Fannie and Freddie

Fannie and Freddie are not some pop music duo but colloquialisms for two of the world's largest financial companies. Both are entirely outside the area of interest for a majority of the investing public, even though they deserve serious attention because of their unusual situation. Depending upon how the US government will treat them in future, we will see if they are today's sleeping beauties or sleeping monsters. Under certain conditions, their shares could provide very attractive long-term opportunities for investors.

Fannie Mae (Federal National Mortgage Association) was established by Congress in 1938, originally as an agency of the federal government. It was transformed into a joint-stock company in 1968 with the objective of generating profits. Freddie Mac (Federal Home Loan Mortgage Corporation) was founded in 1970, then transformed in 1989 into a joint-stock company owned by private investors. The shares of both companies have therefore been traded on the stock market for several decades.

The mission of Fannie and Freddie was (and remains) to support realisation of the American dream, a crucial part of which is for the largest-possible number of Americans to own their housing. The roles of Fannie and Freddie consist in substantially supporting the mortgage market, including by making mortgages affordable and accessible. They do this in essentially two ways. First, for a fee they issue guarantees to banks that their mortgages will be paid. Second, they themselves buy entire bundles of mortgages from banks. Their role on the mortgage market is immense and irreplaceable. One way or the other, they currently are involved in nearly half of all existing US mortgages. Without their support, mortgages would be much more expensive and less accessible.

Through their existence, Fannie and Freddie also have been exceptionally profitable companies. In the 1990s, their profits put them at the top of the global rankings and their shares have long been cherished by investors. As these things go, the more you get, the more you want and already at the beginning of this century, clouds had begun to gather over Fannie and Freddie. The first signals took the form of accounting machinations, weak management, and efforts to grow at any cost regardless of risk. It should be said that even the government pushed Fannie and Freddie to support mortgage issuance even of very doubtful quality. After all, the state did establish them and it still partially regards them as an extension of itself.

The global financial crisis of 2008 hit both companies hard. At that time, they held or guaranteed mortgages valued at USD 5.2 trillion. As the mortgage crisis was gradually worsening, Fannie and Freddie came under financial stress. Due to their enormous leverage and accumulating losses, they began to be strapped for capital and in the end required a massive government bailout. Although it is true that Fannie and Freddie were private companies, due to their historic ties to the government, and especially due to their enormous size, their liabilities were implicitly guaranteed by the government.

In September 2008, the US government was forced to invest new capital into both companies. The amount of this capital injection eventually reached USD 187 billion and the government became the owner of 79.9% stakes in the two companies by newly issuing senior preference shares. Conservatorship was imposed on Fannie and Freddie, and the original shareholders lost practically everything. Nevertheless, the two companies could continue operations. The conservatorship also included a deal which the government essentially concluded with itself and specifying an annual dividend for state-owned preference shares of 10% of the invested capital.

When in early 2012 it was shown that Fannie and Freddie would again achieve large profits, the government saw its chance and negotiated new rules with itself. Instead of a 10% dividend, the government would now automatically collect all future profits. This was exceptionally advantageous for the government both financially and in terms of timing. Something had to be used to pay for Obamacare. This arrangement is valid to this day. By our estimates, the government has collected from Fannie and Freddie more than USD 260 billion, which is much more than it had had to put into the two companies. There is nothing inherently bad in this, because in 2008 it had taken upon itself a great risk by taking over the two companies. To this day, it faces a string of lawsuits initiated by owners of the original preference shares who thereby had suffered losses.

The crux of the problem lies elsewhere. Because the state collects all the profits from Fannie and Freddie, the two companies operate practically without equity capital. At the end of 2016, Fannie and Freddie together had assets of USD 5.3 trillion and equity of USD 11 billion. That is leverage (the ratio of assets to equity) of 481. This is crazy!!! By comparison, the American bank Wells Fargo has assets of USD 1.93 trillion and equity of USD 199 billion. That puts its leverage at less than 10. Bank of America has leverage of 8.2 and JP Morgan 9.8. Those are reasonable numbers and suggest that large US banks are well capitalised and able to withstand the next recession or crisis.

The capitalisation of Fannie and Freddie is much worse than at any point prior to and including 2008. Operating a financial company with USD 5.3 trillion in assets and practically zero capital is madness. This legacy of the Obama years is a ticking time bomb. It is really incredible that a state which knows that it had to bail out the two companies before, knows it cannot get along without them, and knows that their size constitutes a potential source of systemic risk, and despite all its talk about bad capitalists and need for regulation, could not resist its own momentary greed. It would not take much before the government would need to pour more capital into Fannie and Freddie, and so continuing the current model wherein the government takes all the profit means it is merely a question of time before that day of reckoning arrives. Be that as it may, the conservatorship which was originally intended as a temporary measure still continues even 9 years later.

Trump's Secretary of the Treasury, Steven Mnuchin, sees that the current situation of Fannie and Freddie is unsustainable and he has said he wants to change it. It is not clear when and how that will happen. The Obama Administration's original ideas that the two companies would be gradually dissolved are currently not very realistic, because the mortgage market will not get along without them and it is unclear what could take their place without seriously endangering the functioning of the mortgage market. The whole US economy would look quite different without Fannie and Freddie after all, because activities related to the housing sector account for more than 20% of its GDP.

The logical solution would be to return the two companies fully into the hands of private capital and force the new owners to increase equity substantially. The government could obtain a large amount of money from selling its stake and would substantially reduce the risk related to Fannie and Freddie's existence while markedly cutting their leverage. Last year's combined profits of Fannie and Freddie came to approximately USD 19 billion. At a P/E of 12, they could collectively have a capitalisation of USD 228 billion. Equity capital could range around this level after recapitalisation. This would put the leverage at 23, which is adequate considering their business.

If something like this were to happen, Fannie and Freddie's recapitalisation and return into private hands could present a very attractive opportunity for investors. Perhaps US politicians will have enough sense to do that. If they do, we might buy in.

Invest with care!

Daniel Gladiš, 19 September 2017

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