

## **Fannie Mae and Freddie Mac**

### **Recommendation**

A series of recent events in Washington suggest that speculative investments in the preferred shares of Fannie Mae and Freddie Mac may prove to be very attractive. Purchase of the common shares in both entities lack the same appeal and could conceivably, ultimately prove to have no value at all.

### **Recent Developments**

On February 1, Senator Mike Crapo (R.; ID) released an outline of his plan to eliminate the conservatorship within which Fannie and Freddie have functioned for more than 10 years. This announcement comes only days after Joseph Otting the Comptroller of the Currency (OCC) and acting Director of the Federal Housing Finance Agency (FHFA) was reported to have indicated that he also had a plan for the future status of the two Government Sponsored Enterprises (GSEs).

A few days before that, President Trump nominated Mark Calabria to become the permanent Director of the FHFA. Mr. Calabria is Vice President Pence's chief economic advisor but, more importantly, he is believed to have written the Omnibus Housing legislation proposed, but not passed, by Senator Richard Shelby (R.; AL) when Shelby headed the Senate Banking Committee. Finally, Steve Mnuchin, the Treasury Secretary seems to be ready to act, upon the promise he made two years ago, to end the conservatorship related to Fannie & Freddie.

### **Judicial Issues**

It is also conceivable that the two main court cases related to these companies could reach some resolution. The probability here is not particularly high since it appears that neither of the Justices involved want to make a decision.

The Washington District Court under Justice Royce Lamberth has been instructed by the District Appeals Court to determine what obligation, if any, the United States government has to pay past dividends to the junior preferred shareholders in these companies. The Justice seems unwilling to act because he initially ruled they were entitled to nothing because the government could act however it chose in matters of this nature.

In the Federal Claims Court Justice Margaret Sweeney has made a number of rulings concerning discovery that suggest that she may believe that the government may owe shareholders some recompense but she has not made that decision. Moreover, the Administration, whether Democratic or Republican, continues to successfully ignore much of what this Judge wants.

### **Demographic and Other Pressure**

There are other issues at hand here suggesting that the government may want to settle the GSE issues because the government wants a housing recovery. Historically, housing has been the best mechanism to spur economies that are in recession. This economy may be slowing and, therefore, a boost from housing would be welcome.

The demographics indicate that the demand is certainly there. After years of declines in absolute size, the number of people aged 25 to 35 years of age have begun to grow again. This is the critical age group

since first time marriages for women generally occur at age 28, while for men it is 29. More marriages lead to more births. This in turn forces parents to consider living in large spaces – i.e., buying a house.

Therefore, the obstruction is on the funding not the demand side.

- New banking rules related to construction and development loans and loan securitization has reduced the flow of funds into housing.
- Rising rates tell homeowners that selling existing homes and buying a new one would be a major financial error. Some observers, like Jim Herbert the CEO of First Republic Bank, have indicated that there is an actual shortage of houses for sale.
- Draconian requirements like the Qualified Mortgage Rules is another meaningful problem. This is because these rules prevent many first time buyers from qualifying for a loan.
- Perhaps, most important, is that the secondary market for mortgages is simply not robust given Fannie and Freddie's status as government wards in the conservatorship. Making conventional first mortgages and holding them in portfolio is generally a losing proposition for banks.

Senator Mike Crapo has called the housing finance system flawed and in need of fixing.

The government keeps claiming it wants the private sector to help solve this mortgage supply problem but it takes no action on private sector suggestions. Moelis and Co. has a proposal that would go a long way in meeting the government's demands but the powers in Washington will not relent.

### **Money is the Big Reason**

The key reason, in my view, that the government refuses to release its hold on the GSEs is because these companies are cash cows for the Treasury. The United States invested \$187.5 billion aggregate in the two firms. To date it has received \$286.0 billion back. Plus, based on the terms of the adjusted deal mandated by the Treasury, the GSEs still owe the government \$187.5 billion. Going one step further, the government is forcing the companies to pay a portion of their revenues to support other government programs not related to housing.

The incentive to do nothing is therefore very great and the government has in fact done nothing but fight in the courts to maintain the status quo. It has shown no willingness to kill this "cash" cow for years -- until now.

### **Why?**

From my perspective there is only one reason. Housing construction has stalled. Housing starts are averaging 1.2 to 1.3 million on a seasonally adjusted basis down from the 2.0 million plus hit at the peak of the last cycle. The government needs more housing production.

Economic history is clear, in past economic down cycles housing has been the key driver of the recovery. If the Administration fears a slowing economy, then it makes enormous sense to rebuild housing. That is the overwhelming rationale for solving the Fannie/Freddie issue now.

For the very naïve, it is also possible that the government may be about to acknowledge that it did break the law. The Housing and Economic Recovery Act of 2008 (HERA) required the FHFA to release the GSEs from the conservatorship when they had regained their financial stability. This happened 7 years ago but the government would not let go.

Then, there are the court battles. The one that rings true to me is that the government did acquire private property (ownership of Fannie and Freddie) without just (any) compensation. It broke every supposed law that this country has concerning the protection of private property. Clearly, I am not a lawyer and this is a personal judgment but I still have faith that Judge Margaret Sweeney in the Federal Claims Court could rule in this vein. A ruling for the plaintiffs could cost the government hundreds of billions of dollars.

## **The Solutions**

### What Did Not Work

For most of the past ten years, every major bill introduced in the Congress was driven by the same philosophy – i.e., get rid of Fannie Mae and Freddie Mac. In the beginning, the bills like Johnson/Crapo demanded the creation of a new mortgage system in this country that would have made socialists very happy. In essence, the government would have completely nationalized housing finance in this country.

This bill was introduced in 2014. By 2017, the Corker/Warner Bill eased government involvement but it still advocated a system that was incredibly bureaucratic. Remember, the fear of another housing crisis that would cause a financial panic, was driving the thought processes of these legislators.

The Shelby Banking Bill was the least onerous. However, it was still very anti-Fannie and Freddie and it underlined the need to remove government support of the agencies.

### Thirty-Year Fixed Rate Mortgage

My view at the time and now is that none of these bills understood the history of the mortgage finance industry in this country. The underlying theme has always been if the government wanted more housing production it had to reduce the monthly payment on a home purchase. This was accomplished in two fashions:

- Lengthen the maturity on a fixed rate, self-amortizing mortgage; and
- Use some type of government backstop to insure that
  - Interest rates are low, and
  - That these mortgages are paid.

Simply stated, this means using 30-year fixed rate mortgages (FRM) with some type of government guarantee. I do not have exact figures here but I am confident that 4 of every 5 home mortgages in this country are in this category. Therefore, what brought the legislative thrusts down in the past decade is that they made no provision for the continuation of underwriting this product.

The assumption has always been that there is some way to obtain private sector support for underwriting 30-year FRMs. In essence, the legislators believed that private lenders could be incented to make 30-year loans with no government backstop at a time when interest rates in the United States were at the lowest in its history. Guess what – no private lenders bought in to this idea.

### Current Approaches

There are three current approaches being advocated at the present time to resolve the Fannie/Freddie dilemma:

- One is to “recap and release.” Basically, this means recapitalizing these companies and putting them back into operation pretty much as they always have functioned. Again, there is no precision here, but generally speaking this is an approach that the Democrats would accept particularly if the government guarantee was used to support the sale of low income housing.
- A second broad idea is to recreate Fannie and Freddie as mortgage insurance companies. In essence these two companies would have no government support or guarantees for their products. They would simply compete with other companies that insure financial instruments for the available business. The third GSE, Ginnie Mae, which is a wholly owned government corporation, would provide the 30-year guaranteed FRM. Senator Crapo supports this view
- A third idea is to spin the two GSEs out as traditional banks. They would receive no guarantees but they would be capitalized as banks and focus on the creation of mortgage loans. FHFA Director nominee Mark Calabria has advocated this position.

My guess, and given the plethora of ideas here it is definitely just that, the ultimate result will be a combination of points one and two:

- There will be no disruption of the current operations of the two companies.
- They would function solely as mortgage packagers and insurers, and they would lose the ability to buy or own any mortgages for their own portfolios.
- Plus, there would be a much heavier presence of Ginnie Mae in the guarantee arena. However, mortgage originators who wanted the guarantee would pay a heavy price for it, which would be passed on to home buyers.

## **Private Investors**

### Preferred Stock

Just as there are multiple guesses as to what the ultimate resolution of the Fannie/Freddie dilemma will be; there are just as many concerning the resolution of the rights of private shareholders. At present, it is believed that:

- Fannie Mae has an estimated 15 junior preferred issues outstanding with a total face value of \$19.1 billion. The stated yields on these issues ranges from 4.75% to 8.25% with some floating rate issues not considered. Assuming an average yield of 5.5% and 10 years of no payments, one might argue that the preferred shareholders in this company have lost \$10.5 billion in dividends.
- Freddie Mac has an estimated 19 junior preferred issues with a stated value of \$14.1 billion. The yields on these issues, also ignoring the floating rate offerings, range from 5.00% to 6.55% (there are 8 issues tied to LIBOR and constant maturity Treasuries of varying terms). Using the same assumptions as above, missed dividend payments might be \$7.8 billion.

The Federal Appeals Court in Washington has asked Judge Lambeth to determine if there is a contractual obligation to pay these dividends. It is also interested in knowing what the payment should be if there is to be a payment. To my knowledge the Judge has ignored this request.

Conversations with the plaintiffs in these cases suggests that there will be negotiations with the government as to what the payouts will be, if they occur. The thought is to look at the AIG settlements to determine how the payouts will work.

Mark Calabria has been nominated to head the FHFA. If he is confirmed by the Senate, which is highly likely, he will be the main negotiator on the government's side. He has written a number of comments on this subject and the overall disposition of Fannie and Freddie. He is an advocate of point 3 above.

On the issue, of government obligations to shareholders, he is as outraged as I am (only in his case it means something). The likelihood is high if he is to be the key decision maker on the government's side that the preferred shareholders will receive some payments. How much? Unknown.

### Common Stock

If I understand, the Appeals Court position properly, it sees no need to pay the common shareholders anything. There is no contractual arrangement between them and these two companies.

So what the common shareholder must rely upon is government greed:

- There are 1.3 billion shares of Fannie Mae stock outstanding. The government has warrants for 4.6 billion additional shares.
- There are an estimated 0.6 billion shares of Freddie Mac outstanding. The government has warrants for an estimated additional 2.6 billion.

If the decision is to pay the common shareholders nothing, then the government's warrants on an estimated 7.2 billion shares are worthless.

- Playing games with an Excel spreadsheet, one can make an argument that if the Senior and Junior preferred shares remain in existence the shares of Fannie and Freddie may be worth \$3 to \$4. apiece. The warrants could be worth some number above \$25 billion.
- If one assumes no new financing and the elimination of the senior and junior preferreds, then the stocks could be worth double digits and the warrants would have a substantially higher value.

However, if these two companies were to be cut loose a stock offering in each would be merited. How big this offering would be depends on whether the companies are to be set up as financial insurers or banks.

### **Conclusion**

There finally appears to be a reason for ending the conservatorship of Fannie Mae and Freddie Mac. The government needs a housing recovery. The people are being put in place to make this happen. It seems highly likely that if the new people have their way, junior preferred shareholders will gain some payments that makes buying these shares a reasonable speculation.

The risk reward calculation is far higher for buyers of the common shares. The risk, however, in this equation is too high for me to participate here.

### **Addendum**

#### **Brief History**

## Creation

Most investors are well aware of Fannie Mae's history so only brief comments are needed here primarily to emphasize the nation's historic need for this company. In the 1920s the typical mortgage was, what is euphemistically called, a "balloon" mortgage. The homeowner was required to make interest payments on a monthly basis and the full amount of the principal when the term came due in five years. This is not very different than home loans in Canada today. At the end of the term, the home is/was typically refinanced under similar footings.

The system worked reasonably well until the Depression. At that time borrowers could not repay the principal amount and lenders were not willing to "roll-over" the loans. They lacked the money to do so. Repossessions soared and the government entered the industry to alleviate the social problems that developed.

As one can imagine, the solution was not easily achieved. The first problem is that banks did not want to lend money to anyone other than the government for any reason. By 1944 only 16% of the banking industry's assets were in loans.

Therefore, in the 1930s the government had to utilize a series of new strategies to rebuild the home finance industry.

- The first step was to create a 20-year self-amortizing mortgage, which no bank was willing to issue.
- The second step was to create the Federal Housing Administration (FHA) to insure the new mortgages against any loss to the lender. The banks still did not want to originate the new mortgage instruments.
- The government then created the Federal National Mortgage Association (legacy FNMA) (the precursor to today's Fannie Mae) to buy all of the FHA-insured, 20-year self-amortizing mortgages in the open market. Bankers did not trust the government (wise men) so they still refused to originate the loans.
- Finally, the FHA and legacy FNMA worked out an arrangement with mortgage brokers whereby the mortgage brokers would originate the new loans get them insured and then sell them to legacy FNMA in bi-weekly auctions.

## Policy Device

This system was a winner; in 1950 new housing starts surpassed 2 million for the first time. The housing industry was a major key in stimulating the growth of the post war economy.

In fact, the system had been so effective that it became an accepted tool for helping the U.S. economy avoid recessions for the next 20 years. Whenever the economy slipped, legacy FNMA would increase the amount of loans that it would buy in its bi-weekly auctions.

This ultimately caused problems, however. The first was that the debt of legacy FMNA was the direct obligation of the United States government. In essence, it drove up deficits in bad times due to the agency's contra-cyclical purchasing policies. Moreover, a great deal of the assisted housing that legacy FNMA funded was rapidly turning into ghettos/slums. Additionally, many argued that the presence of FNMA in the markets distorted interest rates and the price of housing, which was true in my view.

## Reconfiguring the System

These latter considerations did not deter the government. In the late 1960s it was facing a new crisis. The nation was at war and a surprising number of its biggest cities were being put to the torch. The government created two commissions, one under ex-Senator Paul Douglas of Illinois and the other under the Kaiser Foundation to study housing and the urban problem. The solutions these commissions offered was to put poor people into their own houses based on the view that people do not burn down the houses that they own.

Therefore, programs were needed to get families and other households into their own homes. The Omnibus Housing Act of 1968 mandated that the government insure the building of 26 million new housing units by 1978. It was recognized that this could not be done under the Depression era system currently in use; particularly when a war had to be funded at the same time. So the government passed the Emergency Home Finance Act of 1970 that created:

- New mortgage documents including Section 235 and 236 mortgages which were subsidized at 1% rates.
- New private sector mortgage insurance companies.
- An array of new mortgage backed securities.
- New housing finance agencies that replaced legacy FNMA.
  - The Government National Mortgage Association (today's Ginnie Mae) was created to raise money for all government assisted housing programs.
  - The Federal Home Loan Mortgage Corporation (today's Freddie Mac) was created as a division of the Federal Home Loan Bank System until it was spun off to the public in 1989, to meet the needs of those banks and thrifts that had refused to participate in the depression era programs.
  - A new Federal National Mortgage Association, also owned by the public, was established to bring more funding into its traditional mortgage system and get its debt off the government budget.

Once again the government had a winner. In 1972, housing starts including mobile homes hit the 3 million mark, a level never seen before or since. The government met its goal of building 26 million new housing units by 1978.

## The Good Times Turn Sour

Initially, the markets focused on Ginnie Mae debt offerings. Their success allowed investors to reach out for higher yields and more risk. This meant acquiring traditionally structured mortgage backed bonds. Later it meant bonds backed by a wider variety of collateral from auto to credit card to student loan to other debt instruments.

It also meant taking on more risk in the housing sector. This included using negative amortization mortgages, interest only loans and other various modified loan packages to back new mortgage backed securities (MBS). It meant loosening underwriting standards to find more "qualified" borrowers for the new MBSs. Plus, outside of the Fannie Mae world it meant the creation of a variety of structured financial vehicles which came to be known as collateralized loan obligations, and collateralized debt obligations.

Inside Fannie Mae's world there was an intense competition for growth. The firm was in white heat to surpass the gains of Freddie Mac. The HUD regulators wanted more low income housing. Congressional committees were demanding more help for the low income households. Plus, and most importantly, new huge sources of funding had been developed due to the trade surpluses of East Asian nations. This money was seeking investments and was willing to fund just about any new set of demands for housing.

The result was a collapse. Too many of the new loans were no good. The securitized packages being purchased and guaranteed by Fannie Mae and Freddie Mac had major problems. Both companies had abdicated their responsibility to know what they were buying because it seemed each agency wanted to buy everything that it could and much that it could not – i.e., sub-prime loans and HELOCs.

### Salvage

The financial system collapsed in the fall of 2008 and Fannie and Freddie went with it. In late September 2008, the United States government took control of these companies through a conservatorship arrangement. It used this technique because it did not want to put the companies into bankruptcy and on to the nation's balance sheet. After almost five years of huge losses (there is another story here because the losses were actually not real), both companies broke into profitability in the first quarter of 2012.

In the interim, it is estimated that in this period Fannie and Freddie bought 90% to 95% of the newly originated mortgages. There would have been no housing recovery without these firms.

However, both the in-house and acquired portfolios were then downsized in accordance with conservatorship rules. They were reduced at the rate of 15% per year until they reached a core level of \$250 billion.

### **Conservatorship**

Under the conservatorship arrangement:

- The government purchased 1 million shares of Variable Liquidation Preference Senior Preferred Stock, Series 2008-2.
  - Investment
    - The initial price was effectively \$1,000 per share for a total of \$1 billion.
    - Subsequent to that event the Treasury invested an additional \$116.1 billion into Fannie Mae and \$72.6 billion into Freddie Mac.
  - Dividend.
    - The initial dividend was set at 10%.
    - In January 2013, the dividend was based on a complex formula (known as the Net Sweep) which in effect meant that the U.S. Treasury would receive as a dividend 100% of the company's increase in quarterly net worth.
- The government also received a warrant to purchase new stock at a nominal price up to an amount that would equal 79.9% of the newly diluted outstanding shares.

The terms of the Senior Preferred dividend eliminated all possibility that public holders of the firm's junior preferred stock would receive any payments at all even after the government has been repaid all amounts invested in the company. Thus, by the end of 2018, the U.S. Treasury will have received 286.0



billion with the sky's the limit going forward. Plus, the two firms still owe the original \$186.0 billion (initial investment not counted).

Common shareholders have no rights under the conservatorship and will receive no payments of any type, either. The decision to arbitrarily eliminate any ownership benefits from the public shareholders is being adjudicated based on more than one lawsuit. Basically the shareholders are claiming that the benefits of private property was expropriated by the government without payment somewhat like Castro's actions in Cuba and Chavez activities in Venezuela

The public stockholders are arguing that:

- The original move to place Fannie Mae into a conservatorship rather than into receivership was done because it was the government's intention to assist the company until it could return to normal operations. This was explicitly stated in HERA and at the time by the Director of the FHFA.
- The decision by the government to obtain 79.9% of the firm was made to leave a position for the existing public shareholders.
- The decision to eliminate any possibility of payments to the existing shareholders was not in accordance with the law.

### **Conclusion**

History argues that Fannie Mae and Freddie Mac have been an integral part in stimulating economic growth for decades the government needs these companies again. There may be something yet for the public shareholders.