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CRS Report for Congress

Fannie Mae's and Freddie Mac's Financial Problems: Frequently Asked Questions

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Summary

Recent turmoil in the housing and financial markets has raised doubts about the future of Fannie Mae and Freddie Mac, which are chartered by Congress as government-sponsored enterprises (GSEs) and are widely believed to have an implicit guarantee from the federal government. Now the implicit guarantee is nearly explicit: Section 1117 of the Housing and Economic Recovery Act of 2008 (H.R. 3221, P.L. 110-289) authorizes the Treasury to purchase any amount of Fannie or Freddie securities, whether debt or equity, if necessary to provide stability to financial markets, prevent disruptions in the availability of mortgage credit, or protect the taxpayer. This means that if either of the two GSEs is unable to raise funds in private markets, the federal government could simply purchase debt securities that the firms were unable to sell elsewhere, or recapitalize either firm by purchasing stock, possibly becoming the majority shareholder in the process. The Federal Reserve has taken actions to allow Fannie and Freddie to borrow directly from the discount window, a privilege normally available only to Federal Reserve System banks. The Securities and Exchange Commission has issued an emergency order restricting short selling of Fannie and Freddie's stock.

The Office of Federal Housing Enterprise Oversight (OFHEO) — the GSEs safety and soundness regulator — has repeated assurances that Fannie and Freddie have adequate capital, but as highly leveraged financial intermediaries, Fannie Mae and Freddie Mac have limited capital to cushion them against losses.

This report will be updated as warranted.

Why Are Fannie Mae's and Freddie Mac's Stock Prices Declining So Much? Recent changes in the perception of the risks that Fannie Mae and Freddie Mac face — in terms of future profitability and even continued financial viability — may have combined to reduce the price that investors are willing to pay for a share of the enterprises. Between the end of 2007 and August 1, 2008, Fannie's stock lost 72% of its value, while Freddie's fell by 77%.

Fannie and Freddie are government-sponsored enterprises (GSEs) whose charters limit them to buying single family and multifamily home mortgages originated by others. This lack of diversification makes them more exposed to housing and mortgage market problems than other financial institutions such as commercial banks that have other lines of business. The GSEs have a special relationship with the federal government, sometimes called an implicit guarantee, that has allowed them to borrow at interest rates only slightly above those paid by the federal government.

The two GSEs are very highly leveraged versions of banks: they borrow money to lend, and they maximize profits by keeping their capital reserves close to the minimum permitted by their regulators. Unlike banks, they can only purchase home mortgages that others have made. Like banks, the GSEs are required by law and by their regulators to maintain a certain ratio between their loans and reserves to protect against loan losses. A key component of reserves is shareholders' equity or the current value of the shareholders' investments.

What Risks Do Fannie Mae and Freddie Mac Face in Today's Economic Environment? Fannie Mae and Freddie Mac purchase home mortgages. They package some for sale as mortgage-backed securities (MBS) and hold others in their investment portfolios. The GSEs guarantee timely payment of principal and interest of the mortgages in their MBS. As mortgage foreclosure rates have climbed since 2006, and as home prices have fallen, the value of the mortgages and MBS that the two firms hold in their portfolio has also fallen. Uncertainty about the duration or severity of the housing slump means that markets cannot now gauge the riskiness of the GSEs with any degree of confidence or precision.

The GSEs finance their portfolios of long-term (typically 30-year) mortgages with short-term borrowing (typically three months to five years). This increases the GSEs' profits because short-term borrowing is usually less expensive than longer term loans. This creates *interest rate risk*, which is the risk that if short-term interest rates increase, profitability can be reduced or can even turn to losses. To try to reduce these risks, the GSEs use a variety of financial derivatives.

In a worst case scenario, the interest rate on short-term loans to the GSEs could increase enough to cause substantial losses and investors could stop entering into derivative contracts with the GSEs.[1] This would leave the GSEs, who anticipated being able to roll over their short term debt, unable to refinance.

What Are Some Possible Market-Based Solutions? One part of a market-based solution for this would be for the GSEs to sell part of their mortgage portfolios to pay off their debts. But fears over *default risk* have reduced the market value of these existing mortgages. Fannie Mae's portfolio has relatively high credit quality overall, but

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[1] A derivative is a financial contract whose value is linked to another financial instrument, price, or variable. For example, two companies could trade a derivative whose value was linked to the difference in the interest rates on two-year and ten-year Treasury bonds.

OFHEO has called into question the credit quality of Freddie Mac.[2] The GSEs use derivatives to reduce, but not eliminate, default risk.

Another part of a market-based solution would be for the GSEs to sell stock and to use the proceeds to finance their mortgage portfolios and to increase existing reserves to cover any losses. From the point of view of current holders of GSE stock (including senior management), this slices the pie that represents the value of each GSE into more pieces without making the pie any larger, diluting the value of the shares of existing stockholders. When stock prices are low, as they are now for both Fannie and Freddie, selling new equity is an unattractive option.

What Risks Do Fannie Mae and Freddie Mac Create for the U.S. Government? In addition to the implicit guarantee, which all GSE debt is required by law to explicitly deny, some argue that the GSEs are too big and too interconnected to be allowed to fail. The argument is that because of their size and activity in various financial markets, if the GSEs were to be unable to borrow and enter into various derivative contracts, no one could. Another way to view this is that if in fact the GSEs carry little risk because of their government connections, then their financial market difficulties would suggest that much broader difficulties are being experienced by some other financial institutions lacking these government connections.

If the government were to lend money to the GSEs, there would be the risk that one or both GSEs would be unable to repay the loan. This risk could be reduced by requiring collateral in the form of assets or stock, but the value of such collateral could decline.[3] Another risk is that the Treasury might not charge the GSEs a high enough interest rate to cover Treasury's costs.

What Risks Do Fannie Mae's and Freddie Mac's Financial Problems Create for Homeowners and Those Planning to Become Homeowners? Fannie Mae's and Freddie Mac's financial problems create no risks for homeowners who want stay in their homes and who do not want to refinance. Homeowners would continue to pay their existing mortgages the same way as they do today.

There could be problems for those wishing to refinance, buy, or sell a home. In 2007, the GSEs financed 91.3% of the conforming mortgage market.[4] In the current financial environment, if the GSEs were unable to buy mortgages from originators, it is not clear that other investors are prepared to step into the secondary mortgage market.

This could raise credit requirements and interest rates for anyone who wanted to refinance, take out a second mortgage, or get a home equity line of credit. Subprime and

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[2] Office of Federal Housing Enterprise Oversight, *Report to Congress: 2008*, p. 20 and 34, available at [http://www.ofheo.gov/media/annualreports/ReporttoCongress2008.pdf].

[3] The government has received stock in previous market interventions and has sometimes returned a small profit. See CRS Report RL34423, *Government Interventions in Financial Markets: Economic and Historic Analysis of Subprime Mortgage Options*, by N. Eric Weiss.

[4] *The 2008 Mortgage Market Statistical Annual*, Volume II (Bethesda, MD: Inside Mortgage Finance Publications, 2008), pp. 3, 9. A conforming mortgage is one that is under the conforming loan limit, which is as high as $729,750 in high cost areas.

Alt-A borrowers might wish to refinance to obtain lower interest rates in the conventional market; others might wish to tap their home equity to pay for home improvements, college, or medical expenses.[5] It could affect those who want to sell their homes because purchasers would have a more difficult time obtaining a mortgage and could pay a higher interest rate. The amount of this interest rate increase is difficult to predict.

The Economic Stimulus Act of 2008 raised the loan limit for Federal Housing Administration (FHA) guaranteed loans in most high cost areas of the nation to the same maximum that the GSEs are permitted to purchase.[6] As a result, FHA-guaranteed loans in theory can replace most conventional loans.

What Is Fannie Mae's and Freddie Mac's Financial Position? The Office of Federal Housing Enterprise Oversight (OFHEO), which is Fannie Mae's and Freddie Mac's safety and soundness regulator, has repeatedly said that the GSEs have adequate capital.[7] In other words, according to OFHEO, the GSEs have sufficient funds to survive their current financial difficulties.

This assertion is difficult to verify independently. Details of the GSEs' portfolios and guarantees are confidential proprietary information. In broad terms, the GSEs purchased slightly more than $169 billion of private label subprime MBS in 2006 and 2007; they purchased slightly less than $58 billion of Alt-A MBS in the same time period compared with a combined balance sheet of $1.677 trillion.[8] At the end of 2007, the subprime and Alt-A MBS represented 13.5% of the GSEs' total assets.

In 2007, the two GSEs reported losses of just under $5.2 billion. Prior to 2007, the GSEs had not reported a combined loss since 1982.[9] To make certain that the GSEs have adequate funds to cover potential losses, OFHEO (like all financial regulators) imposes capital requirements. At the end of 2007, the two GSEs had a $24.8 billion surplus over the regulatory capital requirement of $58.4 billion; they had a surplus of $50.8 billion over the risk-based capital requirement of $38.8 billion.[10] These amounts can be compared with the combined retained mortgages portfolios of $1.434 trillion and the $3.501 trillion in MBS that the GSEs guaranteed for a total of $4.934 trillion.[11]

The regulatory capital surplus amounted to 0.50% of the $4.934 trillion and 1.03% of the risk-based capital surplus. If the GSEs were to face losses in excess of their income by these percentages, they would be forced to either reduce their capital requirements by

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[5] Alt-A mortgages are mortgages taken out by borrowers with good credit who decide not to provide documentation on income, assets, and/or property value.

[6] P.L. 110-185, 122 Stat. 613 et seq.

[7] OFHEO, Statement of OFHEO Director James B. Lockhart, July 10, 2008, available at [http://www.ofheo.gov/newsroom.aspx?ID=440&q1=1&q2=None].

[8] OFHEO, p. 113 and 116. Subprime and Alt-A MBS purchases prior to 2006 are not available.

[9] OFHEO, p. 115.

[10] OFHEO, p. 120.

[11] OFHEO, p. 116.

selling mortgages and MBS from their portfolios or to raise new capital from investors. The GSEs hold subprime and Alt-A MBS that are far in excess of their surplus capital.

OFHEO reports that the credit quality of the GSEs mortgage portfolios declined in 2007.[12]

What Has Congress Done to Improve the Financial Condition of the GSEs? Congress has previously acted to assist GSEs that were in financial difficulty. When Fannie Mae was losing significant amounts of money in 1982, Congress passed the Miscellaneous Revenue Act of 1982 that provided some tax benefits for Fannie Mae.[13] The Farm Credit System, another GSE, was aided with the Agricultural Credit Act of 1987, which authorized the issuance of $4 billion in bonds to support system members.[14]

Section 1117 of the Housing and Economic Recovery Act of 2008 (H.R. 3221, P.L. 110-289) authorizes the Treasury to purchase any amount of GSE securities — debt or equity — if necessary to provide stability to financial markets, prevent disruptions in the availability of mortgage credit, or protect the taxpayer. This means that if either of the two GSEs becomes unable to raise funds in private markets, the federal government could simply purchase the debt securities that the firms were unable to sell elsewhere, or recapitalize either firm by purchasing stock, possibly becoming the majority shareholder. This authority expires on December 31, 2009.

This action sends a signal to the markets that the Treasury is prepared to intervene rather than let either GSE fail. If this is enough to maintain confidence and persuade investors to continue to purchase GSE debt, no Treasury purchases may be necessary.

P.L. 110-289 also created a new regulatory agency to oversee GSEs, with enhanced safety and soundness powers. In the long run, this may bolster confidence in the stability of the GSEs.

What Are Other Actions the Federal Government Has Taken to Address the Financial Condition of the GSEs? Treasury, the Federal Reserve, the OFHEO, and the President currently have the power to take certain actions. The Secretary of the Treasury is authorized to lend the GSEs $2.25 billion each, but this is more a symbolic amount than a total solution. On the basis of Fannie Mae's issuance of $1.588 trillion in short term debt in 2007, the $2.25 billion would have lasted less than 12.5 hours. On the basis of the $598.6 billion issued of short term debt that Freddie Mac issued in 2007, the $2.25 billion would have lasted just under 33 hours.[15]

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[12] OFHEO, p. 20-21, 33-34.

[13] P.L. 97-362, 96 Stat. 1726 et seq.

[14] P.L. 100-233, 101 Stat. 1568 et seq.

[15] Freddie Mac, *Debt Issuance by Trade Date*, available at [http://www.freddiemac.com/debt/data/cgi-bin/debtissuance.cgi?order=TD].

On July 13, 2008, the Federal Reserve Board of Governors granted the New York Fed the authority to lend directly to the GSEs.[16] Section 1118 of P.L. 110-289 requires the new GSE regulator to consult with the Fed to ensure financial market stability.

In addition to the Fed's general authority to be a lender of last resort, the GSEs' charters give the GSEs a special relationship to the nation's central bank.[17] The Federal Reserve can use the GSEs' bonds purchased on the secondary market for open market operations.[18] This could indirectly help the GSEs by adding to the demand for their debt.

OFHEO has general safety and soundness authority over the GSEs, including the ability to require, approve, monitor, and enforce remediation plans if the GSEs are found to be undercapitalized.[19] In an extreme case, OFHEO could appoint a conservator who would assume the powers of the shareholders, directors and officers of the corporation.[20] The speed with which OFHEO could take these actions would in part depend on the GSEs. The GSEs have the right to contest any of these actions, and the law sets out various periods of time for the GSEs to review proposed actions, to contest OFHEO's actions, and in some instances to appeal to the courts.[21] The new GSE regulator will have these same powers and will have more authority to implement them than OFHEO had.

On July 15, 2008, the Securities and Exchange Commission (SEC) issued an emergency order restricting short selling in the stock of 19 financial institutions, including Fannie and Freddie.[22] The SEC acted to prevent the possibility that false rumors could drive share prices down and cause the market to lose confidence, thereby cutting off the firm's access to credit markets, as happened to Bear Stearns in March 2008.

Who Invests in the GSEs? There is little information available about who holds GSE stock, bonds, and MBS. The Fed reports statistics for combined ownership of government agency and GSE debt and GSE MBS. At the end of 2007, non-United States investors held $1.479 trillion of $7.397 trillion. Other large investors were U.S. commercial banks ($929 billion), life insurance companies ($388 billion), state and local government retirement funds ($317 billion), mutual funds ($566 billion), asset-backed securities issuers ($378 billion), and the GSEs themselves ($710 billion).[23]

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[16] Federal Reserve Board of Governors, *Press Release*, July 13, 2008, available at [http://www.federalreserve.gov/newsevents/press/other/20080713a.htm].

[17] The Fed's lender of last resort authority is delineated at 12 U.S.C. 343. Fannie Mae's charter is at 12 U.S.C. 1716b et seq; Freddie Mac's charter is at 12 U.S.C. 1401.

[18] 12 U.S.C. 347c.

[19] 12 U.S.C. 4611 et seq.

[20] 12 U.S.C. 4620.

[21] 12 U.S.C. 4617 and 4623.

[22] [http://www.sec.gov/rules/other/2008/34-58166.pdf]

[23] Federal Reserve, *Flow of Funds Accounts of the United States*, June 2008, p. 88, available at [http://federalreserve.gov/releases/z1/Current/z1.pdf].