Mortgage Market Note

U.S. Treasury Support for Fannie Mae and Freddie Mac

December 5, 2008

MORTGAGE MARKET NOTE 08-4

I. Introduction

The Housing and Economic Recovery Act of 2008 (HERA) authorized the Secretary of the Treasury to support Fannie Mae, Freddie Mac, or the Federal Home Loan Banks (FHLBs) by purchasing obligations and other securities from those government-sponsored enterprises (collectively, the housing GSEs). HERA gave the Secretary broad authority to determine the conditions and amounts of such purchases.

On September 7, 2008, Treasury Secretary Paulson exercised that authority by initiating individual agreements with Fannie Mae and Freddie Mac (the Enterprises) to purchase senior preferred stock. In addition, the Treasury Secretary established two special facilities to purchase obligations of the housing GSEs: one to purchase GSE-guaranteed mortgage-backed securities (the GSE MBS Purchase Facility) and the other to purchase GSE debt (the GSE Credit Facility). Secretary Paulson has stated those three actions "have essentially guaranteed Fannie Mae and Freddie Mac securities."[1] That guarantee is intended to improve investor confidence in the ability of each housing GSE to continue to provide liquidity to mortgage markets and to meet its obligations. Investor confidence is essential to liquid and well-functioning mortgage markets, which in turn benefit homeowners and qualified mortgage borrowers by lowering borrowing costs and supporting home prices.

On November 25, 2008, the Federal Reserve announced it would purchase $100 billion of debt issued by the housing GSEs and $500 billion of MBS guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae. Those purchases should further bolster investor confidence in Fannie Mae and Freddie Mac securities.

[1] See http://treasury.gov/press/releases/hp1301.htm

This Mortgage Market Note answers three basic questions about the Senior Preferred Stock Purchase Agreements, the GSE Credit Facility, and GSE MBS Purchase Facility:

- What do they do?
- How do they work? and
- When do they expire?

II. Senior Preferred Stock Purchase Agreements

What they do

The Senior Preferred Stock Purchase Agreements (SPSPAs) are the cornerstone of the financial support that the U.S. Treasury is providing to Fannie Mae and Freddie Mac. The SPSPAs effectively provide a very long-term federal guarantee to existing and future debtholders. Each SPSPA commits the Treasury to purchase up to $100 billion in senior preferred shares. That commitment protects the credit interests of all holders of the Enterprises' senior and subordinated debt and MBS. To put the $100 billion per Enterprise commitment in perspective, that amount is over three times Fannie Mae's statutory minimum capital requirement as of June 30, 2008, and nearly three-and-a-half times Freddie Mac's statutory minimum capital requirement as of that date.

Put another way, from the perspective of Enterprise debt and MBS holders, the Treasury commitment is equivalent to each Enterprise having raised $100 billion in new capital, thereby increasing its capital buffer by an amount that is more than three times greater than its minimum requirement. That additional capital supports all past and future debt and MBS issues with no set expiration date.

How they work

The SPSPAs effectively guarantee senior and subordinated debt and Enterprise-guaranteed MBS by ensuring the solvency of each Enterprise. If an Enterprise's liabilities exceed its assets under generally accepted accounting principles, the Treasury must provide sufficient cash capital to eliminate that deficit in exchange for senior preferred stock. The SPSPAs legally bind the U.S. government, through the Department of the Treasury, to provide the necessary capital under the stated conditions. The Federal Housing Finance Agency is responsible for determining whether the Treasury's obligation has been triggered.

In return for the support provided through the SPSPAs, Fannie Mae and Freddie Mac provided certain compensation to the Treasury and accepted various restrictions. The compensation to the Treasury included the issuance by each Enterprise of $1 billion in senior preferred stock and warrants for the purchase of common stock representing 79.9 percent of its outstanding common stock. The senior preferred stock pays an annual dividend of 10 percent in cash or 12 percent in additional senior preferred stock. In addition, beginning March 31, 2010, the Treasury is entitled to receive from each Enterprise a commitment fee as compensation for the explicit support provided by the SPSPA.

The SPSPAs also restrict each Enterprise from issuing debt in excess of 110 percent of its debt outstanding as of June 30, 2008. Further, each Enterprise's retained mortgage portfolio may not exceed $850 billion as of December 31, 2009, and must decline by 10 percent per year until it reaches $250 billion, which would occur no later than 2021. As of September 30, 2008, Fannie Mae's consolidated balance sheet included retained mortgage assets of $745 billion and Freddie Mac's included retained mortgage assets of $695 billion.

When they expire

The Treasury's commitment to provide capital to an Enterprise pursuant to their SPSPA has no set expiration date. That commitment terminates only when one of the following events occurs:

- The Treasury has provided the full commitment of $100 billion in the form of senior preferred stock purchases.
- The Enterprise liquidates its assets. In the event of such a liquidation, the Treasury will fund any capital deficiency up to its commitment under the SPSPA. After that final funding, the funding commitment in the SPSPA would terminate.
- The Enterprise has repaid, defeased, or made other provision for all its mortgage guarantee obligations and debts.

The Justice Department has issued an opinion[2] that each SPSPA creates a binding obligation on the United States to provide the financial backstop set forth therein, without time limit, for the duration of the SPSPA and the liabilities protected by the SPSPA. Thus, the Treasury's

[2] See http://www.usdoj.gov/olc/2008/treasury-gse-ltr-opinion.pdf.

commitment to provide capital to Fannie Mae and Freddie Mac is enforceable in federal court by the action of holders of debt issued or MBS guaranteed before or during the term of the commitment. The effective guarantee of Fannie Mae and Freddie Mac debt and MBS will continue as long as those instruments are outstanding.

III. GSE Credit Facility

What it does

The GSE Credit Facility ensures that all three of the housing GSEs will have access to financing from the U.S. Treasury. Through this facility, the Treasury will provide secured funding on an as-needed basis. The facility ensures that a lack of access to funding in the open market will not prevent a housing GSE from conducting its business, including making timely payment of interest and principal on senior or subordinated debt obligations. The facility has not yet been used, but remains available until December 31, 2009.

How it works

The Treasury will provide funding directly to a housing GSE from its general fund held at the Federal Reserve Bank of New York (FRBNY) in exchange for eligible collateral from the GSE. Eligible collateral is limited to MBS guaranteed by Freddie Mac and Fannie Mae and advances made by the Federal Home Loan Banks. The FRBNY will act as the Treasury's fiscal agent to advance funds to the GSEs and to administer collateral arrangements. Loan requests must be approved by the Treasury and the adequacy of collateral verified by the FRBNY.

Since the primary goal of this facility is to bridge relatively short periods when funding is unavailable to a GSE in the open market, loans are expected to be for less than one month but no shorter than one week, although specific maturities will be determined based on individual loan requests. If necessary, a maturing loan may be replaced with a new loan under the same borrowing procedures as the initial loan.

Loan amounts will be based on available collateral as determined by the FRBNY, and loan rates will be set at the Treasury's discretion. The Treasury has announced that it expects the loan rate will be half a percentage point above the London Interbank Offered Rate (LIBOR) for a similar maturity dollar-denominated loan. Since the facility was put in place on September 7th through the end of October 2008, the one-week LIBOR rate ranged from 1.64 to 4.76 percent and the one-month LIBOR rate ranged from 2.49 to 4.59 percent. During that period, Fannie Mae issued short-term debt with maturities ranging from 91 to 182 days at yields ranging from 1.59 to 3.54 percent and Freddie Mac issued short-term debt with maturities ranging from 27 to 91 days at yields ranging from 1.09 to 2.89 percent.

When it expires

The facility will offer liquidity if needed until December 31, 2009. Loans will not be made that mature beyond that date.

IV. GSE Mortgage-Backed Securities Purchase Facility

What it does

The GSE MBS Purchase Facility provides a mechanism through which the Treasury can make unlimited purchases in the open market of MBS guaranteed by Fannie Mae and Freddie Mac. Such purchases help improve the liquidity and stability of the secondary market for U.S. residential mortgages, which, in turn, improves the availability of mortgage credit to homebuyers, mitigates upward pressures on mortgage rates, and supports home prices.

How it works

The Treasury has designated two independent asset managers to undertake the purchase and management of a portfolio of Enterprise MBS as the Treasury's financial agents. Each portfolio is being managed with clear investment guidelines and investment objectives. The primary objectives of the portfolio include promoting market stability, ensuring mortgage availability, and protecting the taxpayer.

By providing a new source of direct investment in Enterprise MBS, the facility should reduce upward pressure on mortgage rates associated with investor uncertainty and loss of market liquidity. The unlimited nature of the Treasury commitment and the Treasury's ability to hold assets to maturity should give the Treasury the ability to stabilize these markets and ensure the continued flow of funds to mortgage borrowers.

For example, if investors demand unusually large risk-adjusted spreads between the yields on Enterprise MBS and LIBOR or simply stop buying these securities in sufficient quantity to maintain the flow of funds to mortgage originators, Treasury may use this facility to purchase sufficient Enterprise MBS to reduce or eliminate the negative consequences. Such actions would support the domestic economy by facilitating real estate sales and home refinancings that support consumption expenditures.

The Treasury purchased $5.1 billion in Enterprise MBS in September 2008 and $21.5 billion in October. Program purchases are included in the *Final Monthly Treasury Statement of Receipts and Outlays of the United States Government*.

When it expires

The Treasury authority to make new purchases through the facility expires on December 31, 2009. However, the Treasury may continue to hold a portfolio of Enterprise MBS purchased through the facility beyond that date.