BUDGET BULLETIN
A WEEKLY BULLETIN PRODUCED WHEN THE SENATE IS IN SESSION.
COMMITTEE ON THE BUDGET Republican Staff
Judd Gregg, Ranking Member
202/224-0642 http://budget.senate.gov/republican

111th Congress, 2nd Session: No. 5a December 14, 2010

INFORMED BUDGETEER:

WHAT ABOUT FAN AND FRED?

- When the 112th Congress opens for business next month, it will expect the Obama Administration to submit a comprehensive proposal for housing finance reform, as required by the Dodd-Frank Wall Street Reform Act enacted over the summer. In preparation for that report, the Treasury held a conference on "the future of our nation's housing finance system, including Fannie Mae and Freddie Mac," whose operation is now controlled by the U.S. government under the conservatorship action that the Treasury took in September 2008 as those two entities were about to go bankrupt.

- Before examining the Administration's proposal on the future of the housing finance system – and the role, if any, of the government-sponsored enterprises (GSEs) Fannie and Freddie in that future system – it will be important to understand past and present developments in housing finance. This *Bulletin* seeks to provide those basics for budgeteers. (For a more comprehensive treatment, please see CBO's report from January 2009.)

Thumbnail Sketch of GSE History

- One of CBO's many reports over the past 20 years on the risks posed by Fannie Mae and Freddie Mac succinctly summarized the rationale for and early history of those two entities:

> Fannie Mae, Freddie Mac, and the Federal Home Loan Banks—collectively, the housing GSEs—were created to provide liquidity and stability in the home mortgage market, thereby increasing the flow of funds available to mortgage borrowers. . . Fannie Mae was originally created as a wholly owned government corporation in 1938 to buy mortgages, primarily from mortgage bankers, and hold them in its portfolio. Although it was converted into a GSE in 1968, Fannie Mae continued the practice of issuing debt and buying and holding mortgages. Freddie Mac, created in 1970 as part of the Federal Home Loan Bank System, bought mortgages primarily from thrifts. Rather than holding the mortgages in its portfolio, Freddie Mac pooled them, guaranteed the credit risk, and sold interests in the pools to investors—creating mortgage-backed securities.

- While Fannie Mae had been part of the federal budget after it was created in 1938, the *Report of the President's Commission on Budget Concepts* (p. 29) in 1967 recommended that if "the Federal intermediate credit banks [aka GSEs] are completely privately owned, they…should be excluded from budget receipts and expenditures." Accordingly, when Fannie Mae began to offer for sale shares of stock to the public in 1968, it also went off the federal unified budget. Freddie Mac was similarly excluded from the federal budget when it was created in 1970.

- Despite the fact that both GSEs were owned by stockholders, the GSEs' federal charters conferred certain benefits from and connections to the federal government that, in the eyes of the markets, suggested an implicit backing by the federal government of the GSEs' activities. As a result, the GSEs were able to borrow money almost as cheaply as the Treasury did because the markets viewed GSE debt as nearly as safe. And investors such as pension funds, sovereign wealth funds, central banks of other countries, and financial institutions all bought GSE debt as a "safe" investment comparable to Treasury debt.

- Many factors – long predicted by experts and ignored by successive Congresses and administrations – combined to produce the spectacular collapse of Fannie and Freddie at the end of the Summer of 2008:

  ✓ The GSEs were chartered to keep the flow of mortgage financing available throughout the U.S. In recent years, they did this by purchasing mortgages from originators, packaging them into mortgage-backed securities (MBS), and selling them to investors and charging a fee for a guarantee. Then the GSEs would take the proceeds to buy more mortgages from originators who would make more home loans. In addition, the GSEs held increasingly larger amounts of mortgages in their own portfolio (that were financed by debt) in order to increase their profits and stock price (even though it exposed them to significantly more risk), and also reported inflated earnings, all which had the effect of augmenting the compensation of Fannie and Freddie executives, as documented by their regulator.

  ✓ The GSEs aggressively and successfully lobbied members of Congress and a series of presidents and their administrations against efforts to require the GSEs to hold more capital (because it would have reduced their profits) that would have provided more of a buffer against bankruptcy.

  ✓ In the run-up of the housing bubble, the GSEs lowered their underwriting standards so they would not lose market share to other market participants who were making poorly documented loans to borrowers who were destined to default.

  ✓ The collapse of housing prices not only resulted in losses on the GSE-guaranteed loans that deviated from sound underwriting, but also produced defaults on otherwise routine loans where the borrowers found themselves underwater or under foreclosure in combination with the loss of income from unemployment associated with the recession.

- At the end of 2009, Fannie and Freddie together owned or guaranteed $5.5 trillion residential mortgages, or about 47% of the nation's $11.7 trillion in outstanding residential mortgages.

Chronology of Conservatorship

- On July 30, 2008, the Housing and Economic Recovery Act of 2008 (HERA) was enacted (according to the Bush Administration) to provide the Treasury with tools to "increase market confidence in the housing [GSEs] and to aid the stability of the financial system by providing the Treasury Department with the temporary authority to assure the GSEs continued access to liquidity and capital."

- To address the concern that Fannie and Freddie had gotten into trouble partly because of insufficient supervision, HERA created the Federal Housing Finance Agency (FHFA), a regulator with enhanced authority to oversee Fannie and Freddie. FHFA replaced the Office of Federal Housing Enterprise Oversight (OFHEO), an independent agency (nonetheless situated within the Department of Housing and Urban Development) created in 1992 that was previously responsible for monitoring the safety and soundness of Fannie and Freddie.

- From 1992-2008, OFHEO had the authority to place the GSEs into conservatorship (but never did). HERA continued the GSE regulator's authority to appoint a conservator for the GSEs if they become undercapitalized (i.e., don't have enough money to pay their obligations), **plus it provided a funding mechanism**

to continue to operate the GSEs (such a funding mechanism had not been available to OFHEO).

- Specifically, HERA gave the Treasury temporary authority (expiring on December 31, 2009) to purchase an **unlimited** amount of stock from Fannie and Freddie if the Treasury Secretary determined it necessary to provide stability to the financial markets, prevent disruptions in the availability of mortgages, and protect the taxpayer. (Although then-Treasury Secretary Paulson asked for that authority, he claimed in the Summer of 2008 that he never expected to use it.)

- HERA also mandates that, in certain instances, FHFA place the GSEs into receivership rather than conservatorship (OFHEO never had the authority to place a GSE into receivership). For example, if FHFA certified that a GSE's obligations exceeded the assets any time during preceding 60 days, then HERA requires FHFA to place the GSE into receivership.

Conservatorship vs. Receivership of a Financial Institution

Conservatorship is the legal process in which a court orders or a regulator appoints a person or entity to establish control and oversight of a company to put it in a solvent condition. A conservator is the person or entity appointed to continue to operate the company, conserve its resources, and restore it back to profitability. In a conservatorship, the powers of a company's directors, officers, and shareholders are transferred to the conservator.

In contrast, in a receivership, the appointed receiver closes down the operations of a company and liquidates it by selling the assets and paying company obligations (to the extent possible) according to priority established in law.

- On September 6, 2008, the Director of FHFA placed Fannie and Freddie into conservatorship of the United States Government, without any announcement of a date certain for how long that conservatorship would last (instead, the Director said "FHFA will act as the conservator to operate the [GSEs] until they are stabilized").

- The next day, then-Treasury Secretary Paulson executed a contract (called a Senior Preferred Stock Purchase Agreement – SPA) with the GSEs saying he would buy **up to $100 billion** in stock from each GSE – putting what would be only a *temporary, initial dollar limit* on the use of the unlimited authority granted under HERA (but there was *no time limit* on when the GSEs could make draws under this contract).

- Paulson said the SPAs would "ensure that each company maintains a positive net worth," and were made "necessary by the ambiguities in the GSE Congressional charters, which have been perceived to indicate government support for agency debt. . . . the U.S. Government created these ambiguities, we have a responsibility to both avert and ultimately address the systemic risk now posed by the scale and breadth of the holdings of GSE debt."

- Under these SPA contracts, the Treasury makes capital infusions on a quarterly basis in amounts equal to the negative net worth (the amount by which liabilities exceed assets at that point in time on the basis of generally accepted accounting principles) that each GSE reports on its balance sheet. In exchange, the entities give the Treasury senior preferred stock with an annual dividend of 10 percent (basically, the stock acts like a debt instrument where the GSEs pays 10 percent interest on the principal, which is the amount of the stock purchase). By making these payments, the Treasury ensures that each GSE maintains a positive net worth, thereby avoiding the requirement in HERA that the federal government place Fannie or Freddie into receivership when their obligations have exceeded their assets during the preceding 60 days.

- On February 18, 2009, Paulson's successor, Treasury Secretary Geithner, amended the initial SPA contracts by pledging that Treasury was prepared to expand its amount of stock purchases from Fannie and Freddie up to a limit of **$200 billion each**.

- On December 24, 2009 (seven days before the authority under HERA to enter into any contract with the GSEs was going to expire), the Treasury further amended the SPAs, pledging that Treasury would purchase **as much stock as necessary to keep each GSE solvent through December 31, 2012**.

- The outcome of this chronology is that there are two parts of the contract assistance that Treasury has to keep track of in terms of dollars or time.

- As shown in blue in the table below, Treasury is currently providing assistance under the part of the contracts whereby they can provide an unlimited amount of cash (aka buy unlimited stock) from the GSEs up until December 31, 2012, so far handing over a gross $10 billion to Fannie and $12 billion to Freddie (the next payment totaling about $3 billion is expected on December 31, 2010).

Treasury Infusions To-Date under SPA Contracts
($ in billions)

Source of SPA Authority	Fannie	Freddie	Total
Amount received to-date under Feb. 18, 2009 amendment (and the initial, preceding contract of $100b) with authority up to $200b	**75**	**51**	**126**
Total amount *remaining* under Feb. 18, 2009 contract (available to be used after 2012)	*125*	*149*	*274*
Amount received under Dec. 24, 2009 contract with unlimited $ authority (expires Dec. 31,2012)	**10**	**12**	**22**
Total Gross Payments To-Date from Treasury to GSEs	**85**	**63**	**148**
MEMO: Draws on SPAs expected on December 31, 2010	**3**	**a/**	**3**

a. Less than $500 million
Source: http://www.fhfa.gov/webfiles/19475/TreasFED11052010.pdf

- Under the initial part of the contracts (now in hiatus through December 31, 2012), Treasury has provided a gross $75 billion to Fannie and $51 billion to Freddie (shown in red). On January 1, 2013, Treasury will still have authority to provide another $125 billion in assistance to Fannie Mae and $149 billion to Freddie Mac, with no time limit on when Treasury can provide that assistance (and regardless of the amount the GSEs receive between January 1, 2010 and December 31, 2012).

- Gross Treasury payments to the GSEs to date total to $148 billion (in green).

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WHAT ABOUT FAN AND FRED? (CONTINUED)

- Note that, thus far, the GSEs have been losing too much money to pay hardly any of the required dividends to Treasury as required under the SPAs. So they have had to ask Treasury to give them $16 billion (through subsequent draws on the SPAs) to pay the cash dividends they were required to pay to Treasury as a result of previous sales of stock to Treasury. Since these dividend payments are essentially a payment from the Treasury to itself, they do not represent a net cost to the taxpayer; so the net cost of Treasury's stock purchases to-date has been $132 billion, not $148 billion.

Conflicting Budgetary Treatments Perpetuates Confusion

- Certainly, these cash transfers represent large amounts of assistance from the federal government in support of the GSEs, but do they tell policymakers everything they need to know about the extent of taxpayers' exposure to the costs associated with the federal government's backing of the GSEs?

- Continued conflicting budgetary treatments by the two key budget agencies – the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) – suggests that the Executive Branch is not being transparent about its actions in propping up Fannie and Freddie.

- After the U.S. government assumed control of Fannie and Freddie in September 2008, CBO, under then–Director Peter Orszag, observed in its *Budget and Economic Outlook* in January, 2009:

> because of the extraordinary degree of management and financial control that the government has now exercised,… the [GSEs] should now be considered federal operations. Although the GSEs are not legally government agencies and their employees are not civil servants, CBO believes it is appropriate and useful to policymakers to account for and display the GSEs' financial transactions alongside all other federal activities in the budget.
>
> That view is consistent with the principles expressed by the 1967 President's Commission on Budget Concepts, which asserted that "the federal budget should, as a general rule, be comprehensive of the full range of federal activities. Borderline agencies and transactions should be included in the budget unless there are exceptionally persuasive reasons for exclusion." The commission suggested certain broad criteria to help make such determinations. For example, who owns an entity and selects the managers? Do the Congress and the President have control over an entity's program and budget, or are its policies set primarily in response to private owners and not to accomplish some broader public purpose? Clearly, Fannie Mae and Freddie Mac are currently controlled and operated by the federal government and heavily dependent on the government for their access to the credit markets.

- Since 1968, the GSEs had not been shown as part of the federal budget. But as a result of the conservatorship action in September 2008, CBO began showing the effect on its deficit projections, recognizing that Fannie and Freddie had become part of the federal budget.

- Because Fannie and Freddie were now effectively tools of the federal government for providing credit assistance for home mortgages, CBO decided to use the same credit budgetary accounting treatment (accrual – computing the present value of anticipated cash flows) that has applied to all other federal credit programs (such as student loans and small business loans) since enactment of the Federal Credit Reform Act of 1990.

- In addition, CBO decided to use a discount factor that recognizes the riskiness of those cash flows, similar to what the law required CBO and OMB to use for the Troubled Assets Relief Program (enacted in the Fall of 2008).

- Just as for other federal loan programs, CBO prepared estimates of the subsidy cost associated with the various loan cohorts in the GSEs' past and future loan portfolios.

- CBO first prepared an estimate of the subsidy cost of the GSEs' "old book of business" at the time of their takeover in September 2008. Since the federal government had appointed itself the conservator of the GSEs and had pledged in contract to make payments to the GSEs to prevent their insolvency, the federal government was committed to covering losses associated with the GSEs' portfolio of business entered into before October 2008.

- Recall that included in this "old business" portfolio were all the mortgage loans that Fannie and Freddie bought, packaged, sold, and guaranteed as part of the housing bubble and sub-prime debacle of the years leading up to 2008. CBO initially estimated in January 2009 that the federal government was assuming a loss of about $200 billion on that pre-October 2008 portfolio. Since then, CBO has revised its estimate of the total cost of that old portfolio to **$248 billion**.

- CBO also prepared estimates of the subsidy that the federal government would be providing for the GSEs to conduct new mortgage-related business in FY 2009 and after while under the conservatorship of the federal government.

- For example, since CBO expected Fannie and Freddie would purchase $1.6 trillion in new mortgage loans during 2009 and then either hold them or package them into mortgage-backed securities and sell them with a guarantee against default, CBO estimated the federal government was providing a $43 billion subsidy (=costs=outlays) to underwrite that new business. In other words, some subset of those estimated $1.6 trillion in mortgages would sour several years after they were issued. Then the federal government would have to cover Fannie or Freddie's losses on those loans. Using the credit reform treatment, CBO shows the cost of those estimated losses up front (on an accrual basis) in 2009, when the federal government actually commits to covering those future losses by virtue of its role as conservator of the two GSEs.

- Soon after deciding that this approach was the only correct budgetary treatment of the GSEs, CBO Director Orszag resigned from CBO. President-elect Obama had indicated in November 2008 that Orszag would be his pick for OMB Director in the incoming Administration.

- But in his new job, then-OMB Director Orszag (he resigned from OMB in July 2010) apparently chose not to go to the mat to argue the position he had advocated at CBO. Instead, President Obama's first budget request (and all subsequent budget presentations since then) continued to show (as OMB had under Director Nussle in the Bush Administration before it) that Fannie and Freddie are "still" independent, privately-controlled entities.

- Rather than showing the full subsidy cost to the taxpayers at the time the federal government was making commitments through its conservatorship of the GSEs, OMB only shows in the budget the amount of each purchase of GSE stock that Treasury makes as those transactions occur on a cash basis. Those stock purchases recognize only on an incremental basis the liabilities that the federal government had agreed to assume by placing the

GSEs into conservatorship. As a result, the Administration's treatment understates in the near term the cost of the federal government's support of and control over the GSEs.

Reaction to FHFA Report Provides Perfect Illustration of Confusion

On October 21, 2010, FHFA issued its first and only report estimating what the Treasury might have to pay to the GSEs through 2013 for the privilege of being their conservator.

FHFA outlined three scenarios where current housing prices might 1) continue a nascent recovery, 2) fall off only a little more before recovering, or 3) sink even further in the event of a double-dip recession. Then FHFA estimated what each of those scenarios would imply for losses on the mortgage business of the GSEs and the additional cash that Treasury would have to pay to Fannie and Freddie to keep them solvent through 2013.

The media coverage on this report was breathless about how, despite the $148 billion in gross payments Treasury has already made to the GSEs, the Treasury would likely still have to pay more. It was supposedly big news that FHFA's scenarios suggested that Treasury might have to pay out an additional net $6 billion to $124 billion between now and the end of 2013 to continue to prevent both GSEs from becoming insolvent. The headline number was that Treasury might have to pay out a net total of $259 billion (or $363 billion gross) under FHFA's worst-case scenario (a double-dip recession and an associated slump in housing prices).

But this was not news to informed budgeteers who had been paying attention for the past two years. As early as January 2009, CBO had already estimated for Congress – and anyone else who wanted to know – the cost to Treasury for absorbing the losses on all business on the GSEs' books before October 2008. CBO's latest estimate of that cost is $248 billion (on a net present value, accrual basis).

Guess what? The approximately $150-$259 billion in GSE losses that FHFA expects Treasury will have to cover (under FHFA's medium and worst case scenarios) in cash between September 2008 and December 2013 pretty much represents the extent of losses that will be suffered on the old book of business, since nearly all those losses will have revealed themselves by then. No doubt there are many complications in comparing an accrual estimate for the old book of business with a sum of cash payments to cover the quarterly-estimated insolvency of the GSEs. But for "in the ballpark purposes," FHFA's estimates of cash draws from Treasury through 2013 stems from the same loss activity captured by the $248 billion accrual estimate that CBO already told us (nearly two years ago) the federal government was going to be stuck with by covering the GSEs' old book of business under conservatorship. No one should be surprised that Treasury will keep making payments to the GSEs for a while.

All the new MBSs that the GSEs have guaranteed since October 2009 had improved underwriting standards, so they are not estimated to fail as fast and as often as the previous cohorts. So any losses associated with new GSE business is not likely to comprise a significant part of the GSEs' insolvency that will be wiped away by Treasury's payments through 2013 as estimated by FHFA.

- The Obama Administration subsequently issued a June 2009 white paper on financial regulatory reform that pledged to address the GSEs: "We will report to Congress and the American public at the time of the President's 2011 Budget release."

- But the President's 2011 budget issued in February 2010 failed to address GSE reform. Meanwhile, the budget continued to show the GSEs as "independent" entities not controlled by the federal government and therefore not part of the federal budget (as did the Mid-Session Review of the President's 2011 budget issued in July 2010).

- Congress, perhaps tiring of the Administration's inability to abide by its own deadlines, has put into law (section 1074) a requirement that the Administration provide to Congress by January 31, 2011, a legislative proposal for housing finance reform.

- In the meantime, others have not dallied in proposing that the GSEs be put into receivership or that the federal government create a new model for federal support of the housing market. But while waiting for the Administration's plan (and any subsequent Congressional action to do something different than what Treasury is currently doing as conservator), Fannie Mae and Freddie Mac – essentially wholly-owned subsidiaries of the U.S. Treasury – have continued their significant presence in the mortgage market. Over the course of fiscal years 2009 and 2010, they have entered into $2.1 trillion of new mortgage business, some of which will go bad and turn into additional costs to the taxpayer. The longer the status quo continues, the higher the taxpayer cost will increase.