Whither Fannie and Freddie?

Analysis of the housing GSEs’ staying power

The financial viability of Freddie Mac and Fannie Mae is of vital importance to the community banking industry. There is no debating this point. There are several reasons for this, not the least of which is that community banks, through their investment portfolios, own more Fannie and Freddie debt than ever before. As fallout from the midterm election results continues, the rhetoric will likely build for a near-term solution to the GSEs’ stay in purgatory.

Where do they stand from an ownership standpoint? What are their changing roles in mortgage finance? The GSEs’ ultimate resolution will tangibly affect how community banks build their bond portfolios in the future.

Original intent
Both Fannie Mae and Freddie Mac were originally chartered for the express purpose of creating a secondary market for single-family mortgages. They have had an unusual private-public ownership structure over the past 40 years, in which private investors owned the stock of these companies while the investment markets widely perceived that federal government would backstop their debt, including mortgage-backed securities (MBSs). Listening to government officials and Fannie/Freddie executives explain their awkwardly intertwined arrangement was like watching a group of sixth-graders at their first dance.

As the housing GSEs were beholden to their shareholders, they gradually drifted from their original mission and grew their balance sheets far beyond organic levels. By the early part of the last decade, a big chunk of their assets had nothing to do with high-quality conforming single-family mortgages. Worse, their leveraging grew far higher than what would be considered safe and sound for a commercial bank.

Get Flashed
ICBA Securities’ clearing broker, Vining Sparks, periodically issues an intraday newsletter titled Economic Flash. The newsletter will occasionally discuss matters concerning Fannie and Freddie’s evolving ownership. To be placed on the electronic distribution list, contact your ICBA Securities sales rep or visit www.icbasecurities.com.
Date of infamy
Sept. 7, 2008, was a day of reckoning for the shareholders of Fannie Mae and Freddie Mac. Then-Treasury Secretary Henry Paulson placed the two into conservatorship and effectively wiped out the stockholders. A special class of preferred stock owned solely by the Treasury was created to keep both statutorily capitalized.

In the 2½ years since then, Fannie and Freddie have primarily returned to their original mission: to purchase and securitize qualifying mortgages. Ironically, their role has grown in importance as many hundreds of mortgage companies have gotten out of the home lending business, as have some large depository institutions. The remaining mortgage originators in many cases are making these loans only because they can efficiently sell them immediately to Fannie and Freddie. More than 90 percent of mortgages originated in 2010 were sold or securitized by one of these two.

But this doesn’t mean the GSEs’ financial woes have subsided. Both have consistently posted quarterly losses ever since they became wards of the state. As of the end of 2010, you and I, as taxpayers, owned nearly $150 billion of their stock. That amount will continue to grow as they wade through billions in foreclosures. It could easily double.

Here’s the good news: Any bonds your community bank owns that were issued by Fannie Mae or Freddie Mac have gone up in price handsomely in the past eight months. It doesn’t matter the flavor of those bonds. Bullets, callables, step-ups, fixed- or adjustable-rate MBSs—take your pick.

This is courtesy of stagnant loan demand; declining inflation expectations; continuous jawboning by the Fed and Treasury about the GSEs’ importance to the housing sector, the financial system and the overall economy; and Treasury’s near-total commitment to honoring their obligations. In short, the investing public, understandably, is convinced that GSE debt is an obligation of the federal government.

Possible solutions
There remains a complete lack of consensus regarding Fannie and Freddie’s ultimate fate. Republicans talk bravely about privatizing them completely, and sooner than later. Democrats want to cut the purse strings but are wary of disrupting further an already sputtering housing market. All agree that the unknown additional billions it will take to clean up the foreclosure mess will make this task harder.

It is tough to envision a quick end, even a partial one, to the federal government’s commitment to Fannie and Freddie. Mortgage analysts have estimated that home borrowing rates are 1 to 2 percent lower than they otherwise would be without state support. So offloading them will not happen without cost to the consumer.

Meanwhile, community bank portfolio managers should be comfortable that their current holdings of this debt are well secured. Your market values are proof of that. It is highly likely that after some specific future date, Fannie’s and Freddie’s new debt will be completely private obligations with commensurately higher yields. But don’t worry; that date will be the brightest line ever drawn by the fixed-income market to denote an important before and after. Future columns will address the progression of this bellwether issue as new phases begin.

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