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Freddie Mac/Fannie Mae bailout: Guess Who Wins

Posted by Jerome a Paris on September 7, 2008 - 12:10pm in The Oil Drum: Europe
Topic: Economics/Finance
Tags: bail out, dollar, fannie mae, fnm, fre, freddie mac, government, original, taxpayer [list all tags]

The bailout of Freddie and Fannie has just been announced by Hank Paulson, with supporting words from Bernanke. What's interesting in what's proposed, as usual, is what's unsaid. This would seem to be an incredibly ambitious gambit: a nationalisation, an attempted bailout of ALL the banks, and an open-ended commitment of taxpayer money to save the financial world.

> Treasury Lays Out Fan-Fred Plan
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> WASHINGTON -- U.S. federal regulators outlined their bailout for Fannie Mae and Freddie Mac Sunday morning, including a takeover of the firms by their regulator and a Treasury Department purchase of the firms' senior preferred stock.
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> The plan, outlined jointly by the Treasury Department and Federal Housing Finance Agency, also includes a plan for the Treasury to purchase mortgage-backed securities from the firms in the open market, and a lending facility through the Treasury from its general fund held at the Federal Reserve Bank of New York.

> The Treasury said its senior preferred stock purchase agreement includes and upfront $1 billion issuance of senior preferred stock with a 10% coupon from each GSE, quarterly dividend payments, warrants representing an ownership stake of 79.9% in each firm going forward, and a quarterly fee starting in 2010.

That's the nationalisation bit: it's a slow motion version: there's a small upfront commitment of funds ($1 billion is small change for these companies: even if it represents roughly 10% of their combined market value today, it's less than 1% of their announced equity), but the main part if the warrants, which are rights to buy shares exercisable in the future. This is consistent with the announcement that public funds would be injected over time, as needs arise. But no amounts are given there yet.

What seems apparent is that this is good news for the other owners of preferred shares, which are regional US banks and a lot of foreign governments (which used these shares as a proxy for US Treasuries, with somewhat better remuneration) - they are not going to be wiped out. The preferred shares not being wiped out allows to avoid bankruptcy risk for the banks owning them, and to avoid pissing off a lot of foreign creditors, so it's a reasonable thing to do.

> The FHFA, which regulates the two government-sponsored enterprises, will act as conservator of the two firms, taking control of the companies' day-to-day operations. The agency said in a release that there is "no exact time frame" for when the conservatorship may end, and that the powers of the firms' stockholders will be suspended until the conservatorship is terminated.

As expected, as the government takes over, the normal shareholders are wiped out, something that will allow the Bush administration to claim that they are being tough and not bailing out investors, but we'll see that this claim is fundamentally false.

This whole side of the package will allow the government to claim that the bailout has a minimal cost: $1 billion only for now, a highly disingenuous claim (the warrants will most likely need to be exercised - but only next year, and there is the rest...)

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This is huge. This is the federal government taking over the "toxic waste" in a way that will have an impact not just on Freddie and Fannie, but on the whole market. By "buying" mortgage-backed securities instrad of taking them as collateral, the Treasury does two things at the same time:

- it takes off the assets and liabilities off the balance sheet of the two companies in a definitive way (rather than temporarily) and assumes, for sure, the associated risk;
- it sets a price on these securities. This has been the biggest problem to solve the credit crisis: nobody has been willing to set a price on these assets, because of the uncertainty on the real value of the underlying assets (or because everybody could see that they were falling by the day). By setting such a price, the government creates a highly significant precedent - and, in all likelihood, provides a floor to these prices, ie an implicit commitment (or at least the expectation of a commitment) to buy more such securities.

In doing this, the government is boldly trying to call the end of the financial crisis, set a total price to it, and agree to pay the difference if the cost is higher in the end. This, to me, looks like a full governmental guarantee to the whole banking sector. Of course, a lot will depend on where the price is set to purchase these mortgage-backed assets, but this is still a take-over of the toxic waste by taxpayers, at aprice that may or may not (and, frankly, is highly unlikely to) be right.

But it's even worse than that: by providing an additional lending facility on top of that, the government is saying: we're putting our money (well, yours) where our mouth is - providing further liquidity to the companies and, I presume, expecting them, once the toxic waste has been cleared from their books (which can happen now that there is a floor price), to lend to the mortgage markets again.

It's the usual solution of the Greenspan bubble: as soon as one bursts, we blow another one to cover it up and keep the party going a little longer.

Of course, the goal here is simply to create a boost that lasts until November, and given the kind of weapons used, it's likely to succeed in that short term goal. Saving the US economy is another thing, given that its fundamental problem is spending beyond incomes - more debt does not cure that, rather the opposite. The twin movements of growing spending and stagnant incomes have to be brought back together. Boosting spending via debt cannot work this time; incomes have to be raised - and for the right people.

This plan is not about this, it's about bailing out the financiers that played and lost with other people's money, and give them a chance to try again. Par for the course, of course.