

The Disaster Called Fannie Mae LeedsonFinance.com

I spent a fair amount of time this week looking at Fannie Mae. It's truly a disaster. I'll give you a quick summary of what Fannie Mae does (or is supposed to do) and then I'll describe some facts that should worry you about the company.

Background

Fannie Mae is known as a "government sponsored entity" (GSE). Fannie was chartered by Congress in 1938. The stated goal of Fannie was to support liquidity and promote stability in the mortgage market.

Fannie buys mortgages from mortgage originators (banks, mortgage companies, etc.) if they conform to certain standards. Then, Fannie either holds the mortgage in their own portfolio or they securitize the mortgage. If you're not familiar with securitization, think of Fannie putting a bunch of mortgages into one entity (think of it sort of like a stand alone business) and then selling securities (mortgage backed securities) which will be paid back with the cash flow from the mortgages. Here's the KEY...when Fannie securitizes these mortgages, they guarantee the payments – in other words, even if the homebuyer defaults, Fannie promises to make the full payment to the investor who bought the MBS (mortgage backed security). In effect, Fannie is really a large insurance company!

Fannie has historically done well because they are able to borrow money at a low cost. This low cost of capital arises from the fact that many investors have believed that the US government would never let Fannie fail. This belief existed even though Fannie has always said that the government does not guarantee Fannie's payments. In addition to the low cost of capital, Fannie has also been successful due to the stability of home prices.

Fannie's real troubles started as home prices started declining in the past few years. Homebuyers defaulted and Fannie had to make payments to the owners of the MBS. These losses wiped out Fannie's small capital base. (Fannie had always had a much lower capital requirement than a bank.) Eventually, Fannie was put into conservatorship. This is finance / legal speak for "the government nationalized them." This happened on September 6, 2008. If nothing else, this confirmed our suspicions...the government wouldn't let Fannie fail.

Since Conservatorship

Since being placed in conservatorship, the government has taken action to support Fannie and the mortgage market. Some of the government's actions include:

1. Purchasing preferred stock – in September, the government said it would purchase up to \$100 billion of preferred stock (if Fannie needed this amount of support). This was raised to \$200 billion in May.
2. The Treasury Department has purchased MBS issued by various GSEs. The goal is to lower the cost of mortgages.
3. The Treasury established a credit facility in which Fannie could use MBS (from their portfolio) as collateral.
4. The Fed announced plans to buy up to \$100 billion of Fannie, Freddie Mac and FHLB debt and up to \$500 billion of MBS issued by Fannie, Freddie and Ginnie Mae. Recently, the Fed increased the amounts to \$200 billion and \$1.25 trillion respectively.
5. Fannie's regulator (FHFA) suspended Fannie's statutory capital requirements (the amount of minimum capital they are required to have).

In addition, the government also took action to support homeowners. Two of the most important actions were:

1. they had Fannie suspend foreclosures from November 26 – January 31 and February 17 – March 6.
2. Homeowners Affordability and Stability Plan – this included the “Making Home Affordable Program” which allowed borrowers who had loans with Fannie (or Freddie) to refinance. In addition, it included a \$75 billion mortgage modification program for borrowers with a financial hardship.

Fannie also tried to help homeowners with the HomeSaver Advance Program. This program allows borrowers to cure default by receiving a 15-year loan from Fannie with a 5% interest rate. The loan is not a cash payment; rather, it is used to finance the payments owed by the borrower. In other words, you owe me money, so I'll loan you some money to make your loan current. That makes sense.

Some of the other key developments since entering conservatorship have been:

1. Fannie has experienced tremendous losses – they lost \$25.2 billion in Q4 and \$23.2 billion in Q1. (They make my portfolio look good...)
2. There has been a tremendous amount of refinancing due to low rates. In Q1, there were \$511 billion of originations and 73% of these were refinancings.
3. Fannie maintained a large share (44.2%) of the MBS market. Fannie had \$175.4 billion of new mortgage business in Q1 and securitized \$125.4 billion of this.
4. After only being able to issue short-term debt in the second half of 2008, they have been able to issue longer term debt during the past quarter. This reduces the “rollover risk” that they had.
5. They have maintained their AAA rating. I would assume that this is because of the government lifeline and support. The only other possible explanation would be if Moody’s and S&P were completely asleep at the switch. I guess that means that there are two possible explanations.

Factors to Worry About

As I read through Fannie's 10-Q, it really scared the hell out of me. It's hard not to believe that Fannie will end up costing the government at least \$150 billion. The funny (sad) thing is that \$150 billion is rounding error in this mess. In normal times, this would be a huge story. Now, no one cares.

Regardless, I see Fannie as a great opportunity to depress you, so let me tell you some of the things that should really bother you about the entity:

1. Fannie has conflicting goals. Their 10-Q states that their goals are to immediately provide assistance to the mortgage market and the housing market. One of their other stated goals is to protect the interest of taxpayers. The reality is that Fannie Mae has become a tool in the government's struggle to prop up the housing market. This is going to cost taxpayers dearly and it's going to eliminate the remaining interest of shareholders.
2. Fannie is operating in uncharted territory. They are trying to understand delinquency patterns which they have never seen before. There has been a tremendous increase in delinquencies as well as the speed in which delinquencies transition to worse situations. Fannie's lack of understanding can be seen in the poor record of the modification program. Approximately 45% of modifications from the past three years are currently delinquent (again) by more than 60 days.
3. Fannie has incurred more than \$45 billion of losses in the past two quarters.
4. Fannie is going to have lower revenue in the future because their guaranty revenue (their insurance income) will drop. The reason for this is that they are not taking riskier mortgages. Overall, this is a good thing. But the point is that their earlier years of "profitability" will not be reached again.
5. Fannie's losses will increase because of modifications. Think about how this works. Fannie pays the mortgage servicers to negotiate with borrowers and this results in lower interest rates, longer terms or reduced principal. All expenses are borne by Fannie. Paying servicers money to negotiate lower payments to Fannie does not seem like a promising model.
6. Fannie is incurring significantly greater losses when they foreclose on homes. The loss severity has increased from 19% in Q1 2008 to 36% in Q1 2009. Home prices have continued to drop in Q2 and the loss severity should worsen.
7. The portfolio is deteriorating. Approximately 3.15% of Fannie's loans are seriously delinquent (three months behind). This is a significant increase since the end of Q4, when 2.42% of loans were delinquent.
8. Approximately 28% of Fannie's loans cover houses in California, Florida, Arizona and Nevada. In Q1, loans from these states accounted for 58% of losses.
9. Approximately 10% of Fannie's loans are Alt-A loans. (This amounts to \$283.5 billion of loans.) These loans had a delinquency rate of 9.54% in Q1 (up from 7.03% in Q4 and 2.96% in Q1 of 2008).

10. A high percentage of the loan portfolio was originated in 2006 (13% of loans) and 2007 (19% of loans). Loans from these two years have high delinquency rates (6.97% and 6.77% respectively). People who bought houses during these years are very likely to owe more than the value of their home.
11. Fannie has a loss reserve of \$41.7 billion. This is only 28.78% of the non-performing loan value. (As you will read later, the average loss is close to 36% on loans which default. Obviously, we don't know what percentage of nonperforming loans will default or how many loans that are still performing will end up in default.)
12. A significant percentage of Fannie's loans are high loan-to-value on a market value basis. On a market basis, 13.46% of loans have a value greater than the value of the home. These loans have greater chance of default – as homebuyers walk away. Another 10% of loans have market loan-to-value ratios greater than 90%. Selling these homes (with brokerage fees) may not create value for the homeowner – and they are also at risk of walking away.
13. Fannie has no equity. Their net DEFICIT was \$18.9 billion as of March 31. Their deficit on a fair value basis is \$110.3 billion. Understand this number. It's really important. This means that Fannie's liabilities (on a market value basis) are \$110 billion larger than their assets. These numbers come from Fannie – this isn't some outsider with an agenda. Fannie is currently \$65 billion below their statutory capital requirements (which have been eliminated).
14. Fannie has a huge liability outstanding. There are effectively insuring \$2.3 trillion of mortgage payments and they own another \$800 million of loans.
15. Fannie has a huge debt to the US government. Fannie just asked for \$19 billion (to eliminate their deficit). This will bring the government's investment to \$35.2 billion. This will require Fannie to make a \$3.5 billion dividend payment each year. Fannie has said they will only be able to pay this dividend by using further equity infusions from the government! In other words, if the government gives Fannie more money, Fannie can continue to pay dividends to the government.
16. Fannie is relying on troubled vendors. They are relying on mortgage servicers to modify loans, but these servicers have their own problems. Bank of America services 27% of Fannie's loans, and Wells Fargo, C and JPM all service more than 10% of Fannie's loans. More importantly, Fannie is relying on mortgage insurance for \$117 billion of loans. Many of these insurers have had their credit rating downgraded to BBB or BB, signifying their troubles.

Other than the facts that Fannie has a huge liability to investors and to the government, their portfolio and income are deteriorating and they being used to prop up the housing market...they are looking pretty good.

Conclusion

There is a lot that we don't know about Fannie. We don't have a perfect picture of losses because we don't know that much about overlapping categories (e.g., what percentage of California loans are Alt-A with a loan-to-value ratio greater than 100%?). We don't know how severe the losses will be in the future or what the default rate will be. What I really don't understand is who is trading this stock – it still trades and that means there are buyers and sellers. Regardless, the government's loss from Fannie Mae will probably be close to \$150 billion.

I find it amazing how little attention we pay to the Fannie Mae situation. Our Fannie Mae loss will probably be significantly larger than our direct loss from GM, yet it seems like GM receives much more attention. Of course, people understand GM much more than they understand Fannie Mae and that probably explains the difference in media attention. It's also alarming that we don't spend much time talking about a \$150 billion loss – it's truly a sign of our times.