Date - 6/20/2010

QUESTION: Are Fannie and Freddie's on-going problems likely to affect the MBS market? And are our existing mortgage-backed securities at any risk if Fannie and Freddie continue to hemorrhage? What happens after the 2010 elections if Congress decides to dissolve or sell off Fannie and Freddie? I guess my concern is over the fundamental safety and security of my fixed income portfolio, which is overwhelmingly composed of MBS instruments purchased from Freddie and Fannie (and thus not very well diversified)
Keith

Reference: New York Times article included below

ANSWER: Good questions, Keith, and astute. The New York Times article you refer to presents a pretty complete summary of where we are today vis a vis Fannie Mae and Freddie Mac. Of course, I do not know the answer to your questions with any certainty, but it seems pretty clear to me that there is a "most likely" outcome to this process of resolving Fannie Mae and Freddie Mac.

1. All government guaranteed mortgage backed securities issued by the Fannie Mae and Freddie Mac organizations - as they are currently structured - will continue to have that guarantee as to principle and interest payments; mortgages that are defaulted will be purchased by the U.S. Treasury and/or be replaced by the mortgage lenders.
2. Fannie Mae and Freddie Mac will be restructured into private company issuers of mortgage backed securities and funded through private equity issuance of common and preferred stock and bond securities. The new companies will be tightly regulated and very transparent, in terms of their operations and in terms of the entire mortgage underwriting processes, including the mortgage itself, as well as payment histories and record keeping. The maker of the mortgages will undoubtedly be required to retain a part of each mortgage and to subordinate that holding to the balance that is sold to the public through the Fannie Mae/Freddie Mac systems.

What does that mean for the Fannie Mae and Freddie Mac holdings we own in your portfolio and in other investor portfolios?

1. The mortgage bonds we currently own will continue to be guaranteed by the U.S. Treasury until we receive payment of the full amount of the face value on each security.
2. Principal and interest payments due and payable monthly will continue to be credited to our accounts on schedule. The U.S. Treasury will stand behind this payment guarantee.
3. These investments and their guaranties are not dependent upon what happens to the Fannie Mae and Freddie Mac Agencies. Bottom line: There is no risk to the capital, including interest payments that you have invested into these Mortgage Backed Securities. Of course, there are other investment risks, but these are not a function of what happens to Fannie Mae and Freddie Mac.

Dick

Cost of seizing Fannie and Freddie surging The New York Times

June 20, 2010 Phoenix, Ariz. - Fannie Mae and Freddie Mac took over a foreclosed home roughly every 90 seconds during the first three months of the year. They owned 163,828 houses at the end of March, a virtual city with more houses than Seattle. The mortgage finance companies, created by Congress to help Americans buy homes, have become two of the nation's largest landlords.

Bill Bridwell, a real estate agent in the desert south of Phoenix, is among the thousands of agents hired nationwide by the companies to sell those foreclosures, recouping some of the money that borrowers failed to repay. In a good week, he sells 20 homes and Fannie sends another 20 listings his way. "We're all working for the government now," said Mr. Bridwell on a recent sun-baked morning, steering a Hummer through subdivisions laid out like circuit boards on the desert floor.

For all the focus on the historic federal rescue of the banking industry, it is the government's decision to seize Fannie Mae and Freddie Mac in September 2008 that is likely to cost taxpayers the most money. So far the tab stands at $145.9 billion, and it grows with every foreclosure of a three-bedroom home with a two-car garage one hour from Phoenix. The Congressional Budget Office predicts that the final bill could reach $389 billion.

Fannie and Freddie increased American home ownership over the last half-century by persuading investors to provide money for mortgage loans. The sales pitch amounted to a money-back guarantee: If borrowers defaulted, the companies promised to repay the investors.

Rather than actually making loans, the two companies — Fannie older and larger, Freddie created to provide competition — bought loans from banks and other originators, providing money for more lending and helping to hold down interest rates. "Our business is the American dream of home ownership," Fannie Mae declared in its mission statement, and in 2001 the company set a target of helping to create six million new homeowners by 2014. Here in Arizona, during a housing boom fueled by cheap land, cheap money and population growth, Fannie Mae executives trumpeted that the company would invest $15 billion to help families buy homes.

Unaffordable loans

As it turns out, Fannie and Freddie increasingly were channeling money into loans that borrowers could not afford. As defaults mounted, the companies quickly ran low on money to honor their guarantees. The federal government, fearing that investors would stop providing money for new loans, placed the companies in conservatorship and took a 79.9 percent ownership stake, adding its own guarantee that investors would be repaid.

The huge and continually rising cost of that decision has spurred national debate about federal subsidies for mortgage lending. Republicans want to sever ties with Fannie and Freddie once the crisis abates. The Obama administration and Congressional Democrats have insisted on postponing the argument until after the midterm elections.

In the meantime, **Fannie and Freddie are, at public expense, removing owners who cannot afford their homes, reselling the houses at much lower prices and financing mortgage loans for the new owners.** The two companies together accounted for 17 percent of real estate sales in Arizona during the first four months of the year, almost three times their share of the market during the same period last year, according to an analysis by MDA DataQuick.

The population of Pinal County, where Mr. Bridwell lives and works, roughly doubled to 340,000 over the last decade. Developers built an entirely new city called Maricopa on land assembled from farmers. Buyers camped outside new developments, waiting to purchase homes. One builder laid out a 300-lot subdivision at the end of a three-mile dirt road and still managed to sell 30 of the homes.

Mr. Bridwell sold plenty of those houses during the boom, then cut workers as prices crashed. Now his firm, Golden Touch Realty, again employs as many people as at the height of the boom, all working exclusively for Fannie Mae. The payroll now includes a locksmith to secure foreclosed homes and two clerks devoted to federal paperwork.

Golden Touch gets more listings from Fannie Mae than any other firm in Pinal County. Mr. Bridwell said he was ready to jump because he remembered the last time the government ended up owning thousands of Arizona houses, after the late-1980s collapse of the savings and loan industry. "The way I see it," said Mr. Bridwell, whose glass-top desk displays membership cards from the Republican National Committee, "is that we're getting these homes back into private hands."

Prices have plunged. So by the time a home is resold, **Fannie and Freddie on average recoup less than 60 percent of the money the borrower failed to repay**, according to the companies' financial filings. In Phoenix and other areas where prices have fallen sharply, the losses often are larger.

Selling a house generally costs the government about $10,000. The outsides are weeded and the insides are scrubbed. Stolen appliances are replaced, brackish pools are refilled. And until the properties are sold, they must be maintained. Fannie asks contractors to mow lawns twice a month during the summer, and pays them $80 each time. That's a monthly grass bill of more than $10 million. All told, the companies spent more than $1 billion on upkeep last year. "We may be behind many loans on the same street, so we believe that it's in everyone's best interest to aggressively do property maintenance," said Chris Bowden, the Freddie Mac executive in charge of foreclosure sales.

Foreclosures punch holes in neighborhoods, so residents, community groups and public officials are eager to see properties reoccupied. But there also is concern that investors are buying many foreclosures as rental properties, making it harder for neighborhoods to recover. Real estate agents tend to favor investors because the sales close surely and quickly and there is the prospect of repeat business. But community advocates say that Fannie and Freddie have an obligation to sell houses to homeowners.

David Adame worked for Fannie Mae's local office during the boom, on programs to make ownership more affordable. Now with prices down sharply, Mr. Adame sees a second chance to put people into homes they can afford. "Yes, move inventory," said Mr. Adame, now an executive focused on housing issues at Chicanos por la Causa, a Phoenix nonprofit group, "but if we just move inventory to investors, then what are we doing?"

Encouraging homeowners

Executives at both Fannie and Freddie say they have an overriding obligation to limit losses, but that they are taking steps to sell more homes to families.

Fannie Mae last summer announced that it would give people seeking homes a "first look" by not accepting offers from investors in the first 15 days that a property is on the market. It also offers to help buyers with closing costs, and prohibits buyers from reselling properties at a profit for 90 days, to discourage speculation. Fannie Mae said that 68.4 percent of buyers this year had certified that they would use the house as a primary residence. Freddie Mac has adopted fewer programs, but it said it had sold about the same share of foreclosures to owner-occupants.