

**iContact** We Simplify Communication™ Easily Create, Publish & Track Email Newsletters, Surveys, Blogs & RSS Feeds  
**EMAIL MARKETING** ★ Industry-Leading Deliverability **Free Trial**

# FORTUNE



Subscribe To Fortune Magazine  
 Magazine Customer Service

SPECIAL REPORT **Mortgage Meltdown** Complete Coverage

## The \$5 trillion mess

*Fannie Mae and Freddie Mac were created by Congress to help more Americans buy homes. Now their shaky condition threatens the entire housing market.*

By Katie Benner, writer  
 LAST UPDATED: JULY 12, 2008: 9:25 AM EDT

NEW YORK (Fortune) -- They own or guarantee \$5 trillion worth of mortgages - nearly half of all the country's outstanding home loan debt-and they're crashing. Big time.

Fannie Mae and Freddie Mac are struggling with an investor loss of confidence so great that, while they're unlikely to go under, they could conceivably see their ability to function impaired. That would wreak yet more havoc on an already wrecked housing market-making loans tougher to come by and possibly pushing hundreds of billions of dollars in cost onto U.S. taxpayers.

How could the companies end up in such awful straits? Given the way they were created and run, a better question might be: how could they not?

The two companies are so-called government-sponsored enterprises, created by Congress in 1938 (Fannie) and 1970 (Freddie) to help more Americans buy houses.

Their mandate is to maintain a market for mortgages - buying loans from banks, repackaging them as bonds, and selling those securities to investors with a guarantee that they will be paid. This makes lending more tempting for banks because Fannie and Freddie take on risks like missed payments, defaults and swings in interest rates.

But the companies are also publicly traded, with the usual mandate of trying to maximize profits for shareholders.

That effort, of course, involves risk, but as quasi-government programs, they've long carried an implicit guarantee that the feds wouldn't let them fail.

Their hybrid nature created both the opportunity and the temptation for the enterprises to take on more risk and to make themselves ever larger, more important and thus more profitable players in the mortgage market.

### Very special treatment

The market and ratings agencies have treated Fannie and Freddie as bulletproof, even though the actual business of dealing with interest sensitive loans is very risky. This is in large part because of the very special perks granted to the mortgage giants, but to no one else.

Each may borrow up to \$2.25 billion direct from the Treasury. They are exempt from state and

Email | Print | Type Size

### Mortgage backers get whacked



[More Videos](#)

## Most Popular

- | MOST READ  | MOST COMMENTED | EDITOR'S PICKS |
|--|----------------|----------------|
| 1. The \$5 trillion mess <a href="#">More</a>                    |                |                |
| 2. Tesla's wild ride <a href="#">More</a>                        |                |                |
| 3. The Southwest desert's real estate boom <a href="#">More</a>  |                |                |
| 4. The Fannie and Freddie doomsday scenario <a href="#">More</a> |                |                |
| 5. Midnight hour for Fannie and Freddie <a href="#">More</a>     |                |                |

**3.50% APY\***  
 That's 9x fatter than the national savings average.†  
 Available through August 15, 2008  
**HSBC Direct.** SAY GOODBYE TO SKINNY SAVINGS

## Markets

FORTUNE 500 MOVERS	US INDICES	TECHNOLOGY MOVERS
Company	Price	% Change
<b>Lehman Brothers Holdings Inc</b>	14.75	▼ -14.74%
<b>Ashland Inc New</b>	40.56	▼ -14.45%
<b>Rite Aid Corporation</b>	1.04	▼ -13.33%
<b>Ual Corp</b>	3.69	▼ -11.51%

Jul 11 3:56pm ET ↑  
  Sponsored by [Subscribe to Fortune](#)  
 \*SYMBOL LOOKUP

## Top News: CNNMoney.com

- Fed in tug of war over mortgage rules JUL 11
- Fannie and Freddie: A wild ride 18 HRS AGO
- Diesel hits record, gas ticks higher 3 HRS AGO
- Yahoo lashes out at Microsoft over new offer 4 HRS AGO
- How to recession-proof your life JUL 8

local income taxes and from Securities and Exchange Commission registration requirements and fees. And they can use the Federal Reserve as their bank.

One result of all this special treatment was AAA credit ratings. That means Fannie and Freddie could borrow at super-low rates, a benefit they used to purchase - and hold -high-yielding mortgage loans. The spread between the two provided an irresistible earnings stream and the companies just kept getting bigger.

The mortgages they hold on their books alone total about \$1.4 trillion, said Mike Stathis, managing Principal of Apex Venture Advisors, a research and advisory firm.

In the meantime, the companies were allowed to operate in this manner, piling on risk after risk, with virtually no capital cushion (Wall Street speak for the rainy-day piggybank financial companies keep should one of their investments blow up.) As the company's loan portfolio loses value and the mortgage market continues to crumble, it's easy to see why this was a fatal misstep.

Some saw the crisis coming before this week. For example, Alan Greenspan famously warned in 2004 that Fannie and Freddie's rapid growth needed to be curbed because their expansion threatened the financial markets.

Still, the cocktail of high credit ratings, domination of the mortgage securities market, and preferential government treatment led to the sort of shenanigans that go hand in hand with excessive privilege.

Fannie overstated its earnings by \$10.6 billion from 1998 through 2004, and its chief executive Franklin Raines lost his job. Freddie Mac had understated its profit by nearly \$5 billion from 2000 through 2002. Both companies missed earnings filings while their overhauled their books.

"If Fannie and Freddie had been created in the private sector, they wouldn't look like this," says Christopher Whalen, head of research firm Institutional Risk Analytics. "They have a public sector mission to expand housing and run what is essentially an insurance company. But they also have a conduit to securitize and sell loans, which is what broker-dealers like Lehman do; and they have an interest arbitrage piece (making money on the spread between interest rates) that looks like a hedge fund."

Robert Rodriguez, the founder of First Pacific Advisors, hasn't bought Fannie for Freddie bonds for over two years. "With the recent issuance of their financials, we were still uncomfortable with their leverage," Rodriguez says. "We believed there was considerable balance sheet risk in both of these companies."

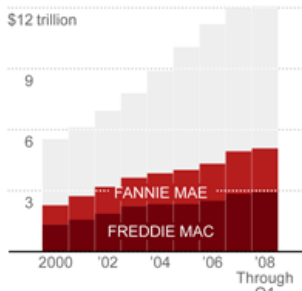
Now the dwindling pool of mortgages, higher foreclosure risk, and a shaky interest rate environment have the companies on the ropes; and investors are beginning to lose faith in Fannie and Freddie.

Both firms told Fortune that they have enough capital to weather the storm and continue to support the nation's housing market.

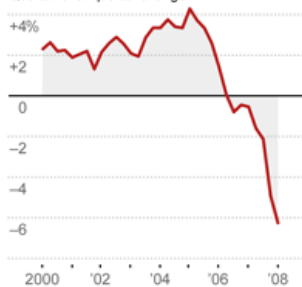
## On The Hook

Fannie Mae and Freddie Mac hold a large portion of the outstanding mortgage debt in the U.S.. As the housing market crumbles, the companies' highly leverage portfolios lose value.

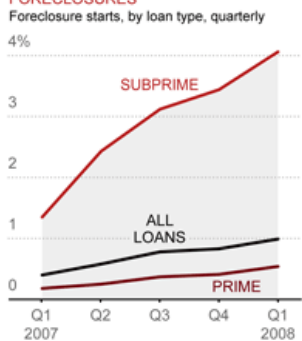
### TOTAL RESIDENTIAL MORTGAGE DEBT



### CASE-SHILLER HOME PRICE INDEX



### FORECLOSURES



SOURCES: OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT; ECONOMY.COM

## Special Report



- The fall of IndyMac
- Regulators seize troubled IndyMac
- Senate passes housing bill amid turmoil
- You're already paying for Fannie and Freddie

## More from Fortune

'iPocalypse' now

The solar gold rush

- Bush, Democrats spar over gas prices 14 HRS AGO
- Home loans: Pricier...and scarce JUL 11
- First big wave of stimulus is over - \$92 billion JUL 11
- Stop speculation now - transit groups JUL 11

Today's top stories

### Sponsors

FREE eBook & Practice Account FOREX.com GET STARTED Free \$50k Practice Account with FOREX.com

FREE SHIPMENT -DHL- when you take our survey. FREE ATLAS when you take our survey

THE PATRÓN SPIRITS COMPANY The perfect place to invest www.patrongift.com

## TRY 2 FREE PREVIEW ISSUES!



Full Name

Address

City

State/Pr  Zip/Postal

E-mail

[Privacy Policy](#)

Outside the U.S. and Canada, [click here.](#)

And yet, Fannie has fallen 32% this week and 65% since the beginning of the year. Freddie plunged 47% so far this week and is down 75% since January.

Investors have lost faith that the companies can operate in their current incarnation without running into major problems.

If investors abandon these companies, what do we learn from this odd Frankenstein of a business model?

"Nobody every believed that Fannie and Freddie were truly private and they never should have been," says Whalen. "Now we will all have to pay for a company that has gone astray." ■

FIRST PUBLISHED: JULY 11, 2008: 10:22 AM EDT

## Sponsored Links

### What's your credit score?

The U.S. Average is 692. See your 2008 report and score now for \$0!  
FreeCreditReport.com

### Mortgage Rates at 5.5%

\$200,000 loan for \$771/month. See New Payment - No SSN Rqd. Save Now!  
Refinance.LeadSteps.com

[Buy a link here](#)

 [Digg](#)  [Facebook](#)  [Yahoo! Buzz](#)

[Bing: An open letter to Freddie and Fannie](#)

[Midnight hour for Fannie and Freddie](#)

## Sponsored Links

### What's your credit score?

The U.S. Average is 692. See your 2008 report and score now for \$0!  
FreeCreditReport.com

### Mortgage Rates at 5.5%

\$200,000 loan for \$771/month. See New Payment - No SSN Rqd. Save Now!  
Refinance.LeadSteps.com

### Project Management

Villanova Project Management Certification 8 weeks - Free info.  
www.VillanovaProjectManagement.com

[Buy a link here](#)

## More Economy

[Diesel hits record, gas ticks higher](#)

[Bush, Democrats spar over gas prices](#)

[Midnight hour for Fannie and Freddie](#)

## Featured



### Tesla's wild ride

Building the world's first electric supercar was never



### Global mentor match-up

These five rising stars are



### Information worth billions

General Electric's CIO, one