

How Fannie and Freddie are pulling the US towards crisis

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by **David Stevenson**

What are Fannie Mae and Freddie Mac?

Fannie Mae is the Federal National Mortgage Association, created as part of Franklin D Roosevelt's New Deal in 1938 to help drag America out of the Great Depression by making mortgages more available. Government-owned until 1968, Fannie then became a private listed company. Two years later Congress created competition with the launch of the Federal Home Loan Mortgage Corporation (Freddie Mac). They are officially called Government Sponsored Enterprises (GSEs).

What do they do?

Fannie and Freddie don't lend direct to borrowers. They buy or underwrite mortgages from commercial lenders, who use the proceeds to advance more home loans. With the GSEs as a back-stop, lenders have become more confident about offering mortgages to borrowers who might otherwise have struggled to obtain finance. Fannie and Freddie raise cash by selling shares, bonds and mortgage-backed securities (MBS). And because the two are seen as backed by the US government (although they don't actually have an explicit guarantee), they have been able to raise funds cheaply. That has helped them expand to the point where, between them, they either hold or underwrite nearly half of the outstanding mortgage debt in America.

Why are they in trouble?

Like every other player in the mortgage market, they have been hammered by the collapse in the US housing market. Property values in the States are in a tailspin, with the S&P/Case-Schiller index of home prices in the 20 metropolitan areas dropping in April by over 15% year-on-year, the biggest recorded fall. Many borrowers are in deep financial trouble – more than 6% of all American mortgages are in arrears. "Foreclosure activity is the highest since the Great Depression of the 1930s," said Rick Sharga of US property monitor RealtyTrac. Filings, the first stage of the repossession process, jumped 53% in June from a year ago, while bank property seizures climbed 171%, the most on record. Since last year this adds up to combined losses for Fannie and Freddie of more than \$11bn, says Bloomberg. Last week, fears the two

might go bust hit a peak, with their stock prices plunging, and the cost of their credit default swaps (CDS, insurance against loan payment default) rising sharply.

Why did the US government step in?

The collapse prompted fears the GSEs would be unable to raise fresh funds. That could mean "an asset fire sale", or in extremis, "bankruptcy", says the FT, with over \$500bn of debt due to be repaid within one year. So the government stepped in last Sunday night to prop them up. Measures included access to emergency funding and a promise to buy GSE stock if necessary. "Everybody has long known the companies are too big to fail," says The Wall Street Journal. "Repercussions of a failed Fannie and Freddie – who together have issued more than \$5trn of MBS, have backed 75% of new mortgages, and who owe \$1.5trn in outstanding debt held by financial institutions around the world – would have been cataclysmic," says the Dallas News. There would be a "complete collapse" in the mortgage market, says Paul Ashworth of Capital Economics. This would "send house prices dramatically lower, provoking a nasty recession", says The Independent, with worse to follow: "Foreign governments which have been helping to fund the US deficit by buying almost \$1trn in Fannie and Freddie bonds, on top of all their holdings in US Treasuries, might pull their money out."

Will American taxpayers end up with the bill?

It's too early to tell, but yes, probably. In the very short term, the US Treasury's offer of taxpayers' cash to bail out the GSEs has stopped the markets pressing the panic button. The cost of Fannie and Freddie's CDS fell, while bondholders are still buying Fannie and Freddie debt and MBS without demanding punishing interest rates. But the GSEs' share prices remain under pressure – and little wonder. Longer term, they need to raise billions of new capital to fund their next tranche of mortgage buying. So having US Treasury backing may not be enough. Against those \$5trn of Fannie and Freddie's combined obligations, the Federal Reserve's holding of Treasury assets has shrunk to less than \$500bn, says Breakingviews, due to all the Fed's new lending initiatives: "The GSEs' needs could put a big dent in the Fed's balance sheet." Even if the government plumps for 'conservatorship' – in effect taking over the two by wiping out shareholders and protecting debt holders – "it's impossible to know how much the ultimate losses at Fannie and Freddie will be", says the FT, "which means the burden of recapitalising them is likely to fall on the US taxpayer".

Is this the last straw for America?

The Fannie and Freddie fiasco is the biggest blow yet to the world's view of America's finances. Even the Savings and Loan crisis of the 1980s and 1990s, when 747 lenders bit the dust and the taxpayer picked up much of the tab, cost 'only' \$160bn. Now America is in real trouble. It

already has to fund a huge \$700bn current-account deficit, while this bail out "leaves it far more vulnerable to a collapse of confidence than Japan in the early 1990s", says Ambrose Evans Pritchard in The Daily Telegraph, as "foreigners will not be willing to supply the capital". Foreign governments own almost \$1trn in US government-related debt. With the dollar hitting new all-time lows, having shed 40% against other major currencies over the last seven years, those investors are nursing huge losses. America could face a foreign "financing crisis" within months, according to Merrill Lynch.

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