Foreign Spigot Off for US Consumers

August 28, 2008

Max Wolff
Senior Economist
The Beryl Consulting Group LLC

As US public attention shifts from the Olympics to running mates and the celebrity "news" de jour, the infrastructure beneath your house is termite-infested. Just beneath the nicely painted exterior and behind all the new appliances, doubt is boring through the beams, gnawing at the studs.

Alongside falling prices, rising mortgage rates, stricter credit conditions and general malaise, the structure that supports American home ownership is being condemned by market valuation. Fannie Mae and Freddie Mac have nose dived and been downgraded toward a smaller future - and these are more important names for your future than Joe, Sam, Kathy, Mitt, Meg.

Fannie Mae was created in the depths of the Great Depression to decrease foreclosure and increase home ownership. In 1968, it was re-chartered as a public company, removed from within official government agency status. Freddie Mac, since its inception in 1970, has financed 50 million homes.

Fannie and Freddie mission statements make clear, they exist to facilitate, ease and cheapen home ownership. They do this by acting as liaisons between international capital markets and mortgage seekers. They borrow at preferential rates - based on the implicit/explicit - assurance of the US government. Borrowed funds are used to buy mortgages and bundles of mortgages. They provide credit guidelines and purchase mortgage issued by banks. This reduces banks' risk and provides banks with more cash, more quickly to make more loans at lower costs. These firms, then, exist to facilitate, ease and accelerate bank lending for home purchase.

Fannie and Freddie form a central hub between lenders and investors. After they buy American mortgages, they bundle sell and guarantee repayment. This transforms mortgages into investments for banks, corporations and governments all over the world. Your home mortgage, bundled with many other folks' mortgages, is sold, repackaged and assured by Fannie and Freddie. This reduces risk and assures global savings flow in to support American purchases of homes. International investment is the foundation on which our home ownership was built.\

Well over US$1 trillion of our mortgages have been sold to foreign investors this way in the recent past. As you sit down and read this, your mortgage may well be "owned" by a firm, individual or central bank thousands of miles away. This relationship is neither healthy nor sustainable in its present form. Rising defaults, falling dollars and the sheer size of past borrowing are turning people off to American mortgages. The foundation below our houses is shifting.

What we are witnessing is the breakdown of the link between middle-class America and the global financial markets it has over-tapped across the last several decades. Fannie and Freddie were the support infrastructure connecting houses to capital market access. They have been caught with weak financials, swollen balance sheets and escalating default, just like the home owners they assist. The size of their retained mortgage portfolios is truly gigantic.

The extent of the firms' guarantee commitments is global in scope. Sixty-six global central banks buy loans bundled and or backed with Freddie Mac and Fannie Mae involvement. As of June 30, 2007 foreign entities and individuals held over $1.4 trillion in securities of US agencies such as Freddie and Fannie.

Fannie Mae's June 2008 statement declares a gross mortgage portfolio of $750 billion and guarantees of mortgage backed securities and loans of $2.6 trillion. Freddie Mac's June statement details a retained portfolio balance of $792 billion and a total mortgage portfolio balance of $2.2 trillion. These two giants have retained interest in over $1.5 trillion and guaranteed over $4.5 trillion in mortgages, mortgage backed securities and loans. There are $11 trillion in outstanding mortgage liabilities in the US. The US housing market continues to melt down with dire consequence. In the seven years from 2001 through late 2007, household real estate value increased by $8.873 trillion to $22.495 trillion. It has since fallen by $426 billion. Many claim we are at or a near a bottom. These claims should be viewed with extreme weariness. The housing downturn is not over and it will take a while after it is over to judge the damage.

The search for parallels with today yields little. The closest one finds is the interesting decline in home ownership across the period 1905-1920 followed by a surging rise across the '20s and then collapse across the 1930s. Fannie was born of this collapse, the ideology of The New Deal and sense that government-driven market interventions could broaden home ownership in America. This was a success. Home ownership did grow spectacularly across the period from 1938-2007. It is falling now as Fannie and Freddie flounder.

In 1940, US home ownership stood just below 44%. At the start of 2008 68% of Americans owned their home. Over the decades, Fannie and Freddie changed, middle-class America changed and the global financial realm underwent several revolutions. The last and most transformative revolution involved the rise of securitization and integration of global financial markets.

Securitization involves transforming assets and promises of future payment into financial products for sale to investors. International financial integration tears down the walls between national banking systems and allows savings, loans and payments to be gathered and transferred across international boundaries.

A world of wealth poured into US real estate through securitization and deregulation. This flow was channeled and molded by the actions of Fannie Mae and Freddie Mac. The decline of these firms will have dramatic and long-lasting implications for home mortgage finance. This will impact the price of American homes, the cost and ease of borrowing for home ownership.

Housing prices have further to fall and global savings will likely never be lent to American consumers at recent percentage levels. Across the past few years America has been borrowing over 50% of the world's internationally available savings. The diminishing role of Fannie and Freddie will impact more people, for far longer than presidential running-mate selections. Policy makers and managements in Fannie and Freddie are stuck. Today's consumer strength, their missions and international financial realities no longer align.

We face a housing finance future different from the recent past. Fannie and Freddie will not be able to function in the same way, or to the same extent. The debates about and plans for these firms will touch millions of families through housing prices, finance terms and cost. Fannie and Freddie are much more important than Joe, Sam, Kathy, Mitt, Meg.