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(1/26) The Bailout Fannie Mae and Freddie Mac

Born as a part of the government and released to the free market in 1968, a story of the debauchery of capitalism and the unconditional support of the United States Government.

A story of growth, greed, disaster and rescue.

(2/26) Our story begins in 1916 with the creation of the first Government-Sponsored Enterprise (GSE), the Farm Credit System.

A GSE is government backed (sort of), privately held agency established by Congress to improve credit flow in some regions of the US economy.

(3/26) The primary way a GSE improves credit flow is by guaranteeing to purchase a specific type/number of loans and then selling them as securities to investors in the secondary market.

(4/26) Think of it like this: if a lender only had enough money to fund X [30-year, $100k] mortgages, it would take years before they could deploy a new loan.

To avoid this issue, a GSE purchases loans from third-party lenders, therefore giving them more cash flow to lend.

(5/26) In 1938, as part of The New Deal, the Federal National Mortgage Association (FNMA a.k.a. Fannie Mae) was founded. The organization's explicit purpose was to provide local banks with federal money to finance home loans in an attempt to raise levels of home ownership.

(6/26) A series of changes in the 50s-60s culminated when Fannie Mae was split into two: private (retaining the Fannie Mae name) and public (Government National Mortgage Association - Ginnie Mae).

Although now private, Fannie Mae never dropped the implicit backing of the US.

(7/26) In 1970 Fannie Mae's mandate was expanded when the federal government authorized it to buy uninsured, unconventional loans

That same act created the Federal Home Loan Mortgage Corporation (FHLMC - Freddie Mac), a sort-of fork of Fannie Mae… for competition, or something

(8/26) Together, Fannie Mae and Freddie Mac grew to be behemoths.

In 1992, George H.W. Bush signed the Housing and Community Act, giving the corporations "an affirmative obligation to facilitate the financing of affordable housing for low and moderate-income families"

(9/26) Initially, the goal was for each GSE to allocate at least 30% of mortgage purchases to low/moderate income borrowers. By 2007 the goal was 55%.

In 2000, after a review of the activities of the GSEs, anti-predatory rules were put into place.

They were removed in 2004.

(10/26) These anti-predatory rules are one of the great WTFs of history. One has to wonder if things could have gotten so out of control had they held.

In 2006, Fannie and Freddie insured 70% of all subprime mortgages. Would there have even been a crisis without them?

(11/26) The GSEs had two things in mind:

- "Following their mandate" and "helping" low/middle income Americans buy homes
- Quarterly earnings reports — they are a corporation after all

Responsible lending? Risk management? Due diligence? That's for nerds.

(12/26) An increasingly deregulated market created a new class of mortgage-securitizers: Private-Label Securitization (PLS), typically operated by investment banks.

By 2004 PLS was so large that congress felt it NECESSARY to drop the anti-predatory rules. For "competition."

(13/26) Here's the thing, the GSEs were not playing on the same field as the PLS.

Investment banks were willing to offer much riskier loans because they sold off most of the security, maintaining minimal exposure.

GSEs guarantee the performance of their securities. Forever.

(14/26) Earnings depended on volume, and so the GSEs took in whatever they could… even after the safe assets began drying up.

The growth of PLS forced the GSEs to lower their underwriting standards, attempting to reclaim market share to please shareholders.

(15/26) Particularly noteworthy was the shift in mortgage product type, from traditional, amortizing, fixed-rate mortgages (FRMs) to nontraditional, structurally riskier, nonamortizing, adjustable-rate mortgages (ARMs)

ARMs were those balloon payment mortgages you've heard about

(16/26) At this point we are in both the meteoric rise and the final act of Fannie Mae and Freddie Mac. As they danced to the tune of Wall Street, more and more unqualified buyers received mortgages.

The music would continue until 2006/2007, when the subprime defaults begin.

(17/26) A Reforms bill was introduced in the Senate in 2005 after a series of accounting problems and management issues at the GSEs.

The bill had a second chance in 2006 when John McCain added his name, but ultimately it died without ever being voted on.

(18/26) In the House, a bill was passed by October 2005, despite the opposition of President Bush:

"The regulatory regime envisioned by H.R. 1461 is considerably weaker than that which governs other large, complex financial institutions."

But that's as far as reform got.

(19/26) And so, Fannie Mae and Freddie Mac continued to buy up mortgages, as many as they could find.

In 2007, both institutions were showing serious signs of distress.

By summer 2008, the crisis was actively unfolding.

(20/26) Both GSEs had positive net worth up until the takeover. However, Fannie had a 20:1 leverage ratio, Freddie 70:1... not including the securities they guaranteed.

But the real issue? Liquidity. They couldn't generate the cash to cover the snowballing mortgage delinquencies.

(21/26) On July 7th, the US Treasury took efforts to backstop the GSEs after their share price dropped by half in a week. The GSEs would receive increases in credit available and the possibility of a capital injection.

The NY Fed also announced it would lend, as necessary.

(22/26) On July 30th, a new law expanded regulatory authority over GSEs and gave the U.S. Treasury the authority to advance funds for the purpose of stabilizing Fannie Mae or Freddie Mac. In ancipiation of the upcoming bailout, the law raised the Treasury's debt ceiling by $800B.

(23/26) By September 6th it was over. The fire has spread so thoroughly through the GSEs that there were only two options:

- Government bailout
- Economic cataclysm

And so, the Conservatorship of Fannie Mae and Freddie Mac was announced, to be executed the following day.

(24/26) In the end, the American taxpayer spent $190B bailing out Fannie Mae and Freddie Mac.

But what's a mere $190B in the face of the $5T that the GSEs supported? 56% of all mortgages.

Why is the solution always "save the people who got us into this mess?"

(25/26) In 2003, Nassim Taleb said:

"The government-sponsored institution Fannie Mae, when I look at its risks, seems to be sitting on a barrel of dynamite, vulnerable to the slightest hiccup. But not to worry: their large staff of scientists deem these events unlikely"

(26/26) In 2022, Haym Salomon said:

"The Global Financial Crisis was bullshit."

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