed. The fall in the securities of both the companies would have resulted in losses for institutions like pension funds, major banks, mutual funds, etc. and global economies because of their investments in debts. "Fannie Mae and Freddie Mac are so large and so interwoven in our financial system that a failure of either of them would cause great turmoil in our financial markets here at home and around the globe." – Henry Paulson stated on September 7, 2008.

On September 7th 2008, the Federal Housing Finance Agency (FHFA) placed Fannie Mae and Freddie Mac under conservatorship and took control of both the companies' assets and operations. The MBS was bought by the government to reduce the interest rates for mortgages and bring back the confidence in the credit markets (Figure 1).

The former Chief Executive Officers (CEOs) of both Fannie Mae and Freddie Mac were dismissed but stayed on to help with the transition.

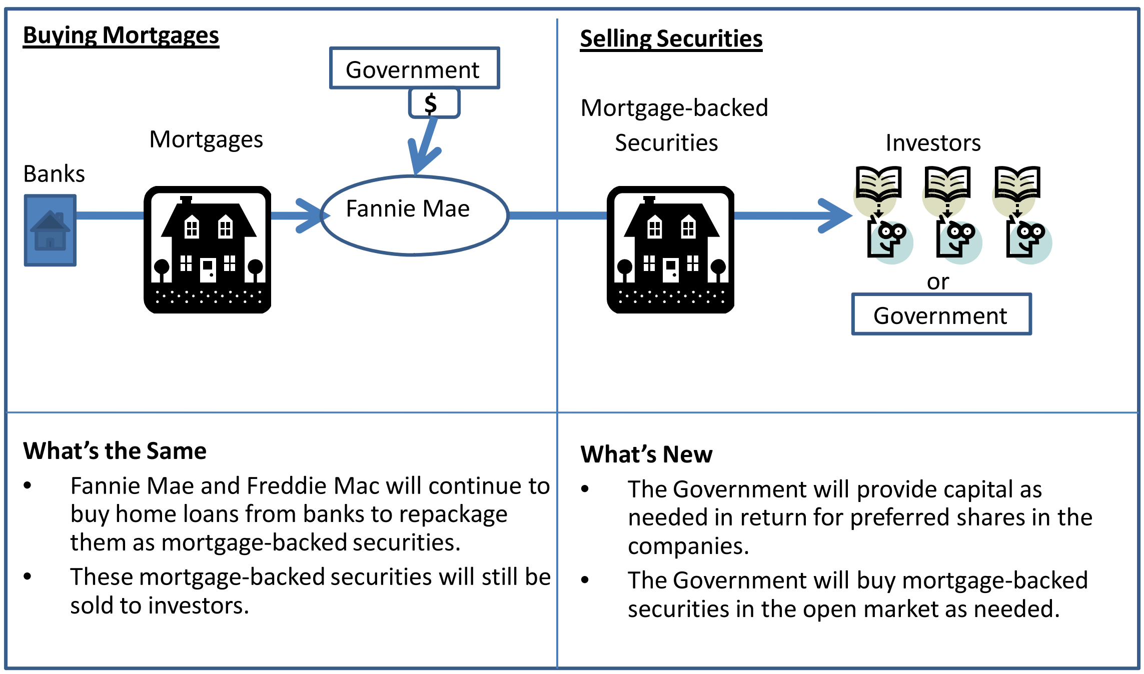
Appointed as CEOs were Herbert M. Allison for Fannie Mae and David M. Moffett for Freddie Mac. Allison was former Vice Chairman of Merrill Lynch and for the last eight years chairman of TIAA-

CREF. Moffett was the former Vice Chairman and CFO of US Bancorp. Their compensation is significantly lower than the outgoing CEOs' was.

To conserve over $2 billion annually in capital, the common stock and preferred stock dividends was eliminated, but the common and all preferred stocks will continue to remain outstanding. Subordinated debt interest and principal payments of bond holders will continue to be made.

Fannie Mae and Freddie Mac under Government conservatorship

Under the Treasury's plan, the roles of FannieMae and FreddieMac in the market will not change in the short term. The government will provide capital and buy mortgage-backed securities as needed.



Source: Labaton Stephen and Andrews L. Edmund, "U.S. takes control of Fannie Mae and Freddie Mac", http://www.iht.com/articles/2008/09/07/business/treasury.php, September 7th 2008

Figure 1

A financing and investing relationship with the US Treasury was set up via three different financing facilities to provide critically needed support to Freddie Mac and Fannie Mae, as well as to the liquidity of the mortgage market. One of the three facilities was a secured liquidity facility for Fannie Mae and Freddie Mac, and also for the 12 Federal Home Loan Banks that are regulated by FHFA.

Analysts and commentators viewed the rescue in many different ways. It is generally thought of as an act of preventing disaster in the US financial system and the housing market especially.

Former chairman of US Federal Reserve, Alan Greenspan, defended the action - "This is a once-in-a half- century, probably once-in-a-century, type of event. I think the argument has got to be that there are certain types of institutions which are so fundamental to the functioning of the movement of savings into real investment in an economy that on very rare occasions – and this is one of them – it's desirable to prevent them from liquidating in a sharply disruptive manner." - Ghosh Jayati, "Who pays the Price?", October 10, 2008.

Mark Zandi of Moody's Economy.com summed it up by saying, "Effectively, the federal government has now become the nation's mortgage lender. This takes a major financial threat off the table."

Since most of the debt owners of Fannie Mae and Freddie were foreign governments and central banks, the US government had to make a decision to placate them to a degree. Brad Setser, an economist at the Council on Foreign Relations, stated, "I suspect this is the first case where foreign central banks exercised their leverage as creditors to push the US government to make a policy decision that protected their interests." – Time magazine, Fox Justin, "With Fannie and Freddie, the US Is Bailout Nation", September 11, 2008.

The takeover of the Fannie Mae and Freddie Mac is probably one of the most expensive bailouts ever faced by taxpayers in the history of the US. Jim Rogers, a famed investor said, "I don't know where these guys get the audacity to take our money, taxpayer money, and buy stock in Fannie Mae. So we're going to bailout everybody else in the world. And it ruins the Federal Reserve's balance sheet and it makes the dollar more vulnerable and it increases inflation." – Bloomberg, Massar Carol and Martin Eric, "Fannie Plan a `Disaster' to Rogers; Goldman Says Sell", July 14, 2008.

And although the rescue saves the interest of future mortgage owners, it will increase the public debt. "At Fannie and Freddie—and, shockingly, at the investment banks—the profits were privatised, but the risks were socialised." - The Economist reports on July 17, 2008,

As a result of the government's intervention, the cost of borrowing for Fannie Mae and Freddie Mac should decline, because the government will be standing behind their debts. Equally important, because the government is backing the companies, their buying and selling of loans will continue.

Lessons to be learnt/Conclusions

The downfall of Fannie and Freddie resulted from a chain of miscalculations and deferred decisions, both by their executives and government officials. They:

- Grew rapidly, particularly in making purchases of risky but profitable subprime and alt-A loans,
- Utilised implicit government backing to borrow at will, but without adequate capital to protect them from unexpected losses,
- Initially played down the dangers posed by an inflated housing market,
- Did not raise enough new capital to weather the storm as the housing slump expanded,
- Powerful political lobbying by Washington to support home loans for low-income families held off major criticism,
- Lawmakers postponed strengthening regulatory oversight due to partisan infighting,
- Over-estimated the power and accuracy of their computer systems and mathematical formulae to compensate for new more complex products,
- Under managed and under measured market and liquidity risk.

"Their business models lacked dynamism. Their risk-taking was obscured by large funding advantages (or "balance sheet arbitrage"). Their guarantee businesses were widely described by equity analysts as fee-based businesses as opposed to businesses that took systematic risks, suggesting that there was confusion about the nature of their business models among outside observers. Lastly, their overall risks and capital adequacy lacked transparency, just like those of such financial institutions as AIG, Lehman Brothers, Bear Stearns, and Washington Mutual" - Herb Addison, Leo M. Tilman, New York Times, October 29, 2008.

The discussion about the rescue of Fannie Mae and Freddie Mac continues and the question of their survival after the end of conservatorship persists. Therefore the companies need to think about the viability of the existing business model, the development of a new kind of strategic vision and to adopt enhanced management and risk practices.

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