

Fannie Mae, Freddie Mac

Phase two of financial crisis

September, 01 2008

By **Jack Rasmus**

[Go to the original at ZMag](#)

Despite repeated efforts during the past year by the Federal Reserve (Fed), the U.S. Treasury, regulatory agencies, and global central banks, the current financial crisis has not been contained—let alone resolved. In the months since the Bear Stearns investment bank bailout in March 2008, the instability of the U.S. financial system has continued to deteriorate.

This past July, a second major financial instability event occurred—the near collapse of the two quasi-government housing market agencies, Fannie Mae and Freddie Mac. Like Bear Stearns, the collapse of Fannie/Freddie was barely averted by an announcement from Fed Chair Ben Bernanke and U.S. Treasury Secretary Henry Paulson that the government would bail out the two agencies. Unlike Bear Stearns, the bailout requires Congressional action and its estimated cost may be as high as \$300 billion, according to independent estimates. That's nearly ten times the \$29 billion bailout cost of Bear Stearns.

Evolution of the Fannie/Freddie Collapse

It is often noted in the business press that Fannie/ Freddie are liable for more than \$5.3 trillion of total mortgage debt outstanding, or roughly half of total mortgage debt in the U.S. which totaled \$10.6 trillion as of March, according to the U.S. Fed's Flow of Funds data. Less often noted is that since 2001 this same mortgage debt had ballooned from \$4.8 trillion to \$10.6 trillion. That's an increase of approximately \$6 trillion in just 7 years. Between 2003-06 alone mortgage debt recorded a net growth of more than \$1 trillion a year. Nearly half of that was "bad" subprime mortgage debt.

While banks and mortgage companies reaped super-profits from multi-trillion dollar mortgage lending during 2003-2006, they simultaneously pushed for the full privatization of Fannie/Freddie. They were not able to achieve that, but were able to keep Fannie/Freddie underfunded and freeze the latter's share of mortgages purchased at no more than 40 percent of the total mortgage market.

But once the subprime mortgage bust began in late 2006, the same banking and mortgage lenders sought to have Fannie/Freddie buy up their bad debt in greater and greater volumes, including their so-called securitized packages of bad subprime mortgages. Fannie/Freddie's bad debt load quickly accelerated. Its share of the mortgage debt market in turn rose rapidly, from less than 40 percent in 2005 to more than 70 percent. By the first quarter of 2008, more than 80 percent of all mortgages issued were purchased or guaranteed by Fannie/Freddie.

Fannie/Freddie's debt load rose quickly, but their funding and reserves on hand to cover the debt did not. By summer 2008 the agencies found themselves with more than \$5 trillion in liabilities, of which \$1.7 trillion was direct debt, with only \$81 billion in reserves.

Created in 1938 to rescue homeowners and mortgages from a similar bout of banking speculation gone bust, in 1968 Fannie/Freddie were partly privatized, which means they were no longer purely government agencies, but became corporations in which private

investors purchased stock. Their private investors range from other financial institutions, wealthy independent investors, private equity funds, hedge funds, pension funds, and various foreign banks and institutions. Fannie/Freddie's directly liable debt (called agency debt) of \$1.7 trillion (of the total \$5.3 trillion) is heavily owned by foreign central banks.

Should Fannie/Freddie collapse, their investors would suffer major financial losses as well as possible defaults and bankruptcies of their own. Foreign central banks would be especially hard hit. That would mean spreading and deepening the financial crisis further, not only in the U.S. but globally.

Investors became concerned that the two agencies could not cover their multi-trillion dollar liabilities with their miniscule liquid funds on hand. With housing prices continuing to fall and foreclosures rising, in early July analysts estimated Fannie/Freddie losses over the coming year of \$100 to \$300 billion depending on how far housing prices might fall. Investors did what most investors in any company do in such circumstances—they began a wholesale dumping of their Fannie/Freddie stock. The break came on Friday, July 11, as Fannie/Freddie stock prices plummeted by 50 percent.

Amazingly, even though Fannie/Freddie's reserves had been declining throughout the current financial crisis, particularly in the first half of 2008, instead of taking action, U.S. government regulators repeatedly eased the amount of funds the agencies were required to keep on hand to cover emergencies such as that which occurred in July. From 30 percent at the outset of 2008, regulators reduced required reserves to 20 percent and then to 15 percent, with talk of a further cut to 10 percent in September 2008 on the agenda.

An opportunity to do something about the situation arose in mid-May, in the form of proposed housing assistance legislation for homeowners facing foreclosure. But Congress did nothing. Instead, it accepted promises that Fannie/Freddie would voluntarily raise capital to add to their reserves. Even tepid proposals to change the agencies' regulators—a kind of rearranging of deck chairs on the Titanic—failed to pass Congress last spring.

In the days leading up to July 11, government regulators, the Fed, and the Treasury repeatedly proclaimed that the two agencies had sufficient capital, were voluntarily raising more, and that no rescue of the agencies was necessary. Of course, Paulson/Bernanke never bothered to explain how companies with such a collapse in stock prices might be able to raise capital and thus avert the crisis. Even before the near collapse, both agencies were jointly able to raise only \$20 billion. By the end of the week of July 7-11, Fannie Mae's stock price was down 76 percent over the previous year, and Freddie's had fallen 83 percent.

Over the weekend of July 12-13, Paulson/Bernanke and regulators did another about-face. When markets opened on Monday, July 14, they announced a plan to guarantee a government bailout of Fannie/Freddie. The plan required neither the Fed nor the Treasury to directly fund the bailout (neither had sufficient funds, in any event). Instead, Congress would be asked to provide the bailout funding. Until such funds were forthcoming, however, the Fed would provide interim emergency loans to the two agencies. Paulson also proposed the U.S. Treasury buy the two agencies' public stock, thus propping up their stock prices, if necessary.

The moribund housing bill, which had earlier failed to pass Congress, was quickly resurrected following July 14. The Bush administration also proposed to repopulate the boards of directors of the two agencies with more Wall Street bankers. And Paulson/Bernanke made public assurances that "all necessary lines of credit" would be open to the agencies until Congress provided more substantial and permanent funding. The Congressional bill that eventually passed in late July ultimately provided for a \$300 billion line of credit—just about what is projected by analysts as the total losses of the two companies over the next period. The \$300 billion is to be disbursed by the Treasury to

Fannie/Freddie as needed, either as loans or as government direct purchases of the companies' stock.

Despite the bailout announcement, a further general fall in the New York stock market and a further crisis in confidence in the banking system and financial institutions followed. The California bank, IndyMac, failed soon after, and stock prices of other regionals like WaMu, National City, and others significantly declined. The Standard & Poor's 500 bank stock index suffered its worst decline since 1989. Many banks and mortgage lending companies now teeter on the edge of default and bankruptcy.

The Strategic Significance of Fannie/Freddie

The near collapse and proposed bailout of Fannie/Freddie represents several important developments in the current financial crisis. First, it means the current financial crisis has not been stabilized, but has actually gotten worse. According to Bill Gross, manager of PIMCO, the world's biggest bond fund, falling U.S. home prices will require financial institutions to write off more than \$1 trillion in losses. The two to three million projected foreclosures may even be larger, given the estimated 25 million whose homes are now in negative equity (worth less than the purchased price) and the remaining mortgage costs.

It also means that the Fed, is no longer able to deal with the crisis on its own—as it essentially did with Bear Stearns. It has now clearly passed the buck to Congress. How much more will the bailout cost? According to a July Standard & Poor's estimate, the cost would run somewhere between \$420 billion and \$1.1 trillion. That compares to the last housing market bailout that occurred in the late 1980s with the Savings & Loan debacle of around \$250 billion.

To date the Fed has committed more than \$400 billion of its roughly \$800 billion to bail out Bear Stearns and prevent the collapse of other banks in the U.S. and abroad. In July it extended prior deadlines to provide special funding to banks and financial institutions still in trouble into 2009 and it will no doubt have to extend that guarantee as the crisis deepens.

The Fed has also lowered interest rates as far as it believes it can—to 2 percent. Its policy of engineering short term interest rate reductions has clearly failed. Lowering rates has not generated a recovery in the real economy or even assisted bank lending much. Banks continue to be reluctant to lend to each other, let alone to other non bank businesses or homeowners. All that lower Fed interest rates have accomplished is to fuel the devaluation of the dollar, feed currency speculators preying upon that devaluation, raise all types of commodity prices in the U.S., and in effect export part of the U.S. slowdown to other economies.

This shifting of the burden for bailing out the financial system to the U.S. Treasury and Congress signals an important shift in capitalist financial strategies for dealing with the crisis. It means monetary (Fed) solutions to the financial crisis have been effectively put on hold. Fannie/Freddie thus represents the shift into the second phase of financial crisis, while Bear Stearns represented the end of the first phase of the crisis.

They also represent a strategic crossroads. It is clear the Fannie/Freddie bailout is inevitable so long as housing prices continue to drop, which they will, foreclosures continue to rise, and housing market losses continue to grow. It remains to be seen how successful a proposed future bailout by Congress and the Treasury will be in stabilizing the two agencies. Should Fannie/Freddie fail to raise at least another \$100 billion in capital or should their stock prices continue to decline, the two agencies might be forced to sell assets at fire sale prices. This very same development began occurring at the end of July among investment and commercial banks also unable to raise capital to cover losses. The hybrid giant bank, Merrill Lynch, began fire sales of its assets at the end of the month, dumping

\$31 billion in bad loans and mortgages for only \$7 billion—a move almost certain to be copied by other banks. Fannie/Freddie might not be able to avoid similar action.

Fannie/Freddie also marked the entry of the New York stock markets into clear bear territory. Stock prices have now crossed a threshold. Despite occasional recoveries, they will proceed to decline further. In even typical postwar recessions, stock prices have fallen 30-40 percent. The current recession is anything but normal, so stock prices can be expected to fall at least as far.

Perhaps one of the more important strategic representations of Fannie/Freddie, and one of the least understood, are their tie-ins to the global derivatives markets. There are three critical numbers associated with Fannie/Freddie. First is their total liability of more than \$5.3 trillion in mortgage debt. Second is their combined direct so-called agency debt of \$1.7 trillion (which is part of that \$5.3 trillion total). Third is the more than \$2 trillion in derivatives they own, which were taken on to hedge their risks in their mortgage portfolio. The derivatives positions connect them to countless (and mostly unknown) global financial institutions. Were Fannie/Freddie to default or go bankrupt on their direct agency debt, the global impact via the derivatives market would be enormous. The magnitude of the current financial crisis would grow several-fold.

Nationalize the Housing Market?

At this point in the crisis, bailout means the government must get more deeply involved in funding residential housing markets than ever before. Of course, banks and financial institutions don't like that idea at all. That dislike is what lay behind their growing opposition to Fannie/Freddie during the boom times of 2002-06 and their drive to fully privatize the agencies at that time. But privatization is now clearly off the table, while bailout and deeper regulation are on, which raises the fundamental question: should private lenders be involved at all in financing the housing market or should the housing markets in effect be nationalized?

Of course, nationalizing is a stopgap measure designed to temporarily refloat the markets and institutions at taxpayer expense. After they are again financially stable, the idea is to sell them back again to private interests after they can make a profit once more. It's the basic capitalist strategy to "socialize the costs" and "privatize the gains," which is the essential capitalist definition of nationalization. Even *Wall Street Journal* editorials now advocate that particular definition, arguing the current arrangements represent a "dishonest kind of socialism." Instead, they propose nationalizing Fannie/Freddie in "a more honest form of socialism." That formula for nationalization is essentially what ex-Fed Chair Alan Greenspan recently proposed: take them over, re-stabilize them at direct taxpayer expense, then spin them back into six or seven private finance companies again.

Despite Greenspan and business press pundits raising the capitalist version of nationalization, the idea of a different kind of nationalization is now possible, as it becomes increasingly clear that private financial institutions are the core cause of the crisis and that the "only game in town" to keep things going is direct government control of the housing markets.

Fannie/Freddie, Deflation, and Epic Recession

Financial instability in the U.S. has continued to worsen, not improve. The key question is why was there a second financial blow up with the near collapse of Fannie Mae and Freddie Mac? The answer to that question is the rampant speculative investing that has been plaguing the U.S. economy for some time.

Since the 1980s, speculative investment has been growing in both its weight and mix as a percentage of total investment in the economy. Speculative investment feeds off of, and

simultaneously drives up, prices for financial and other assets. The most notable current example is what is now happening with commodity price inflation. But before commodity speculation and inflation, it was housing price inflation and the subprime bubble of 2002-06; before that, the technology stock speculation and price bubble of 1998-2000; and before that, other asset price bubbles in the 1980s and 1990s. Speculative asset price bubbles lead inevitably to speculative asset price busts—i.e., deflation.

Following the July bailout, the troubles at Fannie/Freddie continued to worsen. In August both agencies announced combined additional losses of more than \$7 billion, which immediately drove their stock prices to historic lows. Continuing losses and collapsed stock prices will undermine raising sufficient capital to offset expected future losses. The \$300 billion bailout may therefore not be enough.

What's been happening with banks and financial institutions in the U.S. over the past year is that housing and other asset prices have continued to fall faster than banks have been able to raise cash and funds from other sources to offset those losses. The bailout of Fannie/Freddie has not resolved in any way the more fundamental housing crisis. Housing prices will continue to fall at least another 20 percent. Foreclosures will continue to rise by the millions for some time, driving the housing price decline. The recent Housing Bill passed by Congress in July addresses only one-tenth of the eventual foreclosures. The bill's \$300 billion set-aside to cover Fannie/Freddie losses provides less than a third of total estimated mortgage losses from all sources. In short, the bailout has only temporarily staunched the bleeding—at significant taxpayer expense.

More and more companies now face rising costs due to commodity price inflation and simultaneous falling revenues. Their inevitable response will be mass layoffs, which are coming in 2008 and into 2009. The entire process leads to something called epic recession—a recession that is unlike any previous recession and that is global in character (see *Z Magazine*, June 2008). Already numerous economies have begun following the U.S. into recession. The UK, Ireland, Spain, Italy, Portugal, and New Zealand have all clearly tipped into recession. Two of the world's other top four economies, Japan and Germany, have joined the downturn as well. The contraction has clearly begun to synchronize globally.

The ultimate driver of the entire process is the unwinding of the excess \$21.6 trillion in net new debt added to the U.S. economy since 2001 and the deflation that debt unwinding is now causing. Behind the debt-deflation dynamic, however, lies the growing imbalance of speculative investment in the U.S. that has been building for decades and the even more fundamental causes that have been driving that speculation in turn.

Z

Jack Rasmus's writing on the current financial and economic crisis and related topics is available at www.kyklosproductions.com.