

The **GSE** REPORT

Special Supplement

“GSEs’ Liabilities Mount as Federal Budget Deficit Declines”

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GSEs' Liabilities Mount as Federal Budget Deficit Declines

The government sponsored housing enterprises, Fannie Mae and Freddie Mac, take on two types of debt liabilities:

- Direct debt – these are notes sold in the public markets that name Fannie Mae or Freddie Mac as the obligor. Funds from the GSEs' investments and operations are the source of repayment of principal and interest under the terms of the debt offering.
- Indirect debt – this is debt sold to investors, such as mortgage backed securities (MBSs), which has been “enhanced” with a GSE guarantee. The primary source of repayment of an MBS is from mortgage payments made by the homeowner. The GSE has guaranteed timely payment of principal and interest to the investor who bought the MBS; if the homeowner does not pay his mortgage, the GSE ultimately covers any cash shortage and works with the lender/servicer to collect payment from the homeowner.

Fannie Mae's and Freddie Mac's increasing presence in a steadily growing MBS market has meant that the GSEs' indirect liability has grown, too. MBS issuance in 1998 broke all previous records, reaching more than double that of 1997:

Combined MBS statistics for Fannie Mae/Freddie Mac	1997	1998	% increase
Mortgage backed securities issued (\$ billions)	264	577	119%
Mortgage backed securities outstanding (\$ billions)	1,289	1,481	15%

Source: Bond Market Association

The GSEs' loss experience on MBSs during the 1990s has been exceptionally low. The strong economy has lowered homeowner defaults and delinquencies, and any actual losses have been shared with lenders/servicers, under the terms of negotiated lender/servicer “representation and warranty” agreements, and mortgage insurers. Although this indirect liability does not represent the same degree of risk as direct debt, this does not mean that indirect liability is a small risk to the GSEs. During the early eighties, Fannie Mae was hit from two sides. Surging interest rates and rising homeowner defaults contributed to the disastrous financial circumstances that nearly drove Fannie Mae out of business.

Today, the GSEs claim that their unique hedging capabilities will shield them from interest rate risk. The Nobel Laureates at Long Term Capital Management made the same claim. Even with successful interest rate hedging, they will have sharply higher cash requirements if housing markets deteriorate and homeowners default on their mortgages. Worse yet, their exposure to homeowner defaults will increase as –

- the GSEs redefine their mortgage products to include mortgage insurance risk;
- expand into riskier new lines of business, such as subprime mortgages and home equity lines of credit; and
- forego the protections provided to them by well-capitalized lenders through “representation and warranty” agreements by circumventing lenders and going direct to brokers and consumers.

As the GSEs have grown in size and financial clout, they have rapidly accelerated their issuance of direct debt. In 1998, Fannie Mae and Freddie Mac issued \$3 trillion of long-term and short-term debt – a 15% increase over 1997. Most of this was short-term debt that was paid within the year and re-issued. However, long-term debt issued soared at a higher rate than even MBSs during a record-breaking year, rising 133%. This rapid run-up of long-term debt caused outstanding debt to increase 39%:

Combined Debt statistics for Fannie Mae/Freddie Mac	1997	1998	% increase
Short-term debt issued (\$ billions)	2535	2796	10%
Long-term debt issued (\$ billions)	106	247	133%
Debt outstanding (\$ billions)	539	747	39%

Source: Bond Market Association

The GSEs have made no secret of their ambitions to be major players in the debt market. With their “implied” federal guarantee, they can find buyers for their debt, no matter what the overall market conditions are. They made 1998 the year for “benchmark” debt, with the explicit reasoning that broadly available and liquid GSE debt would become the “benchmark” for market pricing, playing the role that Treasury securities play today. The GSEs have announced that they are building a “yield curve” by issuing debt of varying maturities, which could serve as a reference point for investors. As the prominence of Treasury debt shrinks, GSE debt will rise up to replace it:

Debt Statistics (\$ billions)	1997	Total Mkt %	1998	Total Mkt %	% growth, '97-'98
Total Debt Market	12,100	100%	12,800	100%	6%
Treasury Securities	3,457	29%	3,355	26%	(3%)
GSE Direct Debt	539	4%	748	6%	39%
GSE –backed MBSs	1,289	11%	1,481	11%	15%
GSE Direct + Indirect Debt	1,828	15%	2,229	17%	22%

Source: Bond Market Association

If Treasury Securities and GSE Direct + Indirect debt continues to increase/decrease at the rates seen in 1998, GSE liabilities will exceed Treasury debt by the end of the year 2000.

This expanding credit market activity increases the GSEs’ influence on Wall Street, as well. Since Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are the largest debt issuers in the U.S., Wall Street firms worry about staying in their good graces so that they get a piece of the GSE business. As a result, Wall Street analysts are quick to praise the GSEs, and slow to criticize.

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