THE FALL OF FANNIE AND FREDDIE

Autumn leaves mortgage giants in limbo.

BY MARLENE PUFFER

Fall has frequently been a time for major financial market events, and this year is no exception, with the government bailout of fallen U.S. mortgage giants Fannie Mae and Freddie Mac.[1] In July 2008, the Housing and Economic Recovery Act created the Federal Housing Finance Agency (FHFA)[2] with broad powers over the government-sponsored enterprises (GSEs). Between them, these GSEs have $5.9 trillion of guaranteed mortgage-backed securities (MBS) and debt outstanding, greater than all the publicly held debt of the United States Treasury (Figure 1). On September 7, 2008, the U.S. Treasury announced it was placing Fannie and Freddie in conservatorship under FHFA. A similar situation cannot occur in Canada since the government already explicitly guarantees timely payment on mortgage-backed securities and on Canada Mortgage Bonds (CMBs).

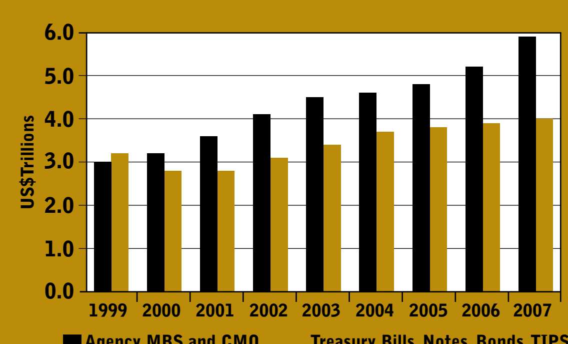
FHFA will assume the power of the board and management and has replaced the CEOs. The Treasury gets $1 billion of senior preferred stock, with warrants for 79.9% of Fannie Mae and Freddie Mac, earning annual interest of 10%. In addition, the Treasury may invest up to $100 billion in each institution and will buy their mortgage-backed debt in the open market. Beginning in 2010, the two firms will start repaying the Treasury. All lobbying of the government and dividend payments will cease. Outstanding stock will continue to trade, although powers of stockholders will be suspended until government control ends. Recovery of value is highly uncertain. Over the past year, Freddie's share price had already fallen 92% prior to the takeover, and Fannie's had fallen 90% (Figure 2).

An important feature is that the mortgage and mortgage-backed securities portfolios retained by the GSEs, which have ballooned in recent years, will gradually be restricted in size. In an effort to increase stability and lower mortgage costs, these portfolios may be increased slightly to $850 billion as of the end of 2009 but must then decline by 10% per year until they reach $250 billion. This key feature helps mitigate systemic risk borne by taxpayers but may restrict mortgage availability.

There are several immediate implications of the plan. Spreads on GSE debt tightened, reflecting the explicit

FIGURE 1

Bonds Outstanding



Source: SIFMA

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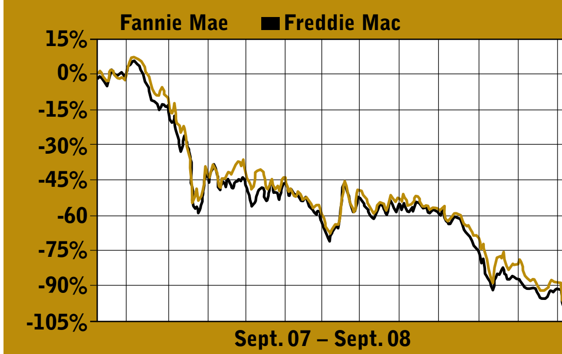
FIGURE 2

GSE Common Stock Prices



Source: Fanniemae

government support (five-year spreads were in roughly 30 basis points the day following the plan announcement), some of which will flow through to lower mortgage costs for consumers.

The Federal banking regulators believe that, while many banks and thrifts hold common or preferred shares of these two GSEs (which could lose most or all of their value) only a limited number of smaller institutions have holdings that are significant compared to their capital. Canadian analysts believe Canadian banks are not at significant risk.

Massive amounts of Credit Default Swaps (CDS)[3] reference Fannie and Freddie debt, and these names are members of the major indices that are used as market benchmarks. The conservatorship of Fannie and Freddie constitutes a "credit event" that triggers payment or delivery of the bonds, which will take roughly 30 days. The market is not experienced at settling credit events for institutions of this size, so this will be the biggest test to date of a process by which the market settles most contracts without an actual exchange of the securities. Rather, an auction will be held to determine a recovery value for the securities that will be used to settle the contracts. It is also the first time a credit in the CDX.IG on-the-run index contract has had a credit event.

LONG-TERM CONCERNS

The key longer-term question is whether explicit government support for housing finance in the U.S. will continue, or whether government support for their activities will be eliminated entirely, or something in between. The rationale for government guarantees (explicit or implicit) in mortgage markets is that there is asymmetric information about borrower quality. Once there is a third-party guarantee, a moral hazard problem arises. In Canada, mortgage-backed securities and Canada Mortgage Bonds carry an explicit government guarantee, which avoids the inherent conflict of interest that exists with Fannie Mae and Freddie Mac. The conflict arises due to the challenge of achieving housing goals (i.e. providing sufficient volume of specific types of affordable loans) and maximizing shareholder value, generally through activities in secondary market portfolios. The overall debate regarding the GSEs is about finding the right balance among capital to ensure safety and soundness, liquidity to protect home ownership, and affordability to support the housing industry, which is reflected in the housing goals. Removing the conflict of interest will stabilize the current situation, but the government now bears greater systemic risk and directly faces the difficult choice of lowering guarantee fees to stimulate the housing market, or increasing guarantee fees to mitigate potential taxpayer losses.

The importance of this systemic risk has been noted in a recent study of the Canadian mortgage market as well: "CMHC has strong controls in place to protect the integrity of the CHT,[4] but CHT is not immune to the current turmoil."[5] Government of Canada involvement in the mortgage market has increased substantially since the creation of the CMB in 2001 with little fanfare. CMB outstanding now totals over $136 billion (compared to $251 billion of Government of Canada bonds), and program expansion was recently announced.[6] In his September 7 statement, Paulson said "…policymakers must address the issue of systemic risk." This is true in both Canada and in the U.S. ∎

Note: See the Winter, 2008, edition of *Canadian Investment Review* for a follow-up analysis of this issue.

ENDNOTES

1. These U.S. Government-Sponsored Entities (GSEs) are corporations with public shareholders. They have federal charters, housing policy-related goals, and are federally regulated. Although their debt did not have an explicit guarantee, market participants have long assumed implicit government support.
2. FHFA was created in July 2008 and combined the Federal Housing Finance Board (FHFB, oversight of Federal Home Loan Banks), OFHEO (oversight of safety and soundness of GSEs) and HUD (Housing and Urban Development oversees the housing policy goals of the GSEs), and increased regulatory powers over the GSEs. Importantly, FHFA is funded by the institutions it oversees and no longer subject to appropriations from Congress.
3. CDS are derivative contracts that offer protection from default on underlying reference securities.
4. Canada Housing Trust is the issuer of Canada Mortgage Bonds and holds Mortgage-backed securities as collateral against CMBs and enters into swap agreements with high -quality banks to convert uneven and prepayable cash flows on MBS into semi-annual coupon payments on CMB.
5. Canada Mortgage Bonds Program Evaluation, CMHC, June 2008. www.cmhc.ca
6. www.cmhc.ca