



## CRS Report for Congress

# Fannie Mae's and Freddie Mac's Financial Problems: Frequently Asked Questions

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### Summary

Recent turmoil in the housing and financial markets have caused concern over the future of Fannie Mae and Freddie Mac, which are chartered by Congress as government-sponsored enterprises (GSEs) and are widely believed to have an implicit guarantee from the federal government. Treasury Secretary Henry M. Paulsen, Jr. has proposed legislation to increase the two GSEs' line of credit with Treasury from its current \$2.25 billion each to an unspecified higher amount and to allow Treasury to purchase stock from Fannie and Freddie. The Federal Reserve has taken actions to allow Fannie and Freddie to borrow directly from the Fed.

The Office of Federal Housing Enterprise Oversight (OFHEO) — the GSEs safety and soundness regulator — has repeated assurances that Fannie and Freddie have adequate capital, but as highly leveraged financial intermediaries Fannie Mae and Freddie Mac have limited resources against losses.

This report will be updated as warranted.

**Why are Fannie Mae's and Freddie Mac's stock prices declining so much?** Recent increases in the evaluation of the risks that the Fannie Mae and Freddie Mac face in terms of future profitability and even continued financial viability may have combined to reduce the price that investors are willing to pay for a share of the enterprises.<sup>1</sup>

Fannie and Freddie are government-sponsored enterprises (GSEs) whose charters limit them to buying single family and multifamily home mortgages originated by others. This lack of diversification makes them more exposed to housing and mortgage market problems than other financial institutions such as commercial banks that have other lines

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<sup>1</sup> James R. Hagerty, Deborah Solomon and Sudeep Reddy, "Treasury and Fed Pledge Aid for Ailing Mortgage Giants" *Wall Street Journal*, July 14, 2008, p. A1; also James R. Hagerty, Deborah Solomon and Sudeep Reddy, "Mortgage Giants Face Pressure Over Capital" *Wall Street Journal*, July 11, 2008, p. A1.

of business. The GSEs have a special relationship with the federal government — sometimes called an implicit guarantee — that has allowed them to borrow at interest rates only slightly above those paid by the federal government.

The two GSEs are very highly leveraged versions of banks — they borrow money to lend, and they maximize profits by keeping their capital reserves close to the minimum necessary and permitted by their regulators. Unlike banks, they can only purchase home mortgages that others have made. Like banks, the GSEs are required by law and by their regulators to maintain a certain ratio between their loans and reserves to protect against loan losses. A key component of reserves is shareholders' equity or the current value of the shareholders' investments.

**What risks do Fannie Mae and Freddie Mac face in today's economic environment?** Fannie Mae and Freddie Mac have traditionally kept some of their mortgages in their investment portfolios and packaged others for sale as mortgage-backed securities (MBS). The GSEs guarantee timely payment of principal and interest of the mortgages in their MBS. The GSEs finance their portfolios of long-term (typically 30 year) mortgages with short-term borrowing (typically three months to five years). This increases the GSEs' profits because short-term borrowing is usually less expensive than longer term loans. This creates *interest rate risk*, which is the risk is that if short-term interest rates increase, profitability can be reduced or can even turn to losses. To try to reduce these risks, the GSEs use a variety of financial derivatives.

In a worst case scenario, the interest rate on short-term loans to the GSEs could increase enough to cause substantial losses and investors could stop entering into derivative contracts with the GSEs. This would leave the GSEs, who anticipated being able to roll over their short term debt, unable to refinance.

**What are some possible market-based solutions?** One part of a market-based solution for this would be for the GSEs to sell part of their mortgage portfolios to pay off their debts. But fears over *default risk* have reduced the market value of these existing mortgages. Fannie Mae's portfolio has relatively high credit quality overall, but OFHEO has called into question the credit quality of Freddie Mac.<sup>2</sup> The GSEs use derivatives to reduce, but not eliminate, default risk.

Another part of a market-based solution is for the GSEs to sell stock and to use the proceeds to finance their mortgage portfolios and to increase existing reserves to cover any losses. From the point of view of current holders of GSE stock (including senior management), this slices the pie that represents the value of each GSE into more pieces without making the pie any larger, diluting the value of the shares of existing stockholders.

**What risks do Fannie Mae and Freddie Mac create for the U.S. government?** In addition to the implicit guarantee, which all GSE debt is required by law to explicitly deny, some argue that the GSEs are too big and too interconnected to be allowed to fail. The argument is that because of their size and activity in various financial

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<sup>2</sup> Office of Federal Housing Enterprise Oversight, *Report to Congress: 2008*, p. 20 and 34, available at [<http://www.ofheo.gov/media/annualreports/ReporttoCongress2008.pdf>].

markets, if the GSEs were to be unable to borrow and enter into various derivative contracts, no one could. Another way to view this is that if in fact the GSEs carry little risk because of their government connections, then their financial market difficulties would suggest that much broader difficulties are being experienced by some other financial institutions lacking these government connections.

If the government were to lend money to the GSEs, there would be the risk that one or both GSEs would be unable to repay the loan. This risk could be reduced by requiring collateral in the form of assets or stock, but the value of the collateral could decline.<sup>3</sup> Another risk is that the Treasury might not charge the GSEs a high enough interest rate to cover Treasury's costs.

**What risks do Fannie Mae's and Freddie Mac's financial problems create for homeowners and those planning to become homeowners?** Fannie Mae's and Freddie Mac's financial problems create no risks for homeowners who want stay in their homes and who do not want to refinance. Homeowners would continue to pay their existing mortgages the same way as they do today.

There could be problems for those wishing to refinance, buy, or sell a home. In 2007, the GSEs financed 91.3% of the conforming mortgage market.<sup>4</sup> In the current financial environment, if the GSEs were unable to buy mortgages from originators, it is not clear that other investors such as commercial banks would step into the secondary mortgage market.

This could raise credit requirements and interest rates for anyone who wanted to refinance, take out a second mortgage, or get a home equity line of credit. Subprime and Alt-A borrowers might wish to refinance to obtain lower interest rates in the conventional market; others might wish to tap their home equity to pay for home improvements, college, or medical expenses. It could affect those who want to sell their homes because purchasers would have a more difficult time obtaining a mortgage and could pay a higher interest rate. The amount of this interest rate increase is difficult to predict.

The Economic Stimulus Act of 2008 raised the loan limit for Federal Housing Administration guaranteed loans in most high cost areas of the nation to the same maximum that the GSEs are permitted to purchase.<sup>5</sup> As a result, FHA-guaranteed loans in theory can replace most conventional loans.

**What is Fannie Mae's and Freddie Mac's financial position?** The Office of Federal Housing Enterprise Oversight (OFHEO), which is Fannie Mae's and Freddie Mac's safety and soundness regulator, has repeatedly said that the GSEs have adequate

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<sup>3</sup> The government has received stock in previous market interventions and has sometimes returned a small profit. See CRS Report RL34423, *Government Interventions in Financial Markets: Economic and Historic Analysis of Subprime Mortgage Options*, by N. Eric Weiss.

<sup>4</sup> *The 2008 Mortgage Market Statistical Annual*, Volume II (Bethesda, MD: Inside Mortgage Finance Publications, 2008), pp. 3, 9.

<sup>5</sup> P.L. 110-185, 122 Stat. 613 et seq.

capital.<sup>6</sup> In other words, according to OFHEO, the GSEs have sufficient funds to survive their current financial difficulties.

This is difficult to verify independently. Details of the GSEs' portfolios and guarantees are confidential proprietary information. In broad terms, the GSEs purchased slightly more than \$169 billion of private label subprime MBS in 2006 and 2007; they purchased slightly less than \$58 billion of Alt-A MBS in the same time period compared with a combined balance sheet of \$1.677 trillion.<sup>7</sup> At the end of 2007, the subprime and Alt-A MBS represented 13.5% of the GSEs' total assets.

In 2007, the two GSEs reported losses of just under \$5.2 billion. Prior to 2007, the GSEs had not reported a combined loss since 1982.<sup>8</sup> To make certain that the GSEs have adequate funds to cover potential losses, OFHEO (like all financial regulators) imposes capital requirements. At the end of 2007, the two GSEs had a \$24.8 billion surplus over the regulatory capital requirement of \$58.4 billion; they had a surplus of \$50.8 billion over the risk-based capital requirement of \$38.8 billion.<sup>9</sup> These amounts can be compared with the combined retained mortgages portfolios of \$1.434 trillion and the \$3.501 trillion in MBS that the GSEs guaranteed for a total of \$4.934 trillion.<sup>10</sup>

The regulatory capital surplus amounted to 0.50% of the \$4.934 trillion and 1.03% of the risk-based capital surplus. If the GSEs were to face losses in excess of their income by these percentages, they would be forced to either reduce their capital requirements by selling mortgages and MBS from their portfolios or to raise new capital from investors. The GSEs hold subprime and Alt-A MBS that are far in excess of their surplus capital.

OFHEO reports that the credit quality of the GSEs mortgage portfolios declined in 2007.<sup>11</sup>

**What are some things that Congress might consider to improve the financial condition of the GSEs?** Congress has previously acted to assist GSEs that were in financial difficulty. When Fannie Mae was losing significant amounts of money in 1982, Congress passed the Miscellaneous Revenue Act of 1982 that provided some tax benefits for Fannie Mae.<sup>12</sup> The Farm Credit System, another GSE, was aided with the

<sup>6</sup> OFHEO, Statement of OFHEO Director James B. Lockhart, July 10, 2008, available at [<http://www.ofheo.gov/newsroom.aspx?ID=440&q1=1&q2=None>].

<sup>7</sup> OFHEO, p. 113 and 116. Subprime and Alt-A MBS purchases prior to 2006 are not available. Alt-A mortgages are mortgages taken out by borrowers with good credit who decide not to provide documentation on income, assets, and/or property value.

<sup>8</sup> OFHEO, p. 115.

<sup>9</sup> OFHEO, p. 120.

<sup>10</sup> OFHEO, p. 116.

<sup>11</sup> OFHEO, p. 20-21, 33-34.

<sup>12</sup> P.L. 97-362, 96 Stat. 1726 et seq.

Agricultural Credit Act of 1987, which authorized the issuance of \$4 billion in bonds to support system members.<sup>13</sup>

Treasury Secretary Henry M. Paulson, Jr., has proposed legislation that would increase the Treasury's authority to lend the GSEs, from the current level of \$2.25 billion each to an unspecified amount and would authorize the Treasury to purchase GSE stock.<sup>14</sup> The Federal Reserve Board of Governors on Sunday, July 13, 2008, granted the New York Fed the authority to lend directly to the GSEs.<sup>15</sup> Part of the Treasury plan would have the Fed assist OFHEO in setting capital requirements for the GSEs. Media reports cite Representative Barney Frank, chairman of the House Committee on Financial Services, as saying that Congress could pass this legislation the week of July 14.<sup>16</sup>

The Administration has urged Congress to pass legislation to reform the regulation of the GSEs; the details of that legislation is quite controversial.<sup>17</sup>

**What are some actions that the federal government can do to address the financial condition of the GSEs?** Treasury, the Federal Reserve, the OFHEO, and the President currently have the power to take certain actions. The Secretary of the Treasury is authorized to lend the GSEs \$2.25 billion each, but this is more a symbolic amount than a total solution. Based on Fannie Mae's issuance of \$1.588 trillion in short term debt in 2007, the \$2.25 billion would have lasted less than 12.5 hours. Based on the \$598.6 billion issued of short term debt that Freddie Mac issued in 2007, the \$2.25 billion would have lasted just under 33 hours.<sup>18</sup>

In addition to the Federal Reserve's general authority to be a lender of last resort, the GSEs' charters give the GSEs a special relationship to the nation's central bank.<sup>19</sup> The Federal Reserve can use the GSEs' bonds purchased on the secondary market for open market operations.<sup>20</sup> This could indirectly help the GSEs by adding to the demand for their debt.

<sup>13</sup> P.L. 100-233, 101 Stat. 1568 et seq.

<sup>14</sup> U.S. Department of Treasury, Statement of Henry M. Paulson, Jr., *Paulson Announces GSE Initiatives*, July 12, 2008, available at [<http://www.treasury.gov/press/releases/hp1079.htm>].

<sup>15</sup> Federal Reserve Board of Governors, *Press Release*, July 13, 2008, available at [<http://www.federalreserve.gov/newsevents/press/other/20080713a.htm>].

<sup>16</sup> James R. Hagerty, Deborah Solomon and Sudeep Reddy, "Treasury and Fed Pledge Aid for Ailing Mortgage Giants" *Wall Street Journal*, July 14, 2008, p. A1, available at [<http://online.wsj.com/article/SB121597057216549037.html>].

<sup>17</sup> Executive Office of the President, "House Amendments to Senate Amendment to H.R. 3221 — Foreclosure Prevention Act of 2008," *Statement of Administration Policy*, May 2, 2008, available at [<http://www.whitehouse.gov/omb/legislative/sap/110-2/saphr3221-r.pdf>].

<sup>18</sup> Freddie Mac, *Debt Issuance by Trade Date*, available at [<http://www.freddiemac.com/debt/data/cgi-bin/debtissuance.cgi?order=TD>].

<sup>19</sup> The Fed's lender of last resort authority is delineated at 12 U.S.C. 343. Fannie Mae's charter is at 12 U.S.C. 1716b et seq; Freddie Mac's charter is at 12 U.S.C. 1401.

<sup>20</sup> 12 USC 347c.

OFHEO has general safety and soundness authority over the GSEs, including the ability to require, approve, monitor, and enforce remediation plans if the GSEs are found to be undercapitalized.<sup>21</sup> In an extreme case, OFHEO could appoint a conservator who would assume the powers of the shareholders, directors and officers of the corporation.<sup>22</sup> The speed with which OFHEO could take these actions would in part depend on the GSEs. The GSEs have the right to contest any of these actions, and the law sets out various periods of time for the GSEs to review proposed actions, to contest OFHEO's actions, and in some instances to appeal to the courts.<sup>23</sup>

The President can appoint five of the 18 members of each of these GSE's board of directors.<sup>24</sup> President George W. Bush has chosen not to appoint any.<sup>25</sup> By law, at least one director would come from the homebuilding industry, at least one from the real estate industry, at least one from the mortgage industry, and at least one would have community-based low-income housing experience.<sup>26</sup> It could be argued that this expertise might be helpful to the boards.

The federal government could improve GSE liquidity by lending to the enterprises from either the Treasury or the Federal Reserve. The government could purchase GSE stock to improve the GSEs' solvency by boosting capital and thereby increasing reserves against losses on their mortgage portfolios and mortgage guarantees; this option would require new legislation.

**Who invests in the GSEs?** There is little information available about who holds GSE stock, bonds, and MBS. The Fed reports statistics for combined ownership of government agency and GSE debt and GSE MBS. At the end of 2007, non-United States investors held \$1.479 trillion of \$7.397 trillion. Other large investors were U.S. commercial banks (\$929 billion), life insurance companies (\$388 billion), state and local government retirement funds (\$317 billion), mutual funds (\$566 billion), asset-backed securities issuers (\$378 billion), and the GSEs themselves (\$710 billion).<sup>27</sup>

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<sup>21</sup> 12 U.S.C. 4611 et seq.

<sup>22</sup> 12 U.S.C. 4620.

<sup>23</sup> 12 U.S.C. 4617 and 4623.

<sup>24</sup> 12 U.S.C. 1723(b) and 12 U.S.C. 1452(a)(2)(A).

<sup>25</sup> "Freddie Sets June 8 as Meeting Date," *National Mortgage News*, February 12, 2007, p. 6.

<sup>26</sup> 12 U.S.C. 1452(a)(2)(A) and 12 U.S.C. 1723(b).

<sup>27</sup> Federal Reserve, *Flow of Funds Accounts of the United States*, June 2008, p. 88, available at [<http://federalreserve.gov/releases/z1/Current/z1.pdf>].