

# FANNIE AND FREDDIE:

## *Why Their “Bad News” May Be Good For You*

### INTRODUCTION:

In a move to restore confidence in the U.S. mortgage market, President George W. Bush signed into law on July 30th, a housing rescue bill that includes a provision for the U.S. Treasury Secretary to inject capital into Government Sponsored Enterprises (GSEs) through direct stock or debt purchases.. The birth of the so called “Housing and Economic Recovery Act of 2008” removed a major element of market anxiety over the fate of the GSEs, namely Fannie Mae, Freddie Mac and the Federal Home Loan Banks (FHLBs). While details of the new law remain sketchy, we believe it reinforces our view that the credit quality of the GSEs’ debt is equivalent to that of the federal government, short of an explicit full faith and credit pledge. Furthermore, we think the new legislation may have been the most significant development to date in the government’s efforts to stabilize the housing and capital markets and to put the economy on track towards recovery.

### **Off-balance-sheet Vehicles of USA.gov**

Established by the Congress in 1938 to provide liquidity in the mortgage market, the Federal National Mortgage Association (Fannie Mae) was converted in 1968 from government ownership to a federally chartered, stockholder-owned private corporation. The Federal Home Loan Mortgage Corporation (Freddie Mac) was created in 1970 as a stockholder-owned corporation with a similar mission to Fannie Mae’s. The two firms’ mortgage “books of business,” including direct mortgage holdings and those guaranteed by them, currently amount to \$5.2 trillion, or roughly half of the US mortgage market.

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Congress passed the Federal Home Loan Bank Act in 1932 to revitalize the thrift industry after the Great Depression. The FHLB System is comprised of its Board and 12 regional banks, each of which is owned by its member institutions including savings and loans, commercial banks and credit unions. Unlike Fannie and Freddie, the FHLBs do not guarantee or buy mortgage loans, but rather provide short-term “advances” to member institutions with mortgage loans as collateral. The FHLBs currently have \$1.2 trillion advances outstanding.

The GSEs, particularly the shareholder-owned Fannie and Freddie, have always been the subjects of criticism. As privately chartered corporations with a public mission, the companies are considered quasi-government entities whose debt obligations are implicitly supported by the federal government. Commercial lenders decry their lower funding costs as an unfair competitive advantage. Conservative politicians point to potential burdens to the taxpayers should one of them fail. Strong lobbying efforts by the GSEs and top level politicians at the firms’ helms have also raised eyebrows over the years. Finally, the mortgage boom and the subsequent reversal of mortgage credit resulted in a recent cascade of media reports covering the “I told you so” crowd that had been critical of the GSEs.

In retrospect, it is not hard to make the case that the GSEs are essentially the off-balance sheet vehicles of the federal government, similar to commercial bank affiliates such as the various asset-backed commercial paper programs that have made recent headlines. The government wanted to fulfill its public mission of lowering funding costs without committing to it its own balance sheet. The charters have been able to give mortgage lenders and debt investors the impression that the government is behind the GSE programs while no specific federal dollars were committed. Depending on which direction the political winds have blown, federal officials have tacitly acknowledged, vehemently denied, or wholeheartedly advocated the federal government’s backing of the mortgage giants. In the end, just as the banks had to lend their own balance sheets to support off-the-books ABCP in stressful times, this new legislation represents the government’s commitment to lend its own credit to support the GSEs.

As shadow mortgage arms of the federal government, Fannie and Freddie have grown steadily over the last 40 years, reaping enormous profits for their shareholders along the way, and eventually becoming large enough to present the classical “tail wagging the dog” scenario to the government. To address the concerns of the GSEs for-profit motives overshadowing their public policy mandates, the new law has created an emergent “world class” regulator with the power to impose standards, enforce orders, and place entities into receivership. Political maneuvering aside, we think that the debt obligations of the GSEs have always been that of the federal government, implicit or not.

## The Levees that Hold Back the Tidal Wave

But this is not the time for political bickering on the bill's cost to American taxpayers since taxpayers are already on the hook, through tax bills or lost jobs. The significance of the legislation in allowing the Treasury to act as the GSEs' backstop is not that the government was forced to "bail out" the mortgage giants, but that their solvency and vitality are critical in the government's efforts to forestall the downward spiral of tighter mortgage credit, sagging home values, worsening foreclosures, and so on.

Massive valuation write-downs at major financial institutions, \$400 billion to date, have severely limited major financial institutions' capacity to originate and hold mortgage loans. With projected credit losses well above historical averages, most lending institutions have hunkered down, reducing the credit available to needy borrowers, especially in high cost areas where "jumbo" mortgages are predominant. The decisions by firms such as General Electric, CIT and National City Corp to exit the mortgage market have also helped to create the glut of unwanted mortgage loans. The "dumping" of mortgage portfolios on the open market in turn depressed the value of all mortgage backed securities (MBS), reduced mortgage investors' appetite for new debt, and hindered new loan originations.

In this backdrop, the federal government cannot afford to have the GSEs reduce their mortgage activities to conserve liquidity or capital. While the firms' "well capitalized" status has not been questioned in the present tense, the mere doubt of their ability to raise capital to absorb future losses was enough to cause the self-fulfilling prophesy of an equity sell-off. The government must ensure that the firms are safe and sound, as well as remain on the front lines in providing mortgage credit to borrowers, prime or subprime, with or without pristine credit scores. In short, the government needs to use the GSEs as levees to hold back the mortgage tidal wave that it may otherwise have to handle itself.

With recent estimates placing potential industry credit losses at triple the current levels, we think that the government's skin in the game is not only plausible, but critical. In this regard, the new legislation provided crucial support for the U.S. housing market and puts mortgage finance on solid footing for the long term.

## A Stabilizing Force in Global Financial Markets

We view the passage of the new law as a positive development for the capital markets as well. The housing and capital markets are intricately intertwined theaters of operation for the federal government. Overlooking the need to shore up either one may make the other task much more challenging. This is because all three GSEs rely heavily on the capital markets for their funding needs. As of March 31, 2008, they had \$2.8 trillion of unsecured debt outstanding.

Adding the \$4.5 trillion MBS guaranteed by Fannie and Freddie, their total debt outstanding approached \$7 trillion, or about a quarter of all U.S. debt outstanding. This figure eclipses the \$4 trillion U.S. Treasury debt.

Although debt investors' confidence in the GSEs' ability to honor repayments was not materially weakened and the entities' triple-A credit ratings were never in jeopardy, concerns with the GSEs' credit, liquidity, and capital issues contributed to the overall uncertainty in the credit markets. Their debt is widely held by major global financial institutions, money market funds, pension funds, and municipalities. The recent jittery credit market also resulted in a wave of flight to quality trades out of financial firms into "safe haven" securities that included GSE "agency" paper. Any credible doubt as to the soundness of GSE debt could have a serious destabilizing effect on the overall credit markets.

Additionally, the potential destabilizing factor may extend far beyond domestic investors. Overseas investors own about one-fifth of the GSE debt, or some \$1.5 trillion. About \$1 trillion of the debt is in the hands of central banks and sovereign wealth funds. Their fundamental pictures notwithstanding, the perception of a GSE's weakened liquidity or capital position could contribute to a flight of foreign investments from American shores. In addition to GSE debt, corporate, credit card, or auto debt may also see reduced foreign demand. The value of the dollar could be further depressed. Once started, this trend could be difficult to reverse.

We think that the new legislation sends the capital markets an encouraging signal that a major corner of the debt market has the support of the federal government. In connection with the Federal Reserve's decision to extend the deadlines on the Primary Dealer Credit Facility and the introduction of the 89-day Term Auction Facility, this stabilizing force may be what the market needs to get through the rough patches the next few quarters are apt to bring.

### **No Panacea, but a Significant Step in the Right Direction**

In addition to authorizing the Treasury's purchase of GSE securities and the creation of the Federal Housing Finance Agency, the HERA legislation creates a new government program to insure up to \$300 billion in refinanced 30-year fixed loans for about 400,000 borrowers struggling with their monthly payments. Under the law, the Federal Housing Administration (FHA) can now insure higher loan limits, up to \$625,500 from \$417,000 in high-cost areas.

The new legislation coincided with another mortgage initiative advocated by the Treasury - the creation of the covered bonds market. After federal regulators finalized a set of voluntary industry guidelines, four major U.S. banks announced on July 29 to issue bonds backed by the banks' own credit as well as by mortgage loans set aside as specific collateral. The announcement

by Bank of America, Citigroup, J.P. Morgan Chase and Wells Fargo opened another channel to reduce the gridlock in mortgage credit.

Economists and analysts came to agree in recent months that a stabilizing housing market and strong capital markets are the necessary conditions for a turnaround in the overall economy. Recent measures by the Treasury, the Federal Reserve, and the new HERA legislation represent the government's concerted efforts to stabilize both. While we think credit issues may linger, housing data may stagnate, and a sustainable recovery may be months away, the recent government initiatives provide a strong positive lift to both markets.

As fixed income investors, we remain as confident in the credit quality of the GSE debt, as we are in the U.S. Treasury debt. In an environment still susceptible to deteriorating credit developments and market surprises, we continue to view GSE debt as defensive credits in a conservative cash portfolio.

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