

Fannie Mae and Freddie Mac Bailout

Over the weekend, the US government and regulatory authorities announced the implementation of a rescue plan for Fannie Mae and Freddie Mac (the "GSEs"), the legislation to provide for this having been passed some months ago.

Why the bailout?

The US mortgage market is very different to what we are familiar with in Ireland. Here, generally, banks issue mortgages to borrowers and hold them on their balance sheet. In the US, banks issue mortgages to borrowers and then sell those loans on to, in the main, the two GSEs, providing certain conditions are met. In other cases, the lender sells on the mortgage to someone other than the GSEs, but only with a guarantee issued by the GSE, for a fee.

The GSEs were, until recently, seen as very safe banks and so they were able to borrow money quite cheaply in the financial markets, and use that money to finance the purchase of the mortgages from ordinary banks.

In recent months, however, as the US housing market collapsed, the markets became increasingly worried about how safe the GSEs really were, as it was thought that they would face significant losses as borrowers would not be able to repay their mortgages. The interest rate at which the GSEs could borrow rose sharply, which in turn meant that new home buyers had to pay higher mortgage interest rates as well, the last thing the housing market needed when it was already so weak.

As well, government regulators insist that the GSEs hold a given amount of capital. But increasing losses on their loans meant that the capital they held was getting dangerously close to that minimum level. And over the weekend several newspapers reported that a special government investigation showed that the GSEs had used dubious accounting rules to keep their capital artificially high – the real capital position was even worse than it seemed.

So the US government was faced with two extremely large banks going bust – which is bad enough – but on top of that this would inevitably mean that homebuyers would have to pay significantly higher mortgage interest rates. This was not politically acceptable and

this alone meant that a bailout was inevitable. (A further complication is the fact that other banks held large amounts of shares, and particularly preference shares, in the GSEs).

The new arrangements should reduce – perhaps substantially – the cost of borrowing for the GSEs, and thus allow them to pass on that lower cost to homebuyers, thus helping the housing market.

How will the bailout work?

Under the rescue scheme:

- The senior management of the two companies have been fired. New CEOs have been appointed from outside.
- The companies will be placed in “conservatorship”, essentially meaning they will be run by the government. The purpose of the conservatorship will be to safeguard/improve the availability of mortgages to the public, NOT to make a profit for the shareholders.
- The government will inject up to \$200bn of capital, as needed, into the two GSEs, over time (quarterly, not in one lump sum). The government will also buy mortgage bonds issued by the two GSEs.
- Though the arrangements are complicated, in essence existing shareholders lose 80% of the value of their shares.
- No dividends will be paid on either ordinary shares or the old preferred shares.
- A special emergency lending facility has been put in place where the Treasury would lend money to the companies, on a short-term basis, if required.
- Special arrangements may be required for other banks that invested heavily in the GSEs shares, including preference shares, and who have incurred large losses.

What does it mean for shareholders?

They will lose about 80% of the value of their shares. Of course if the GSEs had gone bust without government action, they might have lost everything anyway.

What does it mean for US homebuyers?

They should be able to borrow at a lower interest rate as a result of this plan, though the amount is difficult to quantify.

What does it mean for the government bond market?

As the government needs to invest money in the GSEs, it will have to borrow that money in the bond market, so theoretically bond yields

should rise a little. But this impact is likely to be (very) small. US bond yields are about 10 to 20 basis points higher today than on Friday.

What does it mean for the economy?

The direct impact should be positive for the economy, as it will lower mortgage interest rates which would help the housing market and thus the economy in general. The indirect impact is harder to judge. There could be either a positive or a negative impact on confidence. If consumers react by worrying that the situation is so bad that the GSEs have to be rescued, the impact would be negative. If, on the other hand, they are relieved that the government is now running the GSEs and is guaranteeing that they will not fail, the impact could be slightly positive.

What does it mean for the national debt/deficit in the US?

The national debt will obviously rise by the amount of capital that the government needs to inject into the GSEs, and the amount that the government uses to buy GSE-issued mortgage bonds, but this is going to be very small relative to the huge national debt that already exists. On the deficit side, the government could theoretically actually make a profit! If they borrow at government bond yields, and invest the proceeds in mortgage bonds which carry higher interest rates, they can pocket the difference and actually make some money. However, the government is also investing in preferred shares in the GSEs, as well as in mortgage bonds, and these are not necessarily as good investments.

What does it mean for equity markets?

Markets don't like uncertainty, and today's package removes considerable uncertainty about the future of the GSEs, which is a positive. More substantially, the government's actions seem likely to reduce mortgage interest rates, which can only be substantial, and reduce the risk to the financial system of the failure of the two largest banks in the US. So the market reaction has been quite positive. As the time of writing, the US market is expected to open up 3%, while the ISEQ index is up 7% today, most European markets are up between 3% and 4%, while Asian markets closed up anything from 2% to 6%.

(The only counter-argument to this is that some investors may think, or realise, that the economy is even worse than they had thought, to the extent that the GSEs had to be bailed out).