Watershed Moment

September 11, 2008

Max Wolff
Senior Economist
The Beryl Consulting Group LLC

The seizure of Fannie Mae and Freddie Mac will shape and change international credit markets and US real estate financing for years. It will take months to assess and learn how much the worlds of borrowing, lending and home ownership will be altered. Born in the depths of the depression, 1938, to increase home ownership and slow foreclosure Fannie Mae and later Freddie Mac tell the story real estate finance. They also tell the story of the middle class. In 1968 Fannie was moved outside the government and in 1970, Freddie Mac was introduced to provide competition. These firms were born, were altered and influential at cross roads periods in American history. This Sunday we reached another pivot point and true to form, Fannie Mae and Freddie Mac were in the middle of all the action.

On Sunday 7 September 2008, the US Treasury acted on behalf of the US Government to take control of the two largest financial intermediaries in the mortgage market. Fannie and Freddie are also referred to as government sponsored enterprises (GSE). The debt they issue is sometimes called GSE MBS, government sponsored enterprise mortgage backed securities. We knew that action was impending just as we knew that months of assurances from the architects of this plan were disingenuous. Home ownership soared to nearly 70% at the start of this decade and is now falling fast. Foreclosures have spiked. Realty Trac reported 271,171 foreclosures and foreclosure related actions in July 2008. Foreign holders of bundled home mortgages have been selling and pressure was mounting. As this goes to press foreign entities own $1.3-$1.4trillion in Fannie and Freddie issued and backed bundles of US home mortgages. Action was necessary, the action taken will likely prove insufficient.

Let's look at where we are now and what has been done. We will start with exploring the actual decisions. Fannie Mae and Freddie Mac entered conservatorship under the Federal Housing Finance Authority (FHFA) effective 08 September 2008.

The Conservator controls and directs the operations of the Company. The Conservator may (1) take over the assets of and operate the Company with all the powers of the shareholders, the directors, and the officers of the Company and conduct all business of the Company; (2) collect all obligations and money due to the Company; (3) perform all functions of the Company which are consistent with the Conservator's appointment; (4) preserve and conserve the assets and property of the Company; and (5) contract for assistance in fulfilling any function, activity, action or duty of the Conservator. US Treasury/OFHEO/FHFA Fact Sheet of 07 September 2008.

This does not preclude receivership of Fannie and Freddie, it transfers obligations and operations to the FHFA conservator. The government assumes temporary responsibility and cost for Freddie and Fannie. They will honor all interest and principle payments to GSE MBS holders foreign and domestic.

The firms can still be dissolved if that is the choice of the conservator.

The Conservator cannot make a determination to liquidate the Company, although, short of that, the Conservator has the authority to run the company in whatever way will best achieve the Conservator's goals (discussed above). However, assuming a statutory ground exists and the Director of FHFA determines that the financial condition of the company requires it, the Director does have the discretion to place any regulated entity, including the Company, into receivership. Receivership is a statutory process for the liquidation of a regulated entity. There are no plans to liquidate the Company. US Treasury/OFHEO/FHFA Fact Sheet of 07 September 2008.

We all knew a day would come when the debt overhang from the housing bubble created major tax payer losses of a direct variety. September 7th was that day. We all knew our growing foreign debt and fears regarding holding dollar assets- especially mortgage related assets- would create a scenario where US taxpayers were forced to make foreign debt holders whole. September 7th was that day. Leading up to September 07, 2008 major foreign central bank holders of GSE debt began to reduce their holdings. Investors lost interest and demanded higher premiums. This pushed up mortgage interest rates and squeezed Fannie and Freddie. The nearly $1.4trillion in foreign holdings of Fannie and Freddie backed debt were at risk. The Treasury found its hand forced and failed to rally buyers with assurances. The teetering state of the mortgage markets and the $4.6-$4.9 trillion position of Fannie and Freddie placed the GSE at the center of these crises. The extreme weakness- universally denied by officials- required immediate action.

The actions announced are full of ambiguity, massive scope for unspecified future decision making and multi-hundred billion dollar liability for US taxpayers. They assure nearly the full faith and credit- but not exactly the full faith and credit- of the US government to Fannie and Freddie debt.

Terms of the Agreements:

• The agreements are contracts between the Department of the Treasury and each GSE. They are indefinite in duration and have a capacity of $100 billion each, an amount chosen to demonstrate a strong commitment to the GSEs' creditors and mortgage backed security holders. This number is unrelated to the Treasury's analysis of the current financial conditions of the GSEs.

• If the Federal Housing Finance Agency determines that a GSE's liabilities have exceeded its assets under generally accepted accounting principles, Treasury will contribute cash capital to the GSE in an amount equal to the difference between liabilities and assets. An amount equal to each such contribution will be added to the senior preferred stock held by Treasury, which will be senior to all other preferred stock, common stock or other capital stock to be issued by the GSE. These agreements will protect the senior and subordinated debt and the mortgage backed securities of the GSEs. The GSE's common stock and existing preferred shareholders will bear any losses ahead of the government.

In exchange for entering into these agreements with the GSEs, Treasury will immediately receive the following compensation.

• $1 billion of senior preferred stock in each GSE.

• Warrants for the purchase of common stock of each

GSE representing 79.9% of the common stock of each GSE on a fully-diluted basis at a nominal price.

• The senior preferred stock shall accrue dividends at 10% per year. The rate shall increase to 12% if, in any quarter, the dividends are not paid in cash, until all accrued dividends have been paid in cash.

• The senior preferred stock shall not be entitled to voting rights. In a conservatorship, voting rights of all stockholders are vested in the Conservator.

• Beginning March 31, 2010, the GSEs shall pay the Treasury on a quarterly basis a periodic commitment fee that will compensate the Treasury for the explicit support provided by the agreement. The Secretary of the Treasury and the Conservator shall determine the periodic commitment fee in consultation with the Chairman of the Federal Reserve. This fee may be paid in cash or may be added to the senior preferred stock.

• The following covenants apply to the GSEs as part of the agreements.

• Without the prior consent of the Treasury, the GSEs shall not:

• Make any payment to purchase or redeem its capital stock, or pay any dividends, including preferred dividends (other than dividends on the senior preferred stock).

• Issue capital stock of any kind.

• Enter into any new or adjust any existing compensation agreements with "named executive officers" without consulting with Treasury.

• Terminate conservatorship other than in connection with receivership.

• Sell, convey or transfer any of its assets outside the ordinary course of business except as necessary to meet their obligation under the agreements to reduce their portfolio of retained mortgages and mortgage backed securities.

• Increase its debt to more than 110% of its debt as of June 30, 2008.

• Acquire or consolidate with, or merge into, another entity.

• Each GSE's retained mortgage and mortgage backed securities portfolio shall not exceed $850 billion as of December 31, 2009, and shall decline by 10% per year until it reaches $250 billion. US Treasury Fact Sheet September 07, 2008.

The assurances in this agreement are cut from the same clothe that was pulled over the public eyes regarding the health and function of Fannie and Freddie for years. That said, these actions reduce the strain on these firms by placing it at the feet of the US government. This will induce greater purchase of and confidence in GSE debt. The additional announcement of US Treasury buying of unspecified and unlimited quantities of mortgage backed securities (MBS) will divert public funds to rescue bond holders and repair the books of institutions, foreign and domestic, that hold Fannie and Freddie issued or backed assets.

As of June 30, 2008 The Total portfolio of Fannie and Freddie stood at approximately $1.6trillion. The Treasury is promising to cap exposure at $1.9T at year end 2009. Thereafter the conservator has to reduce exposure toward $500billion in 10% increments. These firms will have to limit the growth in their activities and then begin a massive reduction in debt and risk exposure. Fannie and Freddie will be selling MBS to the Treasury, Treasury backing will allow mortgage rates to decline as investors will be cheered by Federal Government backing of their investments. This project aims to erode the difference between buying bundles of mortgages and buying US government debt. In transferring mortgage debt risk to taxpayers this actions also suggests that the safety of US government debt should fall, and the safety of mortgage debt should rise.

The set of commitments to saving taxpayer money runs counter to absorbing mortgage backed securities and supporting housing prices by buying mortgages. It is clear that this plan attempts to substitute government backing and guarantee activity for Fannie and Freddie purchase of mortgages and mortgage bundles. It is not clear how this will reduce mortgage finance difficulty. The Treasury is proposing to buy MBS and transform mortgage bundles into Treasury Securities. The taxpayer support provisions clash with facilitating home lending and strengthening balance sheets. At least one, likely two, of these goals may have to be sacrificed. That is the basic truth that led us to this point. Federal funds and employees will now guarantee mortgages. Fannie and Freddie debt holders will be paid all interest and principle. Safeguarding taxpayers and supplying plentiful and affordable home loans are secondary priorities. The bottom line remains that house prices are too high for incomes and savings levels in America. This plan does nothing to address this fundamental problem.

Soon the Treasury will begin buying Fannie and Freddie backed MBS from the conservator of the FHFA- itself in variant form. There is no explicit stated limit to the size of these purchases and they will be made consistent with the below objectives.

Congress granted Treasury authority to purchase MBS in the Housing and Economic Recovery Act of 2008. The authority expires on December 31, 2009. Treasury will begin later this month by investing in new GSE MBS, which are credi t-guaranteed by the GSEs. Additional purchases will be made as deemed appropriate. Treasury can hold this portfolio of MBS to maturity and, based on mortgage market conditions, Treasury may make adjustments to the portfolio. Treasury GSE MBS Purchase Program Fact Sheet.

The circular and confusing nature of statements and provisions creates massive scope for action. There is nothing in this provision that makes earnings short and over indebted homeowners more likely, able or inclined to repay loans. There is nothing in this provision that extends support to underwater or at risk homeowners. The first, direct and clearest provision makes whole owners of Fannie and Freddie debt while whipping out common shareholders and transferring hundreds of billions of dollars in liability to the Federal Government. Taxpayer monies will be used- if and when needed- to honor payments to foreign and domestic mortgage backed security investors. That much we know is true, the rest we hope for and remains to be seen.