Mike Swanson (7/14/08)

We are at a critical point in the economic history of the United States. I know of no other way to put it. The events of last week were of a character that we've never seen before. On Friday mortgage lender IndyMac Bancorp became the second largest federally insured financial company to fail after it got hit by a bank run. The Federal Deposit Insurance Corporation took it over. That news may be a big story, but is totally overshadowed right now by the teetering collapse of Fannie Mae and Freddie Mac. Both are in danger of going under and the Bush administration, Federal Reserve, and Treasury Department are now meeting on a daily basis to figure out what to do.

On Sunday the Federal Reserve and Treasury Department announced that they were going to allow the Federal Reserve Bank of New York to lend to Freddie and Fannie at 2.25% - the discount rate that Wall Street Commercial banks receive. They also said they are going to seek authority from Congress to expand their current $2.25 billion line of credit to each company. According to Reuters, "Sunday's announcements are likely to raise anew criticism that the government should have moved sooner to rein in the two companies, especially since investors widely assumed they would be bailed out if they got into trouble."

"The government denied it, but what was seen by investors as an implicit guarantee of support allowed Fannie and Freddie to borrow at rates only slightly higher than the Treasury -- and lower than what their banking competitors had to pay."

"This really blows away the notion of an implicit guarantee," independent banking consultant Bert Ely said of the Treasury's plan to ask Congress to allow it to make equity investments in Fannie Mae and Freddie Mac. "It suggests a greater concern about how these companies are doing. It says the problems are deeper. It gets to the solvency of the companies, not just the liquidity."

There is no news that would be worse than the collapse of these two institutions and such an event if it happens will have ramifications for the economy and stock market for years to come. Fannie and Freddie buy mortgages and then package them into bonds, which they guarantee. They then sell the bonds to investors, including mutual funds, hedge funds, pensions, annuities - just about any institutional investor you can think of. Odds are that if you own a mutual fund or annuity that you indirectly own a security backed by one of these two institutions. The two of them combined own half of America's twelve trillion in outstanding mortgages and their failure would be the implosion of the entire financial system.

People have worried about problems in these two institutions for years. Five years ago Armando Falcon, the head of the government agency that overseas Freddie and and Fannie wrote a report that said that the two companies would experience a "financial calamity" if real estate prices were to fall at all due to excess leverage and poor accounting standards. His report took two years of research and was controversial at the time. The day it came out housing stocks had a temporary drop on huge volume. In response to the report the Bush administration fired Falcon. Don't think for a second though that the Bush administration is somehow solely responsible for this mess. There is plenty of blame to go around and one would have to start at the Senate and several powerful Senators on the Banking Committee that are literally owned by the banks. "Angelo's Angel" being one of the worst. If these politicians had done their job the country wouldn't be in the fix it is in now.

Others have warned about what a collapse of Freddie and Fannie would mean. Warren Buffett has made statements in the past that he feared the failure of Fannie and Freddie could set off a "derivatives time bomb" that would implode the whole financial system. By insuring over half of

the mortgages in the country they are two big to fail. This is serious situation folks. We've never seen anything like it before.
Earlier last week former St. Louis Federal Reserve President William Poole said the companies are basically "insolvent" and may need a government bailout. The falling housing prices and foreclosures have caused Fannie alone to lose $6.85 billion in the past year, which in turn is eating away at its balance sheet. Both Fannie and Freddie closed on Friday at a combined market cap of $15 billion and thanks to massive leverage own over $5 trillion dollars worth of mortgages. In comparison the largest US commercial banks such as Bank of America and JP Morgan have market caps of around 10% of their total assets. Congress encouraged Fannie and Freddie to over leverage themselves - and so has the Federal Reserve in the past 10 months - to try to cushion the collapsing real estate market.
Of the $5 trillion that sits on Fannie and Freddie balance sheets only $1.6 trillion is listed on its balance sheet. The rest of it is listed "off" the balance sheet in much the same way that Bear Stearns listed its "Level 3" assets on its balance sheet. The two companies must constantly borrow money just to operate. If borrowing costs rise or they have to make good on the securities they insure than they can fail. Of course this is exactly what has been happening. According to Bloomberg, "Freddie Mac owed $5.2 billion more than its assets were worth in the first quarter, making it insolvent under fair value accounting rules... The fair value of Fannie Mae's assets fell 66 percent to $12.2 billion, data provided by the Washington-based company show, and may be negative next quarter."   Read the full article...