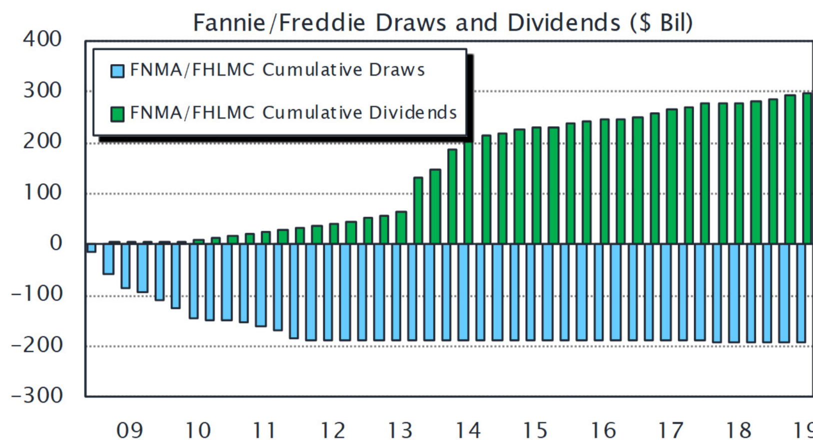
INVESTMENT UPDATE

It's been more than ten years since Fannie Mae (the Federal National Mortgage Association) and Freddie Mac (the Federal Home Loan Mortgage Corporation) were placed into conservatorship by the US government's Federal Housing Finance Agency (FHFA). At the time, Fannie and Freddie were collapsing, their finances ruined by the enormity of losses they were facing from guarantees they made to investors to cover trillions of dollars of mortgage-backed securities the two had issued. The "government takeover" of Freddie and Fannie was controversial, as these were private companies that made promises they could not keep when home prices tumbled; why didn't the FHFA, the federal agency responsible for the regulation of Fannie and Freddie, just let them fail?

The thinking at the time—and we would argue that the regulators were correct in this instance—was that the US housing market was "too big to fail." If the government hadn't make good on the guarantees to investors that FNMA and FHLMC had made, the prices of even riskier assets, including corporate bonds and stocks (not to mention "non-agency" and commercial mortgage-backed securities) would plummet. The severity of losses across all classes of investments could have mushroomed as investors frantically shed risk, threatening not just the US economy, but nearly every economy across the globe. It was feared that the damage to public and private interests could be so deep and widespread that it would take years—maybe decades—to recover.



How did it get to that point? Quick history: FNMA and FHLMC were originally formed as government agencies, Fannie in 1938 and Freddie 32 years later, to provide a secondary market for the trading of outstanding mortgage loans. This meant that banks didn't have to carry 30-year mortgages on their books to term, freeing up those funds to be put to other uses. By the 1980s, Fannie and Freddie had been privatized, while Ginnie Mae (the Government National Mortgage Association, which had become the securitization conduit for government-sponsored FHA and VA mortgage loans) remained a full-fledged agency of the US. All three were issuing mortgage-backed securities (MBS) collateralized by home mortgages that conformed with certain underwriting standards. By the time of the financial crisis, Fannie and Freddie had a combined $5 trillion in mortgage securities outstanding, every dollar of which carried guarantees to pay timely interest and principal payments each month.

Investors were satisfied by the "moral obligation" backing Fannie and Freddie MBS (Ginnies were always fully guaranteed by the government); despite being private enterprises, investors expected—rightly so, as it turned out—that the US government would ultimately step in and make good on these MBS payments. Both Fannie and Freddie had made big profits in the years leading up to the crisis, and both organizations had significant financial leverage. Fannie and Freddie used their hefty profits to pay big dividends to shareholders, with the result that they were far too thinly-capitalized should mortgage defaults rise above typical historical levels. When home prices plummeted and defaults skyrocketed, both organizations quickly ran out of cash.

Under conservatorship, Fannie and Freddie's shareholders were essentially wiped out (including holders of preferred stock), but the creditors were "made whole" from funds drawn from the US Treasury; in exchange, Freddie and Fannie issued senior preferred shares to the government. Ultimately, Fannie and Freddie would draw $187 billion between September of 2008 and 2012 (and another $4 billion in 2017), with the Treasury owning warrants that could be exercised to own 80% of the two organizations. The shares carried a 10% cumulative dividend, meaning that FNMA and FHLMC would have to pay all $187 billion back, plus a 10% dividend on the outstanding preferred stock to the Treasury, no matter how long it took.

As the chart shows, it was all one-way traffic as FNMA and FHLMC suffered heavy losses until 2012, when foreclosures and defaults slowed and both organizations once again began generating profits. Profits so big that the Obama administration changed the terms of conservatorship, eliminating the 10% divi-

dend and replacing it with a "net worth sweep." The FHFA mandated that FNMA and FHLMC would be allowed to retain only $3 billion each in equity capital; all other profits would be transferred to the US Treasury on a quarterly basis.

Which brings us to the present day. To date, Fannie Mae, the bigger of the two, has paid back the $120 billion it drew from the Treasury, plus an additional $60 billion; Freddie had borrowed a total of $71 billion, which has all been paid back, plus an additional $46 billion. In other words, the Treasury has profited by more than $100 billion from its investment in the two firms since they were bailed out. It's difficult to calculate an internal rate of return, since the drawdowns and repayments were made irregularly, but at least one commentator has concluded that the Treasury has earned more than the 10% annual return it originally demanded from the two companies.

In any event, the time is ripe for policymakers to decide what to do with Fannie and Freddie; by definition, conservatorship was always meant to be a temporary, stop-gap solution. But since their income has been siphoned off for years, these firms, as they stand today, are woefully under-capitalized to operate independently. That means that the Treasury will have to give up its cash cow, and end the net worth sweep. To that end, on April 15th, the FHFA swore in a new Director, Mark Calabria, who is keen to cut Fannie and Freddie loose, and to shake up the status quo in the process.

In a recent interview with *American Banker*, Calabria made clear that he wants a clean break for Fannie and Freddie, saying "Anything that's simply a return to sort of pre-2008, I would say is unacceptable." Calabria favors the privatization of the two, with no guarantee, implicit or otherwise, that the government will back securities issued by Fannie or Freddie. This is not a view shared by everyone in Washington, including that of Treasury Secretary Steve Mnuchin, who once made a living as a Wall Street mortgage bond trader. Without at least an implicit government backing, the risk profile of mortgage-backed securities issued by Fannie and Freddie would rise significantly, their bond prices would fall, and mortgage rates would rise. In addition to higher mortgage rates for everyone (an unpopular position for any politician to advocate), without a government connection, it becomes far more difficult for policymakers (including Congress) to force the two to implement programs to support the housing market in underserved neighborhoods.

There's been some chatter that the FHFA doesn't need Congress' approval to end the conservatorship. That's only partly correct. The FHFA apparently does have the power to cut the two free, but only new legislation that revamps their charters can stipulate what, if any, guarantees will be in place in the future. So while Calabria states that he wants to wait "at least an entire Congress" (i.e., until after the 2020 election) to put together a legislative solution, the executive branch's wheels are already in motion. Earlier this month, the administration issued an outline for reform, directing Treasury and the Department of Housing and Urban Development to report back this summer with comprehensive plans for housing finance reform.

It appears that the ultimate goal of the current administration is to have Fannie Mae and Freddie Mac compete on equal footing with other private institutions in the securitization of MBS. Investors will have to do their own credit work to determine if the securities issued by these private entities are "money good." To compete in a free marketplace Fannie and Freddie will have to have billions in capital reserves, capital that neither currently has. Calabria has mentioned public offerings of stock as a possible way to help recapitalize Fannie Mae and Freddie Mac, but investors may not be eager to buy the stock of two companies with such huge liabilities and dicey histories of risk management. Allowing Fannie and Freddie to retain earnings is an obvious first step, but Calabria won't yet commit to that. He has stated that he wants his agency to "enforce a sense of urgency for Congress to act," a clear indication that the administration believes that Congress needs to be prodded.

While we await the tussle over how policymakers extricate Fannie and Freddie from their government overseers, there's another, more immediate development in the MBS market: uniform mortgage-backed securities (UMBS). This month's roll-out of uniform mortgage securities is the FHFA's first major reform initiative since the financial crisis, and another indication that FNMA and FHLMC are being set up to directly compete with each other—and with any other private entity that wants to get into the securitization business. Since their inception, Fannie and Freddie have taken separate approaches to securitizing mortgage loans, with the result being that the MBS that each firm issues are different in some important ways. Under the revised rules, new Freddie Mac UMBS will now be issued with a 55 day payment delay, just like Fannies', and will be fungible with Fannie's UMBS. To further ensure that the bonds issued by each are as similar as possible, rules for servicing fees, "buy downs" (how much lower the MBS' coupon is compared to the underlying mortgage loans), and loan removal policies (how loans in MBS can be "put back" to the mortgage originator) will be standardized. Again, the objective is to have a uniform securitization process so that MBS from either entity will have nearly identical characteristics and performance.

Current holders of Freddie MBS will have the option to exchange their bonds for the new UMBS; we think they will do so—otherwise they run the risk that the market for legacy Freddies may dry up. Holders of FNMA MBS don't have to do anything; their bonds will become the default UMBS. It remains to be seen if the UMBS issued by the two will trade on equal footing. Ultimately, the price of the bonds will be far more dependent on the underlying financial strength of the issuer than on minor differences in payment schemes and other security-specific factors.

Again, there is much left to do if the goal is to have two privately owned entities that have no credit backing from the government. It's clear which way the administration, and by extension, its chief mortgage regulator wants to go. But if that means higher mortgage rates for the average citizen, will Congress be willing to go along? Watch this space for further developments.