The Path for Housing GSEs and its Impact on Corporate Cash Investors

Abstract
Recent events related to government sponsored enterprise (GSE) reform have prompted short-duration investors to question the level and nature of government support for their debt issuance after December 31, 2012. The housing GSEs play a critical role in the U.S. mortgage market, representing 99% of all new mortgage-backed securities (MBS) issuance in recent years. Money market funds owned $402 billion in agency debt at the end of 2010, which accounts for approximately 15% of all fund assets, and direct holdings of agency debt doubled in corporate cash portfolios between 1Q 2009 and 4Q2010. Due to their current government debt classification, the sudden removal of U.S. Treasury support for GSE debt may pose systemic risk. Current and projected capital draws by their regulator indicate that Fannie Mae (FNM) and Freddie Mac (FRE) may not need additional Congressional capital appropriations after 2012. The government's proposal to Congress also indicates its strong commitment to maintaining support. In conclusion, an expected lengthy political process, the possibility of grandfathering existing debt, and the short-duration nature of cash debt, should provide additional comfort to corporate cash investors.

Introduction
For decades, debt investors enjoyed implicit government guarantees on the senior debt of Fannie Mae and Freddie Mac. The guarantees became *de facto* explicit when the U.S. government became the conservator of the government sponsored enterprises during the financial crisis in September 2008. However, with a special provision for the government's capital support agreements set to expire in December 2012, short-duration debt investors are beginning to face uncertainties regarding the extent and nature of that support after 2012.

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Since the submission of the White House's *"Reforming America's Housing Finance Market"* proposal to Congress on February 11, 2010[1], discussions on the future of Fannie, Freddie and the U.S. housing finance market have intensified. While the direction of these discussions is likely to take many twists and turns in the years to come, we are particularly concerned with the future of the U.S. agency debt market should the GSE charters be revoked. To that end, this paper takes a very narrow focus on the following topics: the importance of GSE debt issuance to corporate cash investors, the likelihood and timing of changes in government support for GSE debt,

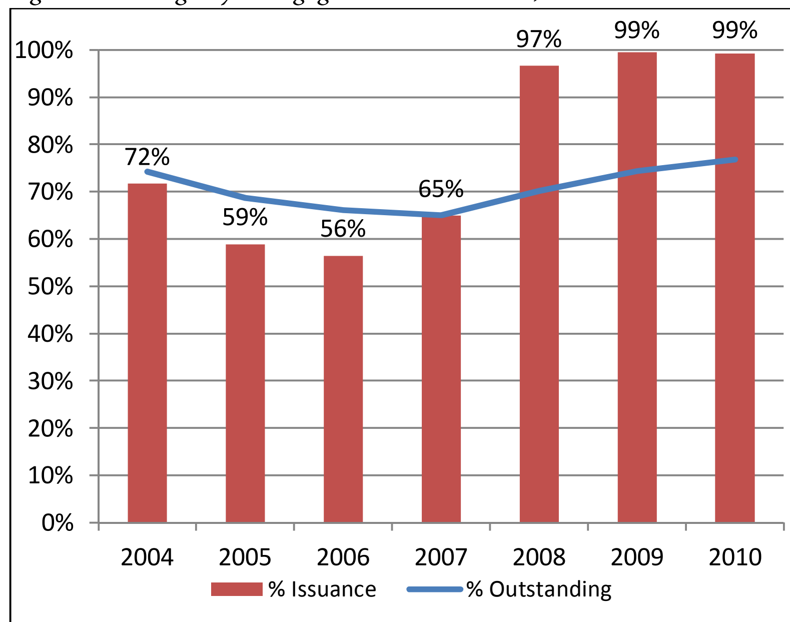
and the ensuing implications for portfolio liquidity and credit quality.

We believe that the senior debt of the housing GSEs will continue to enjoy a very high level of government support after 2012 and believe that corporate cash investors should maintain their confidence in this asset class for the foreseeable future. The GSEs play a critical but complicated policy role in the housing market and we do not expect a speedy political resolution for these institutions. In fact, we think that a hasty revocation of government support may pose systemic risk to the U.S. financial system, thanks to the large presence of GSE government debt in money market funds.

GSEs and the Mortgage Market

FNM and FRE are federally chartered by the U.S. Congress to provide stability to the secondary residential mortgage market and to promote access to mortgage credit and home ownership. The firms accomplish these goals by buying mortgages from lenders and guaranteeing timely payment of principal and interest on mortgage-rated securities.

Figure 1: U.S. Agency Mortgage-Related Securities, Issuance and Outstanding as of Q4 2010



Source: SIFMA

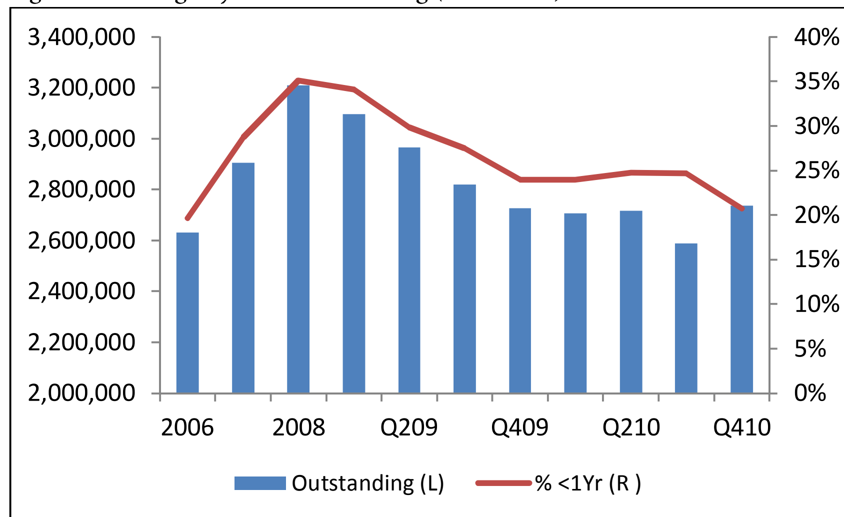
Figure 1 above, shows the issuance and volume of agency mortgage securities outstanding as percentages of the overall mortgage market, according to the industry trade group Securities Industry and Financial Markets Association (SIFMA)[2]. The SIFMA data indicates that since 2007, the housing GSEs have filled a critical void in the mortgage market as private lenders exited the arena. Agency debt issuance accounted for 99% of new mortgage securities in 2009 and 2010, compared to 56% in 2006.

Likewise, the volume of agency mortgage securities outstanding rose to 77% of all mortgage debt, compared to 66% in 2006.

GSE Debt and Cash Investors

Debt issuance from FNM, FRE, and the Federal Home Loan Bank (FHLB) system (another housing GSE providing short term mortgage financing), represents the majority of the U.S. Agency debt market. At the end of 2010, their combined market share represented 91% of all agency debt outstanding[3].

Figure 2: U.S. Agency Debt Outstanding (2006-2010)

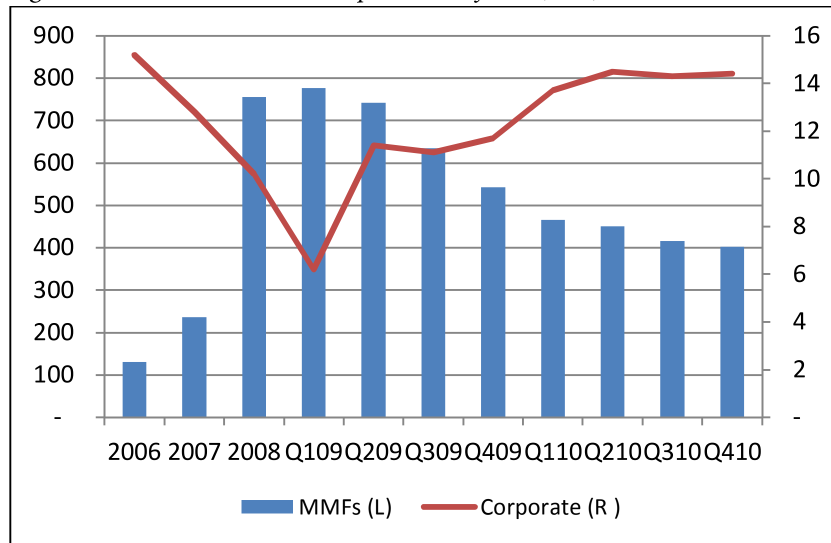


Source: SIFMA

At the same time, Figure 2 above shows a gradual decline of overall agency debt outstanding as well as a decline since 2008 in the proportion of short-term debt (original maturity < 1 year) issuance. Please note that the outstanding amount of short-term GSE debt, known as agency discount notes, stood at $567 billion at the end of 2010, representing 21% of all U.S. agency debt.

The Federal Reserve's Flow of Funds report provides us with insight into the holdings of GSE debt in money market mutual funds (MMFs) and non-farm, non-financial corporations[4]. Figure 3 on page 4 illustrates that, although MMF holdings of GSE debt declined steadily since the first quarter of 2009, the balance at the end of 2010 stood at $402 billion, or 15% of all MMF assets.

Figure 3: GSEs in MMFs and Corporate Portfolios ($bln)



Source: Federal Reserve's Flow of Funds report

We can spot another interesting trend in the world of corporate cash investors. Direct GSE holdings by non-financial corporations dropped to their lowest recent level in the first quarter of 2009 ($6.2 billion) and grew steadily through the next seven quarters. As a result, Q4 2010 holdings of $14.4 billion were twice the Q1 2009 level. We attribute this to corporations liquidating their individual securities holdings and investing in MMFs at the height of the credit crisis and then slowing reversing the course and returning to pre-crisis levels of investment in GSE debt.

Double GSE Exposures: From Figure 3, one should also note that many corporate cash investors hold double exposure to GSE debt. Their direct security holdings may appear well-defined and manageable; however, their indirect exposures through MMFs are potentially far greater than those. In order to tally up an investor's true GSE exposure, one must also include GSEs and GSE-backed securities in repurchase agreements ($3.38 trillion in February 2011 according to SIFMA[5]) that are held in MMFs.

GSEs as Government Securities

Debt investors generally consider GSE debt very safe due to their common classification as "U.S. agency debt", which implies strong government support. In fact, debt investors often use "GSE", "agency" and "government" interchangeably when they refer to GSE debt. However, GSE obligations are not direct obligations of the U.S. Treasury and they are not backed by the full faith and credit of the United States. In September 2008, the government provided a guarantee of solvency to Fannie and Freddie through its preferred stock purchases[6]. In prescribing liquidity and maturity limitations for MMFs, the Securities and Exchange Commission's rule 2a-7 makes the government designation of GSE securities even more crucial[7].

What Constitutes Government Securities: In its revised rule 2a-7 document[7] (page 180), the SEC observes the definition of Government Security as found in section 80a-2(a)(16) of the Investment Company Act of 1940[8] to mean "any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by (underline provided by CAG) and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States…"

Minimum Weekly Liquidity: The revised 2a-7 rule requires all money market funds to hold at least 30 percent of total assets in "weekly liquidity assets". The rule allows agency discount notes with remaining maturities of 60 days or less (instead of seven days) to fall under the definition of "weekly liquid assets" (note 251).

Final Maturity of Floaters: The revised rule does not enforce a legal final maturity of 397 day for floating rate agency securities as it does with corporate securities (note 182). For weighted average maturity (WAM) calculations, a government floater's interest rate reset date is used if the rate resets no less frequently than every 397 days (notes 163&179). As a practical matter, most MMFs limit the final maturity of agency floaters to two years.

SMA IPS Compliance: Separately managed accounts (SMAs) often use investment policy statements (IPSs) to limit investment risk by specifying eligible securities and sector concentrations for the investment portfolio. It is reasonable to assume that not all corporate investment policies make the distinction between GSE and non-GSE government securities. Confusion may arise if GSEs are not perceived to be government securities by some.

Systemic Risk: Given the popularity of GSE securities among debt investors and their representation in the U.S. agency debt market (91%), we think the sudden removal of government support could result in large-scale disruptions to the short-term funding market. GSE discount notes may no longer qualify as weekly liquidity and GSE floaters may need to be sold to comply with 2a-7 final maturity rules. Corporate cash investors also may need to sell to realign their portfolio holdings with IPS specifications.

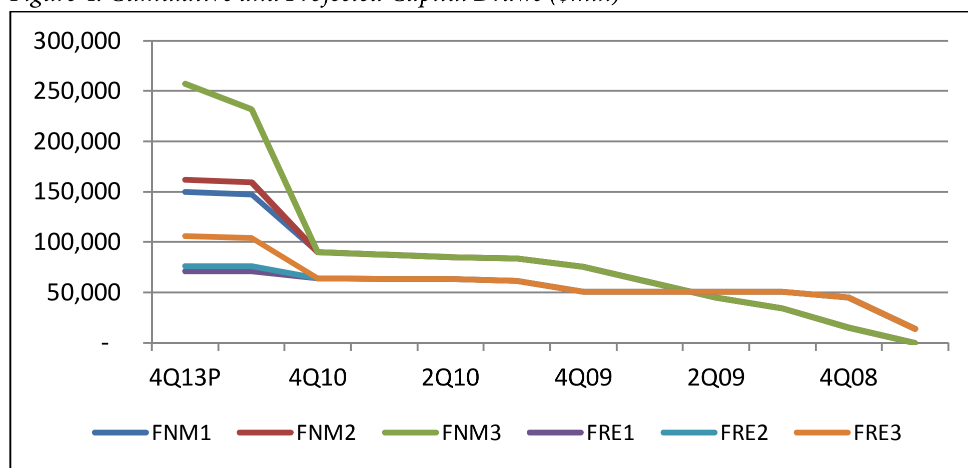
What Happens After 2012?

The U.S. government's initial (in September of 2008) preferred stock purchase agreements of $100 billion each for Fannie and Freddie have no expiration date[9]. The capital draws were intended to eliminate any negative net worth scenarios for the GSEs, and the amounts were increased to $200 billion per firm in May 2009. In December 2009, the government instituted a formulaic cap for the next three years that adjusts upwards quarterly by the cumulative amount of any losses (and downwards of any

gains) realized by either GSE, but not below $200 billion per GSE. After December 31, 2012, the remaining commitment will be fixed and available to be drawn per the terms of the agreements. ***This means that, starting in 2013, each GSE may continue to tap the program for any undrawn amount up to the $200 billion limit.***

Figure 4 below, provides the quarterly cumulative capital draws through Q4 2010 by the two firms by their regulator, the Federal Housing Finance Authority (FHFA)[10]. The current draws are $90.2 billion for FNM and $63.7 billion for FRE, which leaves a combined undrawn amount of $246.1 billion in the post 2012-scenario.

Figure 4: Cumulative and Projected Capital Draws ($mln)



Source: FHFA

In October 2010, FHFA released its projections of potential draws for Fannie and Freddie based on three economic scenarios: “strong near-term recovery”, “current baseline”, and “deeper second recession” of home prices[11]. The scenarios, developed by Moody’s, assumed 31%, 34%, and 45% peak-to-trough home price declines; and 5%, 8%, and 11% recoveries, respectively. The projected paths of capital draws are also depicted in Figure 4.

We can see from the graph that capital draws have been steady since the first quarter of 2010. Under the first two FHFA scenarios, the cumulative draws will be well below the $400 billion limit through 2013, suggesting no special increases in capital will be needed. In the most adverse scenario, the cumulative draw for Fannie will reach $257 billion, above the $200 billion limit. Freddie Mac would need $106 billion cumulatively in this scenario. Fannie needs more capital draws because its mortgage book of business is 45% larger than Freddie Mac’s, according to the FHFA study.

The most severe scenario may require a special capital increase from Congress for Fannie, but not for Freddie. When the hefty 10% annual dividends on the capital draws are excluded, the net costs to taxpayers will be $192 billion for Fannie and $67 billion for Freddie in this scenario, according to the study.

Note that, while in conservatorship, the GSEs are only required to have a positive net worth, and thus only require capital draws when operating losses and write-downs exceed income. We think the likelihood of a deep recession in the U.S. has greatly diminished, which should reduce the amounts needed for future draws. Fannie Mae reported a small profit of $73 million in the fourth quarter of 2010. The firm requested $2.6 billion from the FHFA, $2.5 billion of which were dividend payments to the government[12].

No Over-the-limit Capital Needed: In summary, we do not think the expiration of the special increase in the preferred stock purchase cap will present capital challenges for Fannie and Freddie except for in the direst economic conditions, which are not expected. Investors should not anticipate a credit cliff scenario for GSEs maturing beyond 2012.

The Government's Proposal and Probable Outcome for Debt Investors
The government's February proposal to Congress states that the administration's preference to reduce the government's involvement in the mortgage market[13]. The objective is to going to be achieved by increasing guarantee pricing at Fannie and Freddie, reducing conforming loan limits, increasing down payment requirements, and winding down the two agencies' portfolios at an annual rate of 10% or more. The FHLB system would also be asked to limit loan advances to large financial institutions and to reduce the system's investment portfolios. In winding down the GSEs, the government plans to reduce its role in housing finance to an insurer for narrowly targeted groups of borrowers and a guarantor or catastrophic reinsurer during times of crisis.

The government states in its report that "our commitment to ensuring Fannie and Freddie Mac have sufficient capital to honor any guarantees issued now or in the future and meet any of their debt obligations remains unchanged...and the Administration will not waver from its commitment." It furthers states that "these efforts must be undertaken at a deliberate pace, which takes into account the impact that these changes will have on borrowers and the housing market."

Abrupt End to Support Unlikely: The Treasury's commitment to the solvency and funding stability of the GSEs "now or in the future" should serve as a strong sign that government support will not stop abruptly or diminish in the foreseeable future. In its

Weekly Credit Outlook on February 18, 2011, credit rating agency Moody's viewed the move as credit positive for Fannie and Freddie[14].

Serious Solutions Are Years Away: At the risk of stating the obvious, the government's proposal to Congress is just that, a proposal. Any change regarding the GSE charters will require an act of Congress. The consensus from government watchers is that the divided Congress is not likely to start serious debates until after the 2012 Presidential election. Partisan politics aside, the real challenge is to transport the functions currently performed by the GSEs to other entities, including commercial banks, covered bonds, and private mortgage guarantors, and to limit government liabilities. Benefits of each solution need to be weighed carefully against drawbacks to avoid new systemic risk elsewhere. These factors lead us to believe that an act of Congress to end the charters for the existing housing GSEs may be several years beyond 2012.

Outstanding Debt May be Grandfathered: Should one make the assumption that the GSEs will eventually lose their charters, we believe the government will have a strong incentive to support their outstanding debt to maintain market stability. How Fannie and Freddie exit conservatorship or enter into receivership may determine how the support will be put in place, and the options may include explicit government guarantees, backing by assets in special purpose vehicles with government backstops, or assumption of debt by a new government guarantor. Note that the Federal government, through its preferred stock investments, stands to lose its investments as an equity investor before any GSE debt investors will incur losses.

Cash Investors May have Additional Protection: If one assumes a lengthy period before a resolution is reached, the GSE charters dissolved, and the gradual removal of government support, short-duration investors should be better protected than long-term debt holders. This is because of the visibility afforded to them by the short-dated maturities of the securities. **We project a minimum of three years from a resolution date before government support may be removed on GSE debt, if indeed it is removed.** For the majority of corporate cash investors whose typical holdings are well within this window, we think the risk of losing government support is miniscule. Additionally, if the FDIC's recent rule on breaking up systemic institutions serves as a precedent, a case can be made that short-term creditors may receive better principal protection than long-term creditors in a wind-down event "if they are necessary to maintain essential operations of the firm or to maximize the value of the firm[15]".

Conclusions

The path to U.S. housing finance reform is likely to take a long and winding road. Fortunately, corporate cash investors should have little to worry about with respect to

diminished government support on GSE debt at such an early stage of the reform process.

We have discussed the critical role of the GSEs in the U.S. mortgage market and the popularity of agency debt in money market funds and corporate cash portfolios. Should GSE debt no longer qualify as government debt, the disruption in the money markets alone could present systemic risk. Next, we demonstrated that the current Treasury capital purchase program should remain adequate after 2012 without further Congressional appropriations. We ended our analysis with comments regarding the government's commitment to maintaining support for the GSEs and concluded that corporate cash investors should have little to fear about the end of government support.

We are cognizant of the long-term implications of downsized Fannie Mae, Freddie Mac and the FHLB system on cash portfolios, which may result in a more limited universe of high quality and liquid assets such as agency discount notes, agency fixed and floating rate notes, repurchase agreements, and agency mortgage backed securities. New entities that replace the current GSEs may have different risk characteristics that require investor scrutiny. For now, enjoy them while they are still here. The party will not last forever.

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[1] See the U.S. Department of the Treasury's press release on February 11, 2011 at http://www.treasury.gov/press-center/press-releases/Pages/tg1059.aspx. The full text of the proposal to Congress "Reforming American's Housing Finance Market, A Report to Congress" Dated February 2011 is here: http://www.treasury.gov/initiatives/Documents/Reforming%20America's%20Housing%20Finance%20Market.pdf

[2] See SIFMA statistical tables "US Mortgage-Related Issuance" as of 3/4/2011 and "US Mortgage-Related Outstanding" as of 1/31/2011 at http://www.sifma.org/research/statistics.aspx

[3] See SIFMA statistical tables "U.S. Agency Debt Outstanding" as of 3/17/2011 http://www.sifma.org/research/statistics.aspx

[4] See Flow of Funds Accounts of the United States report as of 4Q 2010 on the Federal Reserve's web site http://www.federalreserve.gov/releases/z1/Current/z1.pdf

[5] See notes No. 2 & 3.

[6] Refer to the U.S. Treasury Department's Frequently Asked Questions: Treasury Senior Preferred Stock Purchase Agreement as of 9/11/200/8 http://www.treasury.gov/press-center/press-releases/Pages/hp1131.aspx

[7] Refer to the full text of the SEC's revised 2a-7 document, "SECURITIES AND EXCHANGE COMMISSION 17 CFR Parts 270 and 274 [Release No. IC-29132; File Nos. S7-11-09, S7-20-09] RIN 3235-AK33 Money Market Fund Reform" for more details http://www.sec.gov/rules/final/2010/ic-29132.pdf,

[8] Refer to page 80 of SEC's final 2a-7 document (note No. 7). Also refer to Section Sec. 80a-2 of the Investment Company Act of 1940. http://www.fdic.gov/regulations/laws/rules/8000-7000.html

[9] Quotes in the paragraph come from the Treasury Department's 2010 Financial Report of the United States Government, Notes to the Financial Statements.
http://www.fms.treas.gov/finrep/note_finstmts/fr_notes_fin_stmts_note11.html

[10] See Federal Housing Finance Agency's "Capital Under Conservatorship" web site as of 4Q10.
http://www.fhfa.gov/webfiles/19846/FNMandFRECapital4Q10.pdf

[11] Refer to FHFA's press release on October 21, 2010, "FHFA releases projections showing range of potential draws for Fannie Mae and Freddie Mac." FHFA releases projections showing range of potential draws for Fannie Mae and Freddie Mac. October 21, 2010. http://www.fhfa.gov/webfiles/19409/Projections_102110.pdf

[12] Refer to the company's 10K report for 2010. http://phx.corporate-ir.net/phoenix.zhtml?c=108360&p=irol-secAnnual&control_SelectGroup=Annual%20Filings

[13] Refer to Treasury Secretary Tim Geithner's written testimony to Congress on March 1, 2011
http://www.treasury.gov/press-center/press-releases/Pages/tg1082.aspx and the full text of the proposal
http://www.treasury.gov/initiatives/Documents/Reforming%20America's%20Housing%20Finance%20Market.pdf

[14] Credit In Depth: US Housing Finance Reform, Moody's Weekly Credit Outlook on February 14, 2010 by Brian Harris.

[15] See FDIC's press release http://www.fdic.gov/news/news/press/2011/pr11007.html

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