Agincourt Capital Management, LLC

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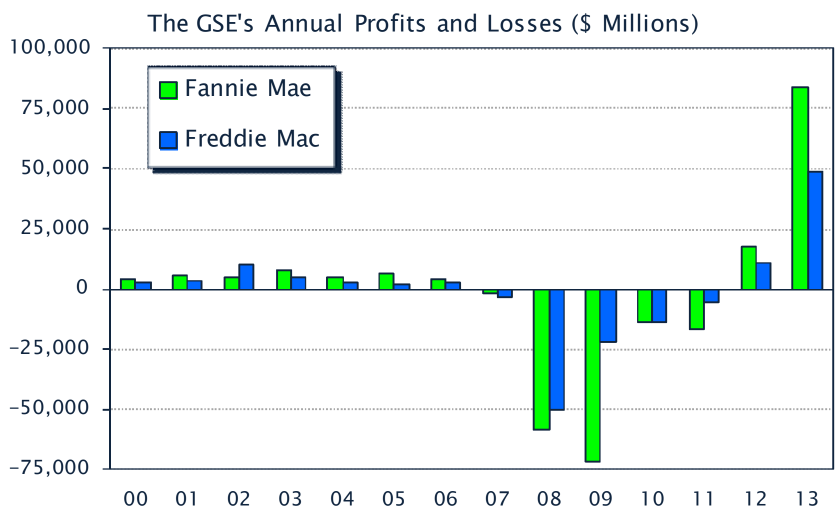
INVESTMENT UPDATE

You would think, five and a half years after the near-collapse of the global financial markets, that we would have made solid progress towards addressing the systematic weaknesses in the US housing market.

You would, unfortunately, be dead wrong.

While banking and financial regulations have been slow in coming, perhaps no reforms are more necessary yet more mired in political in-fighting than those of the acronym-happy Government-Sponsored [mortgage] Entities, also known as the GSEs, also known individually as Freddie Mac (FHLMC, the Federal Home Loan Mortgage Corporation) and Fannie Mae (FNMA, the Federal National Mortgage Association). Along with the Federal Home Loan Bank System (FHLB), Fannie and Freddie have been under the umbrella of the Federal Housing Finance Agency (FHFA—are you sick of acronyms yet?), a government agency that was formed in late 2008 to be the caretaker of these quasi-public entities when the housing market collapsed and their losses would have otherwise put them out of business.



First, a bit of history.

During the Great Depression, Congress created the Federal Housing Administration in order to direct funds to the ailing US housing market (sound familiar?). FNMA was created in 1938 to establish a secondary market for mortgage loans, buying home loans and thus providing liquid funds for the banks that had originated the loans. In the late 1960s, FNMA was split into two entities, transforming FNMA into a privately-owned/quasi-government operation and creating GNMA as the government-owned entity which would specifically guarantee FHA loans. Soon after, GNMA began securitizing home mortgages that were originated by the FHA and the Veterans Administration. GNMA-issued mortgage securities, since they were issued by an arm of the Federal government, were considered "full faith and credit" issues of the US government, just like Treasury bills, notes and bonds.

In 1970 FNMA was given approval to create their own mortgage securities, and FHLMC was established (like FNMA, as a public stockholder-owned company which would be tightly regulated by the government) as a competitor to FNMA. Importantly, these two privately-held companies' mortgage securities were not given "full faith and credit" status, but instead were viewed as having implicit government backing from a "moral" (not legal) standpoint.

Collectively, Fannie, Freddie and Ginnie (as we'll call them from here) provided a deep and liquid pool of capital which helped spur the baby boomer-fueled housing boom of the 70s, 80s and 90s, with very few bumps along the way. All that changed in the 2000s when the nascent sub-prime market, along with Congressional directives to support poorer communities, put both competitive and regulatory pressures on Fannie and Freddie to lower their underwriting standards. At the same time, Congress had "clipped the wings" of Fannie and Freddie, limiting the size of their loan portfolios. These factors led the GSEs into both guaranteeing and investing in much more risky variable rate and subprime loans. By 2007 Fannie and Freddie had ramped up the risk profile of their operations, guaranteeing billions in poor-quality mortgages (out of a portfolio that had grown to more than $3 trillion between the two entities) without a commensurate increase in retained capital, all the better to boost their reported return on shareholders' equity. One doesn't even need the full benefit of hindsight to see that something bad was going to happen.

When the inevitable happened, and home prices plummeted, the value of these poor quality loans crashed as well, and the FHFA was forced to step in and make Fannie and Freddie wards of the state. The Federal government suffered losses in the neighborhood of $200 billion from 2008-2011 as the FHFA had to borrow money from the Treasury in order to have the funds to make guaranteed payments to holders of Fannie and Freddie mortgage-backed securities.

As the chart on the front page shows, however, both Fannie and Freddie are now making record profits. In fact, through the first quarter of 2014, the GSEs have paid back in dividends (the FHFA issued Fannie and Freddie preferred stock to the Treasury in exchange for the funds that were "borrowed") more than $200 billion to the US Treasury, more than offsetting the funds they borrowed during 2008-2011.

Which brings us around to the question that's on every bond investor's mind: What should be done to Fannie and Freddie now that the crisis has passed?

In their 2014 *Strategic Plan*, the FHFA noted, "FHFA's statutory responsibilities as conservator do not involve making policy decisions on the future of housing finance reform. That future will be decided by Congress." Unfortunately, Congress is anything but a smooth-running operation; they don't always find the best solutions and are rarely able to implement critical policy decisions quickly and efficiently. There are enormous sums of money involved here—as we've seen, the GSEs generated $130 billion in profits in calendar year 2013, which significantly reduced the Federal budget deficit. It should come as no surprise, therefore, that Congress is getting plenty of pressure on a number of different fronts to resolve the ownership and management questions that surround the temporary nature of the FHFA's conservatorship of the GSEs.

Most of the proposals that have been floated suggest three options for what to do with Fannie and Freddie: 1) Privatize them, putting them back into the hands of shareholders who will recapitalize them; 2) Liquidate them, break them up and let the private sector take over the myriad functions of the GSEs, via the establishment of many new, smaller companies; and 3) Re-establish, with modifications, the public/private hybrid model that the GSEs operated under for decades.

Of the three choices, #2 seems highly unlikely. The US housing market, for all the improvement we've seen over the past few years, continues to operate on a rather shaky foundation. The mere fact that the non-Agency MBS market remains moribund, with essentially no new securitization of home mortgages that don't qualify under the GSE's standards, indicates just how little demand there is for residential mortgage securities that don't have a government guaranty. Now imagine if the entire mortgage loan market was unable to be economically securitized—how much would interest rates on mortgages have to rise to compensate the mortgage lenders to keep these raw loans on their balance sheets? In short, we are not ready now (and it's doubtful we ever would be) for a completely private and far more fragmented mortgage securitization industry.

There are big money special interest groups that are applying pressure on Congress to move in the direction of option #1. One such organization is a tax-exempt 501c4 group called the "Coalition for Mortgage Security," which has already begun both internet and print campaigns designed to push for the GSEs to be returned to shareholders, and an immediate end to government involvement in the mortgage business. The obvious backing for this group are hedge funds and certain other institutional investors who have bought Fannie Mae and Freddie Mac stock over the past few months for pennies per share, with the idea that legislation could be twisted in their favor. Of course, these organizations don't have to (and in the case of the Coalition for Mortgage Security, have outright refused to) identify their big-money backers, but it's clear from their opinion pieces (recent title: "Treasury Stealing From Freddie and Fannie Shareholders") who stands to gain from their preferred solution to the GSE restructuring. The GSE's share prices have popped up in recent months, making it obvious, along with a ten-fold increase in trading volume, that the bets have been laid down in a not-so-subtle game of inside poker. Of course, these investors have no specific ideas of how the resuscitated GSEs should be run, or regulated, nor do they support any specific legislation.

It's highly unlikely that the GSEs will be simply handed back to the shareholders any time soon; the Treasury is raking in billions in dividends from the GSEs, and, in any case, the shareholders' interests were essentially nullified when Freddie and Fannie went into conservatorship.

Thus, we are left, almost by default, with the third option—the public/private hybrid—as the most likely eventual course of action for resolving the GSE's organizational future. But even here, there is no easy path. Last month, the Senate Banking Committee voted to move the comprehensive (and bi-partisan) Johnson-Crapo bill, which detailed how to restructure and regulate the GSEs and the US mortgage finance system (one provision: existing shareholders get next to nothing), to the floor of the Senate, but the margin of victory in the Committee was so narrow that there's little chance of it ever coming up for a vote by the full Senate. The House has no similar piece of legislation; there are separate proposals from Democrats and Republicans, but they are worlds apart and aren't much more than widely-divergent statements of principals. A main sticking point is how to assign the risks and apportion losses from the mortgages that the GSEs guarantee. Johnson-Crapo proposes that the first 10% of any principal losses would be absorbed by the mortgage lender and the remaining 90% would be guaranteed by the GSEs, backed by taxpayers and a new insurance pool paid for by the mortgage originators. Opponents say that doesn't go far enough in shifting risk to the lenders. There are objections as well regarding subsidies to low-income home buyers.

So, even though there is widespread consensus that the government's caretaking role for Fannie and Freddie must end, there is little agreement about how to do it. Meanwhile, the Federal government is raking in billions from their "investment" in Fannie and Freddie. And with mid-term elections coming up...this could take a while.

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