CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Peter R. Orszag, Director

July 22, 2008

Honorable John M. Spratt Jr.
Chairman
Committee on the Budget
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

On July 14, 2008, the Administration released a proposal that would temporarily authorize the Department of the Treasury to purchase obligations and securities of the government-sponsored enterprises (GSEs) that deal with housing finance—the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Banks.

The Congressional Budget Office (CBO) estimates that there is a significant chance—probably better than 50 percent—that the proposed new Treasury authority would not be used before it expired at the end of December 2009. If the proposal is enacted, private markets might be sufficiently reassured to provide the GSEs with adequate capital to continue operations without any infusion of funds from the Treasury; during that time, it is possible that expectations about the duration and depth of the housing market downturn may brighten. Under that scenario, the temporary authority would not be used and thus would involve no budgetary cost.

In CBO's view, however, that scenario is far from the only possible result. Indeed, many analysts and traders believe that there is a significant likelihood that conditions in the housing and financial markets could deteriorate more than already reflected on the GSEs' balance sheets, and such continuing problems would increase the probability that this new authority would have to be used. Taking into account the probability of various possible outcomes, CBO estimates that the expected value of the federal budgetary cost from enacting this proposal would be $25 billion over fiscal years 2009 and 2010. That estimate accounts for both the possibility that federal funds would not have to be expended under the new authority and the possibility that the government would have to use that authority to provide assistance to the GSEs.

CBO's estimate reflects the current budgetary treatment and existing scorekeeping conventions for federal credit assistance and equity purchases and does not necessarily measure the underlying change in the federal government's financial condition as a result of this legislation. On the one hand, the acquisition of financial assets like equities is recorded as an outlay in the budget even though such purchases may not change the government's underlying financial condition. On the other hand, even if enacting this legislation would not result in outlays over the near term, it might effectively strengthen the linkages between the GSEs and the federal government and thereby increase the government's underlying exposure to the risks associated with the GSEs' activities.

The results of CBO's analysis and its methodology are described in the attachment. In keeping with the agency's mandate to provide impartial analysis, this report makes no recommendations.

I hope that you find the analysis useful. If you have any questions about it, please contact me at (202) 226-2700.

Sincerely,

Peter R. Orszag
Director

Attachment

cc: Honorable Paul Ryan
Ranking Member

Honorable Barney Frank
Chairman
House Committee on Financial Services

Honorable Spencer Bachus
Ranking Member
House Committee on Financial Services

Identical letter sent to the Honorable Kent Conrad.

CBO’s Estimate of Cost of the Administration’s Proposal to Authorize Federal Financial Assistance for the Government-Sponsored Enterprises for Housing

July 22, 2008

Summary

The Administration’s proposal of July 14, 2008, would provide temporary authority to the Secretary of the Treasury to purchase any amount of obligations and other securities issued by the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Banks (FHLBs). Those three entities, known as government-sponsored enterprises (GSEs), are Congressionally chartered financial institutions created to enhance the availability of mortgage credit. The authority provided under this proposal would expire on December 31, 2009. Under current law, the Secretary has permanent authority to purchase debt securities issued by Fannie Mae and Freddie Mac up to a total of $2.25 billion from each.

Enacting this proposal could have no direct federal budgetary cost if the Secretary does not exercise the temporary authority, or it could have a significant cost if the Secretary must lend or otherwise provide funds to keep the GSEs financially viable. The Congressional Budget Office (CBO) estimates the expected federal budgetary cost (that is, taking into account the probability of various possible outcomes) from enacting this proposal would be $25 billion over fiscal years 2009 and 2010. The methodology for this cost estimate is described in more detail below, but conceptually that cost reflects a probability-weighted estimate of the amount of assistance the government might need to provide to enable the GSEs to continue operating after December 2009, when the proposed temporary authority would expire. It incorporates a projection of potential future losses on the GSEs’ mortgage investments and mortgage guarantees under a variety of economic scenarios, based on the CBO’s own evaluation of the firms’ assets and liabilities, and it also reflects analyses from housing and financial industry experts. Should direct federal assistance be necessary, CBO anticipates that a portion would be in the form of debt securities and that the assistance might include equity investments as well.

CBO’s estimate reflects the current budgetary treatment and existing scorekeeping conventions for federal credit assistance and equity purchases and does not necessarily measure the underlying change in the federal government’s financial condition as a result of this legislation. On the one hand, the acquisition of financial assets like equities is recorded as an outlay in the budget even though such purchases may not change the government’s underlying financial condition. On the other hand, even if enacting this legislation would not result in outlays over the near term, it might effectively strengthen the linkages between the GSEs

and the federal government and thereby increase the government's underlying exposure to the risks associated with the GSEs' activities.

In addition, the estimated costs of this proposal are measured relative to the budget resolution baseline, which was issued in March 2008. Since then, deteriorating conditions in the housing market have weakened the financial condition of the GSEs, which currently play a critical role in the functioning of the nation's credit markets. Financial markets already appear to be assuming that expanded authority to assist the GSEs will be granted to the Secretary, and failing to provide such authority at this point could trigger turmoil in the nation's financial and housing markets, with potentially serious adverse consequences for economic activity and therefore for the federal budget.

CBO's estimate recognizes that there is a significant chance—probably better than 50 percent—that the proposed new authority for the Secretary would not be used before it expired at the end of December 2009. If the proposal is enacted, private markets might be sufficiently reassured to provide the GSEs with adequate capital to continue operations without any infusion of funds from the Treasury; during that time, it is possible that expectations about the duration and depth of the downturn in the housing market may brighten. Under that scenario, the temporary authority would not be used and thus would involve no budgetary cost. In CBO's view, however, that scenario is far from the only possible result. Indeed, many analysts and traders believe that there is a significant likelihood that conditions in the housing and financial markets could deteriorate more than already reflected on the GSEs' balance sheets, and such continuing problems would increase the probability that this new authority would have to be used. CBO's cost estimate therefore accounts for both the possibility that federal funds would not have to be expended under the new authority and the possibility that the government would have to use that authority to provide assistance to the GSEs.

In estimating the expected budgetary cost of the legislation, CBO has assumed that the Secretary would want the GSEs to continue to have the ability to tap the capital markets after the temporary authority expired and that financial markets would provide such capital to the GSEs only if market participants perceived the GSEs to be sufficiently capitalized in terms of the value of their assets relative to their liabilities. (Evaluating what financial markets would view as "sufficiently capitalized" requires judgment; CBO's approach is described in more detail below.) In other words, if the value of the GSEs' assets was perceived to be insufficient relative to their liabilities, the Secretary would have to provide equity capital or subsidized debt to the GSEs before the temporary authority expired. CBO's estimate of $25 billion in costs over the 2009–2010 period reflects a probability-weighted average of how large those injections might need to be, including zero as a potential outcome.

CBO expects that most or all of any assistance under the proposed authority would go to Fannie Mae and Freddie Mac. Government and financial experts with whom CBO consulted indicated that the FHLBs are adequately capitalized, with a strong collateral base for liabilities, and are unlikely to require any federal financial assistance over the next 17 months (that is, before the authority would expire at the end of December 2009). The following discussion focuses on the potential costs of assistance to Fannie Mae and Freddie Mac.

Basis of Estimate

CBO analyzed the financial statements of the GSEs and consulted with financial analysts, federal regulators, the GSEs, Administration officials, and financial market participants to estimate the GSEs' possible losses and the amount of assistance that the Treasury might need to provide. In particular, CBO analyzed a distribution of possible losses on the mortgages held by Fannie Mae and Freddie Mac and on the mortgage-related guarantees they have already issued, along with their new business over the next 17 months. This analysis reflects the possibility that the federal government might need to assist one of the GSEs even if the other is financially healthy. CBO also took into consideration the existing credit enhancements on the mortgage assets, likely recoveries on bad loans, and the GSEs' existing provisions for loan losses. In addition, CBO considered estimates of the GSEs' balance sheets generated by analysts at financial services firms.

Although market participants might believe that the authority provided by this proposal would ultimately be extended in subsequent legislation, CBO's estimate cannot reflect such an assumption, and CBO assumes that the authority would expire at the end of calendar year 2009. CBO assumes that before the temporary authority expired, and for the scenarios in which the performance of the GSEs' portfolio is inadequate to leave them in a financially healthy condition at the end of 17 months, the Secretary would need to provide funds to the GSEs so that they could continue to access financial markets after the expiration of that authority. The specifics of how much additional funds might be required, and how the funds might be provided, are discussed below.

Gauging the Financial Position of the GSEs. Capital is the net worth of a firm, measured for accounting purposes as the difference between estimates of what the firm owns (its assets) and what it owes (its liabilities). Capital represents the ability of a firm to absorb losses and pay off creditors without external assistance and is thus an important measure of a firm's soundness.

Capital is measured in several different ways.[1] Historical values represent the prices paid for assets when acquired or the prices received for debt when issued, while the current actual or estimated market values represent the "fair value" of assets and liabilities.

The measure of capital that the housing GSEs must report on their balance sheet, which is based on generally accepted accounting principles (GAAP), is a mix of fair value and historical costs, but it differs somewhat from that used for regulatory purposes. At the end of the first quarter of 2008, the GAAP net worth of the enterprises was $55 billion. The GSEs' regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), requires the firms to report their operations on a mix of fair value and historical costs. OFHEO's accounting measure of capital starts with the GAAP measures and then backs out some unrealized gains and losses. For regulatory purposes, the enterprises held over $80 billion of capital and were classified as "adequately capitalized" by OFHEO at the end of March 2008.

The GSEs also prepare estimates of their net worth entirely on a fair-value basis, using the market value of all the balance sheet items. On a fair-value basis, the value of the GSEs' assets exceeded that of their liabilities by $7 billion at the end of March 2008. (Their liabilities at that time totaled $1.6 trillion.) Another assessment of the value of the two GSEs is provided by the market value of outstanding equity shares, which is a continuous measure of investors' view of the current value of the firms and their future performance. On Friday, July 11, 2008, before the Administration proposed legislation to extend financial assistance to the GSEs, the value of those shares had fallen to a low of $11 billion.

The key point for the purposes of this cost estimate is that market investors do not necessarily evaluate the GSEs consistently with GAAP or the definition of capital required under OFHEO's regulatory procedures. CBO assumes that market perceptions of the value of the GSEs' assets relative to their liabilities, rather than GAAP-based or regulatory capital, would prove crucial to whether the Secretary needed to assist the GSEs.

Use of the Secretary's Authority to Assist the GSEs. The Administration has stated that the goal of the proposed temporary authority to purchase GSE debt and securities would be to enable the firms to continue normal operations and continue to access private debt markets. In and of itself, providing the authority would not necessarily result in its use. Indeed, especially if the federal government's commitment is credible, it is possible that financial markets would

1. Congressional Budget Office, *Measuring the Capital Positions of Fannie Mae and Freddie Mac* (June 2006).

perceive the existence of this contingent authority as sufficient assurance to enable the GSEs to continue raising enough capital to meet their financing needs over the next 17 months.

The expected cost to the federal government from the legislation reflects asymmetrical (one-sided) risks. If the value of the GSEs' assets recovered strongly, the federal government would not need to intervene, but it also would not directly share in that asset appreciation. In other words, the federal budget would not directly benefit if the GSEs' balance sheet recovered dramatically. If the GSEs' assets deteriorated significantly, by contrast, the federal government would probably be forced to inject funds into the firms before the end of the temporary authority to allow the GSEs to continue operating after that period. This asymmetry drives the expected cost to the federal government: In effect, the federal government would bear costs over the next 17 months as a result of the legislation if the GSEs' financial condition was significantly impaired but would not realize any direct financial benefits as a result of this legislation if the GSEs' financial condition strengthened dramatically over that period.

It is not clear specifically what criteria the Treasury would use to provide assistance to the GSEs. The chances that the Treasury would provide assistance presumably increase if the size of unexpected credit losses for the GSEs increases. As the end of 2009 approaches, the Treasury might want to provide some assistance as "insurance" against further unexpected losses after the authority expired; how much insurance the Secretary decided would be warranted or desirable in such scenarios would determine the magnitude of the assistance provided.

For those scenarios where assistance would seem to be necessary, significant uncertainty exists about the magnitude of the assistance that might be given to the GSEs. The amount would need to be sufficient for the GSEs to attract private capital, but it is not clear how much that would be. One possible threshold is for the Secretary to provide sufficient funds to offset additional credit losses beyond those the firms have already recognized in their fair-value balance sheets (as of the first quarter of 2008). It is possible that this threshold might significantly underestimate the assistance that would be necessary, because financial markets might demand that the GSEs have a substantial capital cushion in order to continue tapping capital markets after the temporary authority expired. CBO's cost estimate therefore reflects the possibility that the Secretary might need to offset more than just the additional credit losses beyond those already recognized by the GSEs.

CBO's Estimate of the Losses on Mortgages Held and Guaranteed by the GSEs. To assess possible market perceptions of the GSEs' financial condition, CBO consulted with financial experts and constructed independent models of the possible future evolution of the net assets of the GSEs. In particular, CBO estimated the likelihood that the GSEs' credit losses would exceed those already recognized on their fair-value balance sheets. This approach suggested a significant probability that the firms' net financial position (assets minus liabilities) would not deteriorate further by the end of the 17-month period. It also, however, highlighted scenarios in which the GSEs would be much more financially impaired at that point. For those scenarios, CBO assumed that the financial markets might stop financing the GSEs' operations unless the federal government provided sufficient funds to assure markets that the firms could continue to function.

There is a considerable amount of uncertainty about the credit losses that may be experienced on existing mortgages held and guaranteed by the GSEs in the next few years. Some financial analysts estimate that losses will be smaller than those already recognized by the GSEs in their fair-value balance sheets, and others forecast far greater losses ahead. However, those estimates do not reflect the one-sided nature of the federal government's potential exposure to losses suffered by the GSEs.

CBO's own modeling estimated a broad range of potential credit losses by projecting the discounted cash flows from the GSEs' mortgage loans and guarantees at the end of March 2008, a book of business with a value of about $5.2 trillion. The riskiest loans, known as alt-A and subprime mortgages, accounted for about 15 percent of that portfolio.

The key factor for the GSEs' future credit losses is the path of housing prices in the next several months. If the deterioration in the nation's housing prices continues or accelerates, the GSEs' credit losses will grow. CBO applied a probability distribution of the possible future direction of home prices, including the potential for stabilization, modest growth, and much deeper declines. Using historical and industry estimates of the expected losses on the different types of credit risk that the GSEs face in their current portfolios, CBO estimated the firms' possible credit losses under thousands of possible future market conditions for housing prices. That analysis suggested that there was more than a 50 percent chance that the GSEs' future losses would not exceed those already recognized, but there was almost a 5 percent chance that the added losses would total more than $100 billion. Given that distribution of possible future losses, CBO then evaluated how much assistance might need to be provided to the GSEs to allow them to continue operating in the capital markets. CBO's estimate of $25 billion in federal costs over the 2009–2010 period reflects the agency's assessment of the probability-weighted average of how large those injections might need to be, including zero as a potential outcome, along with the views of other analysts.

Future Sale of Federally Owned GSE Obligations and Securities. Some or all of the costs incurred by purchasing GSE obligations and securities through December 31, 2009, could be offset in later years with earnings (interest or dividends) or receipts from a future redemption or sale of any GSE obligations and securities acquired by the Secretary. The Treasury has not indicated the form of any assistance to the GSEs. CBO expects that any initial infusion would be in the form of purchases of debt securities, but the assistance might also involve an equity purchase.

The budgetary treatment of direct federal loans and loan guarantees is different from the cash basis used to record purchases of private equity holdings on the federal budget. If the Secretary used the temporary authority provided under this legislation to purchase debt securities issued by the GSEs, that transaction would be considered a direct federal loan. The Federal Credit Reform Act of 1990 requires that the budget record the estimated subsidy cost of a direct federal loan at the time the loan is executed. That law defines the subsidy cost as the net present value to the government of all anticipated cash flows over the life of the loan, including interest, principal payments, and fees and considering the risk of a default on the loan.

CBO estimates that the subsidy cost of any credit assistance would be recorded on the federal budget as budget authority and outlays in 2009 and 2010, which is when the agency expects that a federal loan or loans would be extended to the GSEs. Under the Credit Reform Act, all subsequent principal and interest repayments of any loans are counted in the federal budget only as a means of financing because the initial subsidy cost includes the expected value of those cash flows. (The Credit Reform Act also provides for the possibility of adjusting the recorded subsidy cost using permanent authority to make “credit reestimates” in future years. Such reestimates can be either increases or decreases, to reflect actual loan performance.)

The budgetary treatment of federal investments in non-Treasury financial instruments like equities is specified in the Office of Management and Budget Circular A-11, which states that the purchases of such securities should be displayed as outlays and that the sales of such securities and returns such as dividends and interest payments should be treated as offsetting receipts or collections. Consequently, if the Treasury purchased equity in Fannie Mae or Freddie Mac, that purchase cost would also be recorded on the budget as budget authority and outlays in 2009 or during the first few months of fiscal year 2010, before the temporary financial assistance authority expired. It seems likely that over the near term, returns to the government on any equity investment in the GSEs would be negligible because such investments would probably occur in situations when the GSEs’ financial condition was particularly poor.

Budgetary Treatment of GSEs' Operations. Although the GSEs are currently publicly traded shareholder-owned firms, the legislation would at least temporarily strengthen the connections between the GSEs and the federal government. The existing ties between the GSEs and the federal government have a long history. Fannie Mae was established in 1938 as a government-owned corporation to buy mortgages. It was converted into an investor-owned GSE in 1968. In 1970, the government created Freddie Mac. The unique legal status of the GSEs includes exemptions from certain taxes and corporate regulatory requirements. In exchange for preferential treatment under federal law, the GSEs are charged with increasing the flow of funds to mortgage markets while meeting a fiduciary responsibility to their private investors. The GSEs are currently regulated by OFHEO, a federal agency.

A strong argument can be made that if the Treasury used the proposed authority, the GSEs' operations should be incorporated directly into the federal budget. That is, the proposal, especially to the extent it would result in any government acquisition of an equity stake in the GSEs, raises a significant budgetary question. Currently, data on the GSEs are reported along with federal budget information each year, but the activity of those entities is not encompassed within the budget. That treatment could change if the federal government's financial stake or control changes in a significant way. For the purposes of this cost estimate, CBO did not incorporate any change in the underlying budgetary treatment of the GSEs, in part because the proposed authority would be temporary; if it was not used, the relationship between the GSEs and the federal government would presumably return to one consistent with current budgetary treatment after the temporary authority expired.