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Fannie Mae and Freddie Mac in Conservatorship

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Summary

On September 7, 2008, the Federal Housing Finance Agency (FHFA) placed Fannie Mae and Freddie Mac, two government-sponsored enterprises (GSEs) that play a critical role in the U.S. home mortgage market, in conservatorship. As conservator, the FHFA has full powers to control the assets and operations of the firms. Dividends to common and preferred shareholders are suspended, but the U.S. Treasury has put in place a set of financing agreements to ensure that the GSEs continue to meet their obligations to holders of bonds that they have issued or guaranteed. This means that the U.S. taxpayer now stands behind about $5 trillion of GSE debt. This step was taken because a default by either of the two firms, which have been battered by the downturn in housing and credit markets, could have caused severe disruptions in global financial markets, made home mortgages more difficult and expensive to obtain, and had negative repercussions throughout the economy. This report provides basic information on the GSEs, the government intervention, and the potential cost to the taxpayer. It will be updated as events warrant.

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Background

Fannie Mae and Freddie Mac are government-sponsored enterprises (GSEs)—shareholder-owned corporations with government charters—that play a central role in mortgage finance. They buy home mortgages from the original lenders, repackage them as mortgage-backed securities (MBSs), and either sell them or hold them in their own investment portfolios. In 2008, Fannie and Freddie have purchased about 80% of all new home mortgages in the United States. Their combined investment portfolios held mortgage assets (loans and MBSs) valued at $1.5 trillion (as of June 30, 2008).

Over the years, the GSEs have provided strong support to the housing market. When a bank (or other lender) sells a mortgage loan to the GSEs, it receives cash to make new loans, and avoids the risks of holding a long-term asset. Without this secondary (or resale) market, in which private firms participate as well as the GSEs, lenders would have to keep loans on their own books, and mortgage credit would become more expensive and difficult to obtain.

The turmoil in housing and credit markets that began in 2007 has put extreme financial pressure on the GSEs. The value of their mortgage assets has fallen, but the debt they took on to purchase those assets remains. To maintain a positive net worth in the face of falling asset values, financial firms have several options to raise capital, but none of these were readily available to Fannie or Freddie. If they sold assets, they would depress the prices of mortgage loans and MBSs still further, worsening both their own balance sheet problems and those of many other financial firms. They cannot use retained earnings to bolster capital because their operations have not turned a profit since 2006. Finally, rapidly falling share prices made it difficult to impossible to raise capital by selling new equity or common stock.

If Fannie and Freddie were purely private firms, rather than GSEs, some observers assert that they would have failed by mid-2008.[1] GSE status, however, has enabled them to continue to fund their operations by selling debt securities, because the market has long believed that Fannie and Freddie debt was "implicitly" guaranteed by the government, even though by law GSE obligations are not backed by the full faith and credit of the United States. In July 2008, however, the firms' share prices plunged sharply,[2] and the possibility emerged that market participants might refuse to extend credit to Fannie and Freddie under any terms. (This kind of "non-bank run" destroyed the investment bank Bear Stearns in March 2008.) Since then, every auction of new Fannie or Freddie debt (normally a routine event) has been followed closely by the press and the markets.

Even though Fannie and Freddie maintained access to the debt markets (albeit at higher-than-usual interest rates), their inability to raise new capital cast doubts on their long-term viability. If their interest costs continued to rise, and the value of (and their income from) mortgage assets kept falling, they were doomed to fail. Against this backdrop, the federal regulator concluded that

[1] See, e.g., "Too Political to Fail," *Wall Street Journal*, Apr. 21, 2008, p. A16: "[the GSEs] aren't held to the same standards of accountability as everyone else in American business."

[2] In July 2007, both Fannie and Freddie shares traded above $60. Between July 8 and 15, 2008, Fannie Mae shares fell by 60%, from 17.51 to 7.02. Freddie Mac shares fell from 13.46 to 5.26, losing 61% of their value. On July 15, the Securities and Exchange Commission issued an emergency order restricting short selling in the two GSEs' shares.

"the companies cannot continue to operate safely and soundly and fulfill their critical public mission, without significant action" to address their financial weaknesses.[3]

Government Intervention

The Housing and Economic Recovery Act of 2008 (P.L. 110-289), enacted July 30, 2008, provides the authority for the government's takeover of the GSEs. The act created a new GSE regulator, the Federal Housing Finance Agency (FHFA), with the authority to take control of either GSE to restore it to a sound financial condition. The new law sets out a process for placing a financially troubled GSE in conservatorship or receivership. This process is generally similar to the Federal bank regulators' handling of insolvent depository institutions, but the FHFA is not bound by the bank regulators' mandate that failing institutions be resolved at the lowest possible cost.

Section 1117 of the act gives the Treasury emergency authority (expiring on December 31, 2009) to purchase an unlimited amount of GSE debt or equity securities if necessary to provide stability to the financial markets, prevent disruptions in the availability of mortgage finance, and protect the taxpayer.

On September 7, 2008, the FHFA established a conservatorship for Fannie and Freddie.[4] As conservator, the FHFA has taken over the assets and assumed all the powers of the shareholders, directors, and officers. It may take any necessary action to restore the firms to a sound and solvent condition. Stockholders' voting rights are suspended during the conservatorship, and both firms' CEOs have been replaced. Dividends on common and preferred stock have been suspended, although the shares continue to trade. GSE business operations will continue as before; the conservator will delegate authority to the companies' new management to move forward. The conservatorship will end when the FHFA finds that a safe and solvent condition has been restored.

A key element of the plan calls for the government to provide financing to Fannie and Freddie.[5] There are three funding mechanisms:

- **Senior Preferred Stock Purchase Agreement.** Treasury will buy preferred stock as needed to ensure that each GSE maintains a positive net worth. The capacity of the agreement is set at $100 billion for each GSE. In return, the government has received warrants to buy up to 79.9% of GSE common stock for $0.00001 per share. (This means that if the GSEs emerge from conservatorship as stock corporations, the government will be the majority owner, and will have the option of selling its shares at a profit.) According to the Treasury, holders of senior debt, subordinated debt, and MBSs issued or guaranteed by the GSEs are protected by the agreement.[6]

[3] Federal Housing Finance Agency, "Statement of FHFA Director James B. Lockhart," Press Release, Sep. 7, 2008, p. 5.

[4] See Federal Housing Finance Agency, "Fact Sheet: Questions and Answers on Conservatorship" (press release), Sep. 7, 2008, p. 3. Available online at http://www.treas.gov//press/releases/reports/fhfa_consrv_faq_090708hp1128.pdf.

[5] Several fact sheets describing the financing arrangements were posted on the Treasury's website on September 7, 2008, at http://www.ustreas.gov/news/index1.html.

[6] "Frequently Asked Questions: Treasury Senior Preferred Stock Purchase Agreement," Treasury Press Release HP-
(continued...)

- **GSE MBS Purchase Program.** Treasury will buy newly issued Fannie and Freddie MBSs in the open market as needed to improve the availability and affordability of mortgage credit.
- **GSE Credit Facility.** The GSEs will have access to short-term loans from the Treasury, and will be allowed to post MBSs as collateral.

Treasury's and FHFA's intervention has been described as a "seizure," "takeover," "rescue," and "bail-out" of the GSEs. The first two terms are accurate—the FHFA as conservator has taken full control over the operations of the companies. "Bail-out" and "rescue" are more controversial terms. Common shareholders have lost their voting rights and nearly all their investment, and dividends on preferred and common shares have been suspended. On the other hand, the government action benefits the holders of debt issued or guaranteed by the GSEs, who receive "security and clarity" that the "conserved entities have the ability to fulfill their financial obligations."[7] In other words, the bondholders will be the recipients of any taxpayer funds transferred from Treasury to the GSEs under the financing agreement.

Policy and Market Implications

The takeover of Fannie and Freddie, and specifically the commitment to meet all the firms' obligations to debt holders, exposes the government to a potentially large financial risk. Debt issued or guaranteed by the GSEs totals more than $5 trillion. The ultimate value of the firms' assets is uncertain, and the Treasury—by stating that it will maintain a positive net worth in each GSE—has in effect agreed to cover all losses to the GSEs' combined $1.5 trillion portfolios.

During the current crisis, international commercial and investment banks have reported losses, or write downs of asset values, totaling over $500 billion.[8] Much of this stems from marking-to-market, or revaluing MBSs at estimated current market prices, which are often sharply below face value. By comparison, Fannie and Freddie's write downs have been modest: from the second quarter of 2007 through the second quarter of 2008, Fannie reported $5.3 billion in "credit losses," while Freddie reported $2.2 billion.[9] The contrast between the private banks' write downs—25 individual institutions have reported losses (on much smaller holdings of mortgage-related assets) exceeding Fannie's $5.3 billion[10]—and those of the GSEs may suggest that Fannie and Freddie's portfolios contain substantial unrecognized losses. As any such losses are recognized, and any remaining capital is exhausted, Treasury will have to commit new capital (by purchasing preferred stock) to prevent the firms' net worth from falling below zero.

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1131, Sep. 11, 2008.

[7] "Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers," Treasury Press Release HP-1129, Sep. 7, 2008.

[8] Yalman Onaran, "Banks' Subprime Losses Top $500 Billion on Writedowns," *Bloomberg.Com,* Aug. 12, 2008. Available online at http://www.bloomberg.com/apps/news?pid=20601087&sid=aSKLfqh2qd9o&refer=worldwide.

[9] Figures from Fannie Mae and Freddie Mac quarterly financial statements.

[10] Onaran, "Banks' Subprime Losses Top $500 Billion on Writedowns." The comparison between banks and GSEs is not exact. Many private firms may have held larger volumes of subprime MBSs than either Fannie or Freddie, including the most risky "toxic waste" tranches of MBS collateralized debt obligations. On the other hand, virtually all of the GSEs' assets are home mortgages—whole loans or MBSs. Firms like Citigroup and Merrill Lynch (who have written down $55.1 and $51.8 billion, respectively) never had the amount of undiversified exposure to the U.S. housing market that the GSEs have.

The risks of not acting, however, clearly appeared intolerable to the government. A failure or default by Fannie or Freddie would have severely disrupted financial markets around the world. If the GSE portfolios of mortgage loans and MBSs had to be liquidated, prices would plunge, the secondary market for mortgages would be decimated, and the supply of new mortgage credit might be severely restricted. These market disruptions would have negative impacts on the economy as a whole.

Postponing intervention, in the hopes that the mortgage market would right itself and return the GSEs to financial health, carried the risk of raising the ultimate cost to the taxpayers, had the financial deterioration continued.

Much of the current stress in housing and credit markets is based on uncertainty about the true values of mortgage-related financial instruments (and, of course, of houses themselves). As long as further declines are considered likely, market participants will be uncertain about each other's financial condition, and lending markets will remain tight. By intervening and in effect stating that it will bear any further losses to the GSEs (which hold a significant share of all home mortgage assets), the Treasury hopes to reduce that uncertainty and create conditions under which markets can return to normal.

If housing and financial market stability returns soon, the intervention may actually earn a profit for the Treasury. (As part of the funding agreement, Treasury will acquire preferred stock paying a 10% annual dividend, and also has the option to acquire 79.9% of the firms' common stock for a nominal price.) If, however, housing values continue to fall for an extended period, the taxpayer may be required to make good on substantial losses to Fannie's and Freddie's investment portfolios and guarantee obligations.

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