
US capital markets

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Fannie Mae and Freddie Mac

September 7 2008 will be remembered by US capital markets participants as the day on which the government took over operation of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Association (Freddie Mac). To be precise, the Director of the Financial Housing Finance Authority (FHFA) placed Fannie Mae and Freddie Mac into conservatorship. The appointment of the FHFA as conservator was based on legislative provisions that had been enacted in the summer under the Housing and Economic Recovery Act of 2008. The announced purpose of the conservatorship is to assure the entities' safety and soundness while providing stability and liquidity to the housing market. In addition, the US Treasury agreed to purchase preferred shares of both entities and to provide additional capital support to them under certain scenarios, as well as provide short-term secured credit to them when, and if, needed, and purchase mortgage-backed securities issued by them in the secondary market.

In the week following announcement of the conservatorship, it has become clear that Secretary Paulson and Chairman Bernanke were forced to choose among unattractive options. Only with the passage of time will we be able to determine whether their choices were the best available under the circumstances.

Some questions remain to be answered. Were each of Fannie Mae and Freddie Mac so close to failure as to warrant the same level of intervention? Some commentators have observed that Fannie Mae was in considerably stronger financial shape than Freddie Mac and did not require intervention. Did the government consider the immediate, negative impact on financial institutions of having to write down their portfolio holdings of Fannie Mae and Freddie Mac preferred shares? For some, these losses are large. There are many additional questions relating to whether the government anticipated triggering credit events under credit default swaps, options and swaptions, and triggering acceleration of other contracts relating to these GSEs.

Of course, the even bigger question relates to how the US housing market will be financed in the future.

In the US capital markets, these are difficult days that present difficult choices. The US government has taken and continues to take, decisive actions. It will take quite a while before we can assess the results.