The Government's Intervention into Fannie Mae and Freddie Mac

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Moderator: *Welcome to the Federal Reserve Bank of Atlanta's* Financial Update Focus *podcast. Today, we're joined by Scott Frame, an economist in the research division here at the Atlanta Fed. He'll be speaking about the government's intervention into Fannie Mae and Freddie Mac. Thank you for joining us today, Scott.*

Photo of Scott FrameScott Frame: Thank you, Tom.

Moderator: *Scott, could you briefly describe the role of Fannie Mae and Freddie Mac, both in the housing markets and in the larger economy?*

Frame: Sure. Fannie Mae and Freddie Mac are government-sponsored enterprises, or often referred to as GSEs, that participate in the secondary residential mortgage market. As an aside here, GSEs are kind of unusual financial institutions in that they are privately owned but they were actually created by Congress in order to fulfill a public mission.

Now, Fannie Mae's and Freddie Mac's participation in the U.S. mortgage markets takes two broad forms. The first is issuing credit guarantees against mortgage pools to create mortgage-backed securities—this is often referred to as their securitization business—and the second is the purchasing of whole mortgages loans and mortgage-backed securities, and this is referred to as their portfolio investment business. Together, these two institutions held, or guarantee, about $5.5 trillion, or roughly one-half, of U.S. residential mortgage debt. This $5.5 trillion is also equal to all of the privately held U.S. Treasury debt outstanding. The takeaway here, Tom, is that we are talking about enormous financial institutions that are central to U.S. housing markets.

Moderator: *Scott, you've written extensively about Fannie and Freddie's implied claims of government support for their obligations. What role, if any, do you think these claims played in the government's eventual conservatorship of the GSEs, and further, does the government's conservatorship of the companies in hindsight lend truth to those claims?*

Frame: Since their creation, Fannie Mae and Freddie Mac both have enjoyed implicit public-sector support. The markets' perception of an implied federal guarantee of the two GSEs' obligations arises from both provisions in the respective charters, which are actually individual acts of Congress, as well as past government actions to support troubled GSEs.

As financial conditions at Fannie Mae and Freddie Mac deteriorated during 2008, investors became increasingly concerned about the solvency of these two institutions. Both saw their stock prices tumble, and demand for their debt issues declined substantially as investors sought safety in the U.S. Treasury market. Ultimately, investors demanded clarity about the relationship between GSEs and the federal government as a precondition to continue to fund these two institutions. In my view, if the government had not intervened—first through Treasury investment authority and then via the conservatorship regimes—we likely could have witnessed a systemic event.

Moderator: *Well, let me ask you: In your opinion, what were the primary sources of Fannie and Freddie's financial distress?*

Frame: Well, Tom, as we know, house price declines experienced over the past two to three years have resulted in a tremendous wave of mortgage defaults and foreclosures that have, in turn, imperiled financial institutions with significant exposure to U.S. residential real estate. Fannie Mae and Freddie Mac both obviously fit this bill, as do many other financial institutions. Moreover, in Fannie and Freddie's case, both GSEs were very highly leveraged, meaning it didn't take a lot of losses, at least in a relative sense, to wipe out their capital. I would add that Federal Reserve officials had repeatedly warned about this over the past decade.

Now against this backdrop, Fannie Mae and Freddie Mac saw significant losses arising from, first, increased reserves against expected future losses on their credit guarantee business, meaning they needed to put aside reserves because they saw mortgage defaults and foreclosures rising and expected those increases to continue and so they needed to write down the value of those loans. They also saw mark-to-market losses on their own mortgage-backed securities, as well as holdings of subprime mortgage-backed securities. Many people don't realize this, Tom, but Fannie Mae and Freddie Mac were funding about one-quarter of the subprime mortgage market, or about $250 billion, at the outset of this crisis.

Moderator: *Based on their current condition and status, Scott, in your view, what will be the role of the housing GSEs in addressing the ongoing housing crisis?*

Frame: Well, since the imposition of the conservatorship regimes at Fannie Mae and Freddie Mac, both institutions are essentially now instruments of the federal government. As such, their attention to profitability has lessened substantially and instead been replaced by a focus on supporting government policy in the mortgage markets. One example of this is the administration's Homeowner Affordability and Stability Plan. Other examples of this have included the way that they've priced their credit guarantees since the conservatorship, as well as the terms of loan modifications that they've been accepting.

Moderator*: Scott, my last question to you is, in your opinion, what does the future hold for Fannie Mae and Freddie Mac?*

Frame: Well, that's a great question. In my personal opinion, I think Fannie Mae and Freddie Mac will remain in their current state of conservatorship at least until the housing and mortgage market storms have passed. Then a decision has to be made about whether to move some or all of their activities into the government permanently, to make them completely private, or simply reintroduce them in their old form back into the marketplace. Now, I'll add that this decision is further complicated by developments with other financial institutions with large mortgage exposures. I'm talking about troubles at thrift institutions, mortgage bankers, private mortgage insurance companies, and monoline bond insurers. Fundamentally altering Fannie Mae and Freddie Mac will have significant implications for all of these institutions, and I hope to spend some time this summer working through some of these issues.

Moderator: *Well, we will look forward to following your further research. Thank you, Scott.*

Again, we've been speaking to today with Scott Frame, an economist at the Atlanta Fed. This concludes our Financial Update Focus *podcast on Fannie Mae and Freddie Mac. For more information, please see the second quarter 2009 edition of* Financial Update. *On our Web site, www.frbatlanta.org, you can read Scott's working papers about this topic. Thanks for listening, and please return for more podcasts. If you have comments, please send us e-mail at podcast@frbatlanta.org.*