



TREASURY TO THE RESCUE!

What the Fannie-Freddie Action Means to Relocation

In an attempt to aid the downturn domestic housing market and arrest further slides in financial markets worldwide, the U.S. government has taken control of mortgage giants Fannie Mae and Freddie Mac. Moore provides an overview of these two government sponsored entities (GSEs), the federal government actions taken to bail out Fannie Mae and Freddie Mac, and how said action will affect the employee mobility industry.

By Patrick Moore

The decision by the U.S. government to place Freddie Mac (Freddie) and Fannie Mae (Fannie) in conservatorship is, to say the least, a highly significant event affecting the American financial system. The two companies together own or guarantee more than \$5 trillion in mortgage debt. Fannie and Freddie securities have been traded for years as AAA-quality investments. An event of this magnitude certainly has a broad effect on our nation, including many aspects of the relocation business.

First, let us understand the government sponsored enterprises' (GSEs) function and purpose. To ensure that funds are available to homeowners for mortgages, the government established Fannie in 1938, then Freddie in the 1970s. GSEs buy mortgages from lenders—banks, thrifts, mortgage bankers—using money borrowed at favorable rates.

They are both hybrids—private corporations with shareholders to satisfy but with government oversight and regulation. Both Congress and the executive branch share responsibility of oversight; however, the U.S. government has not (until now) backed the GSEs the way, for example, the Federal Deposit Insurance Corporation (FDIC) does our banks. Nevertheless, most investors regard their quasi-government structure as a positive factor in making investments.

Simply stated, Fannie and Freddie both function this way: A bank makes a mortgage loan to a borrower who wants to buy a home. The bank then sells the loan to a GSE and receives a cash payment for the mortgage. The bank is then free to use this cash payment to make another loan, which it also can sell to a GSE—and so on into perpetuity.

GSEs buy loans from many banks and bundle them into big blocks of loans—securities backed by good old American residential real estate. They take the bundles to Wall Street firms that then sell the bundles to investors—mostly governments, large pension funds, major investors, and mutual fund companies. Remember, these have been considered AAA investments—the safest and highest quality. During the past decade or two, the GSEs actually started buying some of their own securities and they began to grow rapidly. Their influence in Washington grew, too—it is reported that, between the two, more than \$150 million was spent in contributions and lobbying last year alone.

All lenders must put aside capital as a hedge against losses. Interestingly, while banks have to hold capital equal to 8 percent of their assets, the GSEs are required only to have 2.5 percent. For this and other reasons, during the past several years Fannie and Freddie attracted harsh critics who issued dire warnings that they were too thinly capitalized and were getting much too big. A few years ago, the GSEs also began buying sub-prime loans for the first time since their creation. A great deal of money and effort went to counteracting the criticism such that little was done to heighten scrutiny—even after an accounting scandal in 2002 and 2003.



TREASURY

by Patrick Moore, continued

Yet, both companies made a lot of money, shareholders were pleased, their political influence swelled, and the world was eager to buy Fannie- and Freddie-backed investments. Then came the housing downturn.

Shockwaves

They started losing money, but still had lots of reserves—still do today. At the time of the government's action, total capital of the two companies was \$81 billion and their losses were projected to be only about \$8 billion, according to The Financial Times.

But as the mortgage market generally got worse, and home values declined, investors began to get really nervous. Stockholders sold and the stock price of each company dropped 90 percent in a few months. That did not affect their capital but it was a serious vote of no-confidence. Then, buyers of mortgages started to shy away from their securities—another sign of low confidence.

So your federal government stepped in to shore up confidence. This calmed the bond markets (those who buy mortgages) but threatened to wipe out stockholders already hit hard. But the financial stakes were starkly different—wipe out \$10 billion in stockholder value or allow loss of confidence to affect \$5 trillion. And, confidence in the GSEs is directly related to confidence in the U.S. economy.

Here's what they did, according to the Mortgage Bankers Association, Washington, DC:

1. Top management was replaced at both companies (conservatorship).
2. They increased their funding ability to buy mortgage securities.
3. The U.S. Treasury bought \$1 billion in stock in each company.
4. Treasury also provided a large line of credit to "backstop" credit needs.
5. Treasury started actually buying mortgage-backed securities.
6. All lobbying and political activity must immediately cease.

Among most experts, the government move will lead to lower mortgage rates (rates actually dropped ½ percent within two days). This will increase the number of qualified buyers as more will qualify for financing. There will be more available credit to potential homebuyers because of U.S. government investment and the provision of a line of credit.

An easing of the uncertainty over the mortgage market will keep investors buying mortgage securities, therefore providing a continuing source of new funds. All of these outcomes should stabilize, even nudge up home values. It is worth noting that the most recent Office of Federal Housing Enterprise Oversight (OFHEO; combined with the Federal Housing Finance board on July 30, 2008 to form the Federal Housing Finance Agency) House Price Index showed home values increased over last year in 34 states. So in most places there appears to be stabilization, definitely a welcome development.

Many predict the GSE takeover will result in an overall improved outlook for the U.S. economy that will increase confidence among business, government, and consumers.



TREASURY

by Patrick Moore, continued

The Effect on Relocation

One of our challenges in selling homes at this time is the number of homes on the market. A recent National Association of Realtors® report stated that more than 4 million homes are still on the market. That is about twice the number in early 2006. The lower rates that accompany the Fannie/Freddie takeover should bring more buyers into the market. As the inventory levels drop, that will reduce the competition for transferee and inventory homes.

Any surge in purchase and refinance activity should have the effect of stabilizing home values, thus easing the loss-on-sale and negative equity situations for many. Funding for destination home purchases will continue to flow and lower rates will improve affordability.

All of these factors should contribute to an improved relocation homesale environment.

We all still need to be well-versed in dealing with negative equity situations, short sales, and program benefits to support transferees pummeled by the housing market. Any actual recovery will take time and we need to take the lead in piloting folks through these shifting waters for some time.

There are potential negatives, of course, to the government's action. Losses related to ongoing operations of the GSEs now fall on us, the taxpayers. The change in public policy that this intervention represents could morph into a bureaucratic miasma after a time. Some worry that the government really intends to dismantle the GSEs, thus removing a prime source of loans for lower income and first-time homebuyers.

What lessons have we learned from the demise of Freddie and Fannie? Here are a few suggested by commentators:

- regulatory failure (or neglect) can have a broad impact;
- some institutions are indeed too big to fail;
- loss of confidence can be more critical than actual indicators; and
- bold U.S. government action can provide solid reassurance.

Perhaps, most of all, our relocation business activities are closely tied to these engines of the credit market.

It is likely there will be more bumps in the road to recovery from our credit quality doldrums, including the purchase of Lehman Brothers, Merrill Lynch, Wachovia, and AIG. But our public officials took bold action and put the vast resources of the U.S. government behind Fannie Mae and Freddie Mac. For now, at least, we can be more optimistic about access to the financing that is essential to the homesale market.

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