Fannie Mae and Freddie Mac

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Fannie Mae®

Origins of Fannie Mae

Great Depression → New Deal

- Personal income, tax revenue, profits, and prices all drop
- International trade drops by more than 50%
- U.S. unemployment at 25%
- Herbert Hoover laissez-faire approach to the economy
  - Rely on businesses to voluntarily keep the economy stable
- Some attempts at reform
  - Federal Home Loan Bank Act - new home construction
  - Emergency Relief and Construction Act (ERA) - public works programs
  - Reforms fell short, but laid some framework for New Deal

New Deal

- Franklin Delano Roosevelt elected in 1932
  - Promised to bring U.S. out of Great Depression
- New Deal
  - Collection of federal programs, public work projects, and financial reforms/regulations
  - Three R’s: Relief, Recovery, Reform
- Bank Holiday to restabilize banks with help from federal supervision
  - Led to federal insurance of deposits - Federal Deposit Insurance Corporation (FDIC)

Famous New Deal Legislation

Who knows some examples?

Key 1930s Reform Legislation

Year	Legislation	Provisions
1932	Reconstruction Finance Corporation (RFC)	Granted emergency loans to banks, life insurance companies, and railroads (passed during Hoover administration)
1933	Civilian Conservation Corps (CCC)	Employed young men (and a few women) in reforestation, road construction, and flood control projects
1933	Agricultural Adjustment Act (AAA)	Granted farmers direct payments for reducing production of certain products; funds for payments provided by a processing tax, which was later declared unconstitutional
1933	Tennessee Valley Authority (TVA)	Created independent public corporation to construct dams and power projects and to develop the economy of a nine-state area in the Tennessee River valley
1933	National Industrial Recovery Act (NIRA)	Sought to revive business through a series of fair-competition codes; Section 7a guaranteed labor's right to organize (later declared unconstitutional)
1933	Public Works Administration (PWA)	Sought to increase employment and business activity through construction of roads, buildings, and other projects
1934	National Housing Act—created Federal Housing Administration (FHA)	Insured loans made by banks for construction of new homes and repair of old homes
1935	Emergency Relief Appropriation Act—created Works Progress Administration (WPA)	Employed over 8 million people to repair roads, build bridges, and work on other projects; also hired artists and writers
1935	Social Security Act	Established unemployment compensation and old-age and survivors' insurance paid for by a joint tax on employers and employees
1935	National Labor Relations Act (Wagner-Connery Act)	Recognized the right of employees to join labor unions and to bargain collectively; created a National Labor Relations Board to supervise elections and to prevent unfair labor practices
1935	Public Utility Holding Act	Outlawed pyramiding of gas and electric companies through the use of holding companies and restricted these companies to activity in one area; a "death sentence" clause gave companies five years to prove local, useful, and efficient operation or be dissolved
1937	National Housing Act (Wagner-Steagall Act)	Authorized low-rent public housing projects
1938	Agricultural Adjustment Act (AAA)	Continued price supports and payments to farmers to limit production, as in 1933 act, but replaced processing tax with direct federal payment
1938	Fair Labor Standards Act	Established minimum wage of 40 cents an hour and maximum workweek of 40 hours in enterprises engaged in interstate commerce

Fannie Mae

- Federal National Mortgage Association (FNMA)
- Part of Second New Deal - Founded in 1938
- Purpose: Expand secondary mortgage market
    - Securitize mortgages through mortgage-backed securities (MBS)
    - Allows lenders to reinvest assets into more lending
        - Increases the number of lenders in the mortgage market by reducing reliance on locally-based savings and loan associations/thrifts
- Fannie Mae would buy mortgages from lenders to free up capital that could go to borrowers

History

- Great Depression caused chaos in the housing market
  - In 1933, 20% to 25% of U.S.'s outstanding mortgage debt was in default
- Fannie Mae was created by amendments to the National Housing Act
  - First chartered as National Mortgage Association of Washington
  - Gives local banks federal money to finance home mortgages
  - Attempted to increase amount of home ownership and the availability of affordable housing
  - Could buy and sell mortgages

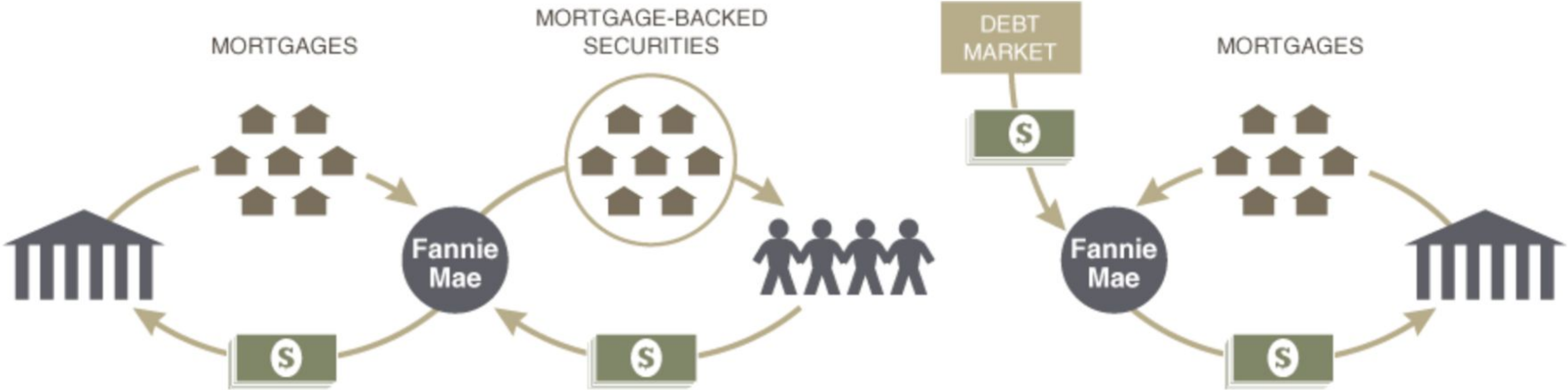
Monopoly over Secondary Mortgage Market

- Federal government wanted to facilitate home mortgages
  - Energize residential construction industry
  - Provide housing for citizens
- Rejuvenate lending institutions by stimulating cash flow for new loans
- Formed liquid secondary mortgage market
- Fannie Mae bought insured mortgages from the Federal Housing Administration (FHA) from private lenders
  - Would either keep the mortgages in own portfolio or sell to private investors
    - Leads to formation of liquid secondary mortgage market

Benefits

- Private lenders more confident about making FHA-insured mortgages
  - Lenders assured that they could turn the mortgages into cash if needed
    - Leads to more inclined to extend mortgage credit
- Smooth out housing market between capital-rich and capital-poor areas
  - Buy and sell loans across the country through Fannie Mae

Fannie Mae's Operations



Fannie Mae **takes mortgage loans** from banks, in order to repackage them in the form of **mortgage-backed securities**. There are limits on the types and size of loans it can guarantee.

Those **mortgage-backed securities are sold** to investors, and Fannie Mae guarantees that the loans will be repaid.

Fannie Mae also **borrows money from the debt markets**, traditionally at a rate much lower than other banks, and uses it to **buy mortgages it holds as its own investments**. By buying these loans, Fannie injects new money into the housing economy.

1949 Expansion of Fannie Mae

- In 1949, Fannie Mae began buying and selling loans guaranteed by the Veterans Administration (VA).
- Whereas the association purchased 6,734 loans in 1948, that number rose to 133,032 in 1950.
- Critics argued that this addition made the government too involved with the private sector.

Federal National Mortgage Association Charter Act

- The Housing and Home Finance Agency acquired Fannie Mae from the Federal Loan Agency in 1950.
- A 1954 amendment by Congress, the Federal National Mortgage Association Charter Act made Fannie Mae a mixed-ownership corporation.
    - Mortgage lenders now had to own common stock to be able to sell mortgages.
- The enterprise became responsible for
    - Providing special assistance to the President or Congress with certain mortgages.
    - Managing mortgages obtained before 1954.

The Largest Mortgage Buyer

- Primary mortgage lenders were temporarily unable to to make new mortgages, because they lacked the required liquid resources in 1966.
- Fannie Mae became the largest mortgage buyer in the market.
- Fluctuating periods of high borrowing costs that caused the association's profits to fall signified the need for major change.

Transformation

- In 1968, Fannie Mae transitioned from a mixed-ownership corporation to a private one, thus separating its activity and debt from the federal budget.
- The Housing and Urban Development Act of 1968 split Fannie Mae in two, the new Fannie Mae and the Government National Mortgage Association (GNMA), or Ginnie Mae.

The New Fannie Mae and Ginnie Mae

- The new Fannie Mae conducted secondary mortgage market activities as was done before.
- Ginnie Mae assumed the government assistance and mortgage management functions and guaranteed FHA and VA mortgages.
- The Department of Housing and Urban Development (HUD) oversaw the new Fannie Mae.

Fannie Mae in 1970

- Oakley Hunter became the new president of Fannie Mae in January 1970 following the removal of Raymond H. Lapin by President Richard Nixon.
- Fannie Mae’s transition to private control was completed on May 21, 1970, and the corporation went public on the New York and Pacific Exchanges.
- The board of directors comprised fifteen members, ten of whom were elected by stockholders and the remaining five who were appointed by the president.
- The federal government authorized Fannie Mae to purchase mortgages not insured by the FHA, VA, or Farmers Home Administration (FmHA), also known as conventional mortgages.
- Freddie Mac was established to compete with Fannie Mae and expand the secondary mortgage market.

Downturn for Fannie Mae

- Fannie Mae was susceptible to a rise in interest rates that began in 1979 and lost millions of dollars borrowing at high rates.
- New chairman David O. Maxwell instituted a number of programs to hand over some of this interest-rate risk.
- One of these initiatives was buying adjustable-rate mortgages, to which many primary lending institutions were shifting.
- In 1981, Fannie Mae began selling mortgage-backed securities (MBS) to assist with financing its mortgage purchases and to generate fee income.
- Institutions traded loans directly for more liquid securities with the MBS swap program.

Recovery and Renewal

- Fannie Mae was profitable once again by 1985.
- The enterprise started to borrow money from abroad to finance its purchases and to market real estate mortgage investment conduits (REMIC).
  - These securities had adjustable maturity dates that attracted unconventional investors.
- On its fiftieth anniversary, Fannie Mae had put $400 billion into the U.S. mortgage industry.
  - $300 billion came after 1980.
- It was added to the Standard and Poor’s 500 stock index in 1988.

The 1990s

- The Fannie Mae Foundation for charitable contributions was established in 1979.
- The association began its Opening Doors to Affordable Housing, Trillion Dollar Commitment, and Partnership Office initiatives.
- The Housing and Community Development Act of 1992 amended Fannie Mae's charter with the provision that the corporation meet annual affordable housing goals established by HUD and approved by Congress.
- The corporation extended its activity into the subprime market by increasing the ratio of loan portfolios in distressed inner cities areas outlined by the 1977 Community Reinvestment Act.
- In 1999, Fannie Mae adjusted its mission statement to emphasize affordable rental housing and homeownership.

Freddie
Mac

Introduction of Freddie Mac

- 1970 - established by Congress as a private corporation through the Emergency Home Finance Act
- Founded to increase competition for the new privately held portion of Fannie Mae
- Authorized to create a secondary market for conventional mortgages (those that lack federal backing)
- Main difference = purchases mortgages from smaller “thrift” banks instead of commercial banks
- Currently regulated by the Federal Housing Finance Agency

Freddie Mac is a shareholder-owned, government-sponsored enterprise (GSE) whose people are dedicated to improving the quality of life by helping to make the American dream of decent, accessible housing a reality. We accomplish this mission by linking Main Street to Wall Street.

“Our statutory mission is to provide liquidity, stability and affordability to the US housing market.”

What is a “GSE”?

- Consists of privately held corporations with public purposes
- Created to reduce the cost of capital for certain borrowing sectors of the economy
- Carry “implicit backing”, but no direct obligations

Early Mortgage-Backed Securities

- 1970 - first MBS offering by GNMA, face value of $70M, investors bought fraction of security
  - “Pass-throughs” - passed principal and interest payments on mortgages through to the investor
- 1971 - Freddie Mac issued first MBS
- 1981 - Fannie Mae issued first MBS
- Pension funds, mutual funds, insurance companies, and banks are all buyers of these securities
- Disadvantages: credit risk, interest rate risk, prepayment risk (option to prepay underlying loans if rates fall)

Introduction of CMO’s

- 1983 - Freddie Mac issued first multi-class MBS (Fannie Mae in 1985) through Salomon Brothers and First Boston
- Consists of a pool of mortgages organized by maturity and risk
- Distribute principal and interest payments based on predetermined rules and agreements
- Structure:
  - Tranches: groups of mortgages organized by their risk profiles, have different principal balances, interest rates, maturity dates and repayment defaults
  - Tranches retired in order of priority
- 1986 - Congress created the Real Estate Mortgage Conduit (REMIC) to facilitate issuance of CMO’s
- Disadvantages: still uncertainty as to when the early tranches will be paid off

Financial Institutions Reform, Recovery and Enforcement Act

- 1989 - “FIRREA” was passed, response to Savings and Loans crisis
- Cut Freddie Mac’s ties to the Federal Home Loan Bank System
- Made regulation of Freddie Mac and Fannie Mae consistent
- Formed an eighteen-member board of directors of Freddie Mac, subject to oversight by HUD
- Converted stock into Voting Common Stock
- Listed on NYSE between 1984 and 2010
- July 8th, 2010 - common stock exclusively traded on OTC under ticker symbol, FMCC

Other important dates...

- 1995 - Freddie Mac began receiving affordable housing credit for buying subprime securities
- 2004 - HUD suggested the company was lagging behind and should “do more”
- 2008 - Freddie Mac put under conservatorship of the U.S. federal government

Linkage of Markets

- Conducts business in both the US residential mortgage market and the global securities market
- Links U.S. homebuyers with the global capital market

“Player” of Two Markets:

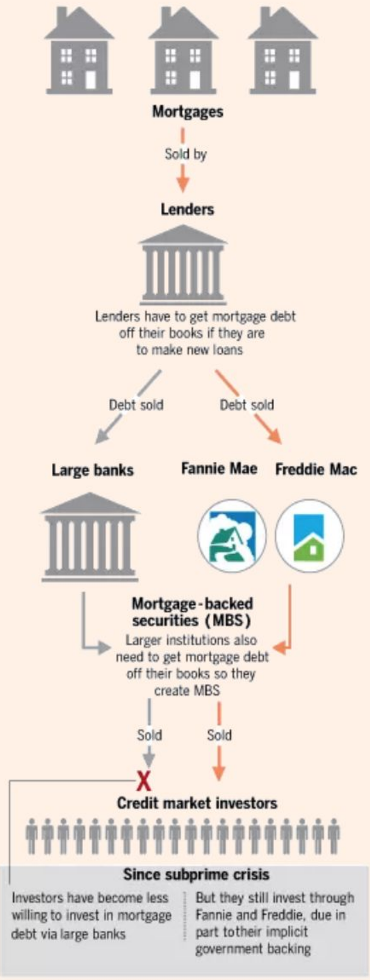
1. U.S. Residential Mortgage Market → finances mortgages through guaranteed mortgage securities backed by pools of mortgages and other financial instruments in the global capital market
2. Global Securities Market

Profit-Driven Company with a Public Mission

How does Freddie Mac make profit?

1. Guarantee Fee Income
    - When principal and interest is passed along to the holder of the MBS, Freddie Mac keeps a percentage of the interest as a guarantee fee for assuming credit risk
    - Similar to an "insurance policy" - guarantees that the principal and interest on the underlying loan will be paid back regardless of whether the borrower actually repays
2. Retained Portfolios
    - Invest heavily in other MBSs
    - Because of implied Federal guarantee, able to issue a debt at yields lower than other corporations
    - Earn spreads on their portfolios which are greater than other institutions because of this funding advantage

How the US mortgage market works



Source: *FT research* FT Graphic

Fannie Mae® & Freddie Mac

Freddie Mac and Fannie Mae: Similarities

- Both were established to promote housing market and mortgage sale
- Though Fannie Mae was established first, both buy mortgages from banks (anything from small individual banks to larger retail banks)
- After purchasing mortgages from private banks, the enterprises rebrand them as MBSs and sell them on the secondary market
- With regard to the financial crisis of 2008, the two organizations were treated fiscally and legally as one body

Freddie Mac and Fannie Mae: Differences

- Freddie Mac was established to compete with Fannie Mae and allowed it to buy non-FHA mortgages and translate them into MBSs
- Fannie Mae purchases mortgages from more retail banks whereas Freddie Mac purchases from more thrift banks
- Freddie Mac buys mortgages that do not have government guarantees for its loans and wants to transfer the risk of default

Ginnie Mae vs. Freddie Mac and Fannie Mae

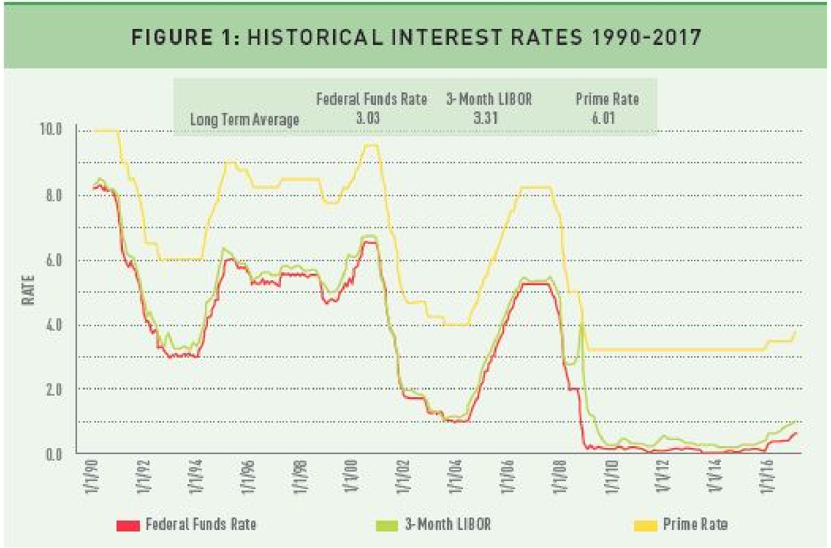
- Ginnie Mae is a government-run organization that guarantees MBSs
- Ginnie Mae insured bonds have the explicit government backing, whereas Freddie Mac and Fannie Mae do not
- Unlike a treasury bond, Ginnie Mae funds can lose value if interest rates go up
- All three type of securities follow similar up-down trends in the market

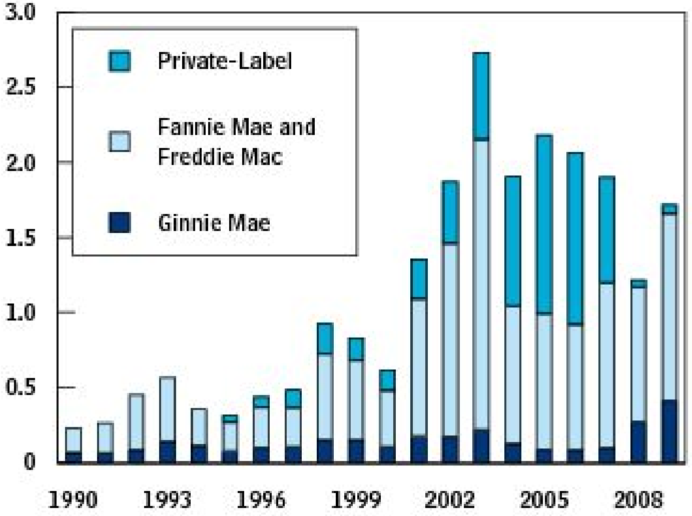
Freddie and Fannie in the Early 2000s

- In 2001, Freddie Mac and Fannie Mae controlled 43% of the the Housing Market
- In 2003, they controlled over 90% of the market

- Through $75 million spent on an advertisement in 2000, Freddie Mac and Fannie Mae positioned themselves as the “purveyor of the American Dream of homeownership”

Interest Rates in the Modern Era





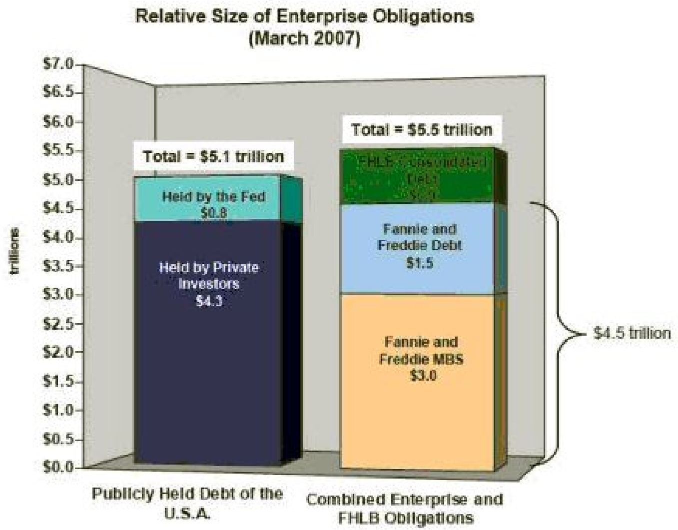
What was the Subprime Mortgage Crisis?

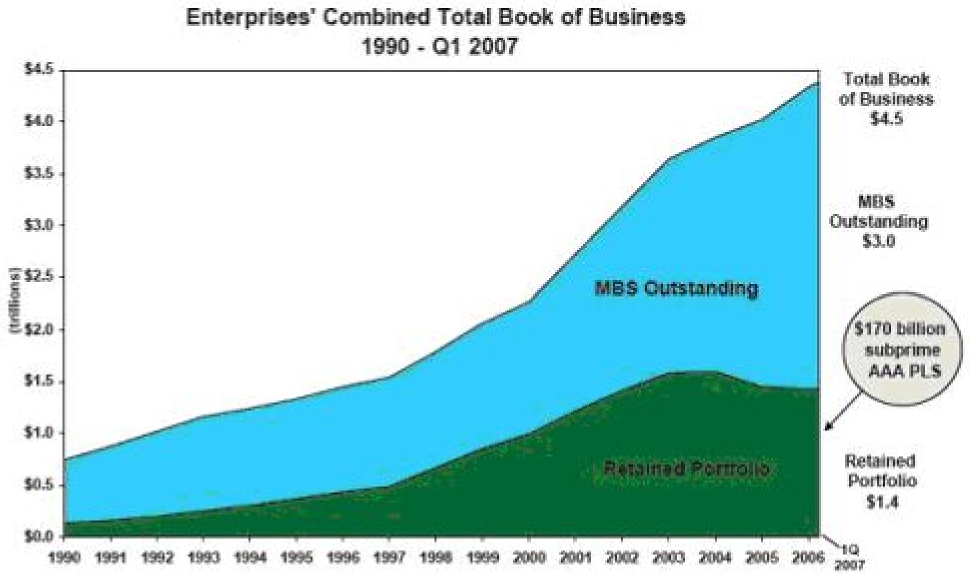
- The mid 2000s were characterised by a housing boom which was correlated with a decrease in interest rates
- Increased housing and easily accessible loans lead lenders to offer home loans to individuals with poor credit and high risk profiles
- Sharp increase in high risk mortgages started in early 2007
- When the real estate bubble burst, many high risk borrowers were unable to make payments on their mortgages

How were Freddie Mac and Fannie Mae Involved?

- GSE status of the two enterprises meant that they had government support while remaining more autonomous due to lack of bureaucratic oversight
- Investors favored the two GSEs over private bank mortgages due to the implied fiscal security
- The two provided MBSs that historically averaged over 35 points (.35%) higher than Triple A rated Treasury Bonds.
- The burst of the housing bubble led to the meltdown of liquidity in MBS, leading to a bailout on September 17, 2008 costing a total of $187 billion

Breakdown of the Mortgage Market





Freddie Mac and Fannie Mae in Recent News

- Biggest investor is the United States government
- High uncertainty due to high political impact and externalities has caused the prices of stock to drop after the subprime crisis
- Since 2012, the GSEs paid over $200 Billion in dividends to the U.S. Treasury
- Bills preventing the Treasury from collecting dividends cyclically appear before Congress

Freddie Mac and Fannie Mae in Recent News

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