



It's Time to Bust Up Fannie and Freddie

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By Greg Hartz, CPA, CFA and Mark Millsap, CFA

Started with government capital and later privatized and traded on the New York Stock Exchange, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) have become the final guarantors of the bulk of the residential mortgage debt in this country. Except for the trial lawyers, perhaps the strongest lobbying groups in Washington belong to these huge entities. Thus the job will require much fortitude and tenacity, but we believe that the time has come to bust up Fannie Mae and Freddie Mac.

Not long ago, our country went through a financial crisis in home mortgage finance with the savings and loan business. Much like today, the term structure of interest rates provided much incentive to borrow short and lend long. When the term structure changed and interest rates rose, the savings and loan industry experienced rising costs on their liabilities while the yield from their assets was frozen, which bankrupted the savings and loan industry. The federal government was called in to pay off the guaranteed liabilities (the insured deposits) and to make an orderly liquidation of the assets (those that had not been stolen or squandered by the managements of the financial institutions).

Fast forward to today. We have two entities, Fannie Mae and Freddie Mac, which have taken the place of the savings and loan industry from a financing perspective. A multitude of mortgage originators has taken the place of the savings and loan industry on the asset side. Many of these are barely capitalized operations that simply collect an origination fee and transfer the risk to Fannie and Freddie. Thus, the moral hazard from guaranteed deposits that existed in the savings and loan business has been transferred to these two behemoths (moral hazard defined as the action of placing more risk in an asset portfolio than would normally be the case and offloading the liabilities to someone else in the event that it does not all work out).

Fannie and Freddie have taken the moral hazard and run with it, leveraging their balance sheets to a point where any sober observer would consider them undercapitalized. Fannie is levered (total debt to total capital) at more than 45 times, and Freddie at more than 26 times. These ratios imply less than a 4% margin for error in the asset portfolio for Freddie and less than a 2.5% margin of error for Fannie.

Fannie and Freddie have obtained this leverage on the cheap, as the debt market has taken the “too big to fail” lessons of the last twenty years and assumed that this doctrine applied to Fannie and Freddie. Wall Street has been only too happy to assist. Anyone on the buy side of fixed income portfolio management knows that in the bond arena today, the market for these securities has mushroomed to the point that there are daily offerings marketed with a wink and a nod that these credits are unquestionably “too big to fail”.

There is no doubt that Fannie and Freddie have been extremely effective in spreading home mortgage finance far and wide in this country. Is there anyone that does not qualify for home financing these days?

It is obvious that the managements of Fannie and Freddie don't even know what lies beneath their balance sheets, evidenced by all of the trouble they have had in determining their financial accounting results. Fannie and Freddie have argued that they can weather any interest rate/loan prepayment scenario with the variety of mortgage structures that exist today, sophisticated hedging techniques employed using derivatives and the increased focus on asset/liability matching. They would also argue that private mortgage insurance and other credit enhancement mechanisms protect them on the credit risk. There is some level of credence to these arguments. However, with the level of complexity present in their thinly capitalized financial structures, we believe that the real answer is unknowable. Systemic risk would be reduced by a larger number of entities and the introduction of more competition, absent the implied “too big to fail” misunderstanding.

To affect this change, we call on the Bush Administration to press for the break up in a manner that would be equitable to current shareholders of Fannie and Freddie. This could be accomplished by the public equity offering of at least four more entities, perhaps accomplished in stages. Fannie and Freddie would be de-levered by the transfer of some assets and

liabilities to the new structures. Shareholders of Fannie and Freddie would receive shares in all and have first shot at acquiring the additional stock of the new companies that would be required to bring the total debt to capital ratio for all of the entities to twelve or less.

Congress, the Bush Administration and Alan Greenspan have all called for stricter oversight and regulation of Fannie and Freddie. We believe that the tremendous complexity inherent in the risk management of Fannie and Freddie will always outpace the ability of government regulators to avert a crisis in our debt markets. We think that a competitive, market-oriented system such as the one proposed is much more likely to keep our country from another crisis similar to that experienced by the savings and loan industry.

Greg Hartz and Mark Millsap are principals in the independent investment advisory firm Foundation Resource Management.