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**Government Takeover of Fannie Mae and Freddie Mac
Viewpoint by the Fixed Income Investment Strategy Group
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On September 7 2008, the US Treasury Department announced steps that amount to a de-facto takeover of the Federal National Mortgage Association (better known as Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). In this "Viewpoint," BlackRock's Fixed Income Investment Strategy Group provides some background as to what has been happening and offers some perspective regarding what this event means for investors.

Background: The Importance of Fannie and Freddie

Historically, and prior to the recent takeover, Fannie Mae and Freddie Mac were government sponsored enterprises (GSEs) that owned or guaranteed about half of the mortgage market in the United States (which equates to over US\$5 trillion of outstanding debt and mortgage-backed securities issued by these GSEs). Both were publicly traded companies that bought mortgages owned by banks and other mortgage originators, securitised them and sold them as mortgage-backed securities to investors. Additionally, the agencies were themselves significant investors and retained large portfolios of mortgage securities. Through these actions, the GSEs helped to ensure a ready supply of liquidity to banking institutions in the mortgage market, thereby facilitating bank lending to consumers for residential real estate. Additionally, the debt that these companies issued is widely held by individuals, institutions, foreign governments, mutual funds and other entities around the world.

Although the GSEs were publicly traded companies that did not have an explicit guarantee of US government backing, there had long been a general presumption among investors that these enterprises were, to some degree, backed by the US government. This so-called "implicit guarantee" resulted both from the history of these organisations (they were created by government charter) and from their critical role in the functioning of the US housing market.

Mounting Pressures on Fannie and Freddie

Fannie Mae and Freddie Mac both came under pressure as the subprime mortgage crisis and the general downturn in the housing market caused delinquencies and foreclosures to rise and many borrowers to default on their mortgages. As has been the case in many areas of the financial sector, Fannie Mae and Freddie Mac have seen their stock prices decline this year, with losses becoming more pronounced in recent months as headlines and rumours questioning the viability of these companies began to circulate. In effect, a crisis of confidence began with some believing that these companies might fail (which would throw the housing market, if not the entire financial sector, into unprecedented turmoil) and some believing that the federal government might take the extreme step of nationalising these enterprises. Initially, the federal government created a plan that would provide capital infusions to the GSEs, but when that was not enough to stabilise the companies, the federal government took the step of assuming outright control of the companies.

Initial Government Action

In mid-July, the Treasury Department and the Federal Reserve began openly exploring possible solutions and government responses to deal with the crisis. It was clear that the government viewed Fannie Mae and Freddie Mac as critical components of the financial system and that some sort of government response would be warranted.

As pressures mounted, the US Treasury announced that it would act to ensure the GSEs had "sufficient capital to continue to serve their mission," and, at the time, emphasised that the government's goal was to keep the GSEs functioning as shareholder-owned entities. Specifically, the Treasury Department increased the line of credit the two agencies have with the Treasury and was granted permission by Congress to purchase equity in either of them, if required. Separately, the Federal Reserve voted to allow Fannie Mae and Freddie Mac to access the Fed's discount window, if needed, as a source of financing.

The Government Takeover

Despite these efforts, pressures on the two companies intensified, partially as a result of the uncertainty surrounding exactly how the Treasury might use its stock-purchasing power. Events finally came to a head when the Treasury announced on September 7 that it was taking control of the companies and would acquire US\$1 billion of preferred equity shares in each company. Additionally, as part of the permanent authority the Treasury now has over the agencies, the Treasury has pledged to provide up to US\$200 billion to the companies to help ensure that they can remain capitalised.

Additionally, the Treasury has indicated that it will buy at least US\$5 billion of new mortgage-backed securities issued by the GSEs on the open market in an effort to ensure that the mortgage market continues to function smoothly. This purchasing power is unlimited, meaning there is no upper limit to the amount the Treasury will purchase. The Treasury's purchasing mandate currently is set to expire at the end of 2009, although it will likely be extended.

Finally, as part of the takeover, Fannie Mae and Freddie Mac now have an unlimited line of credit, with the US Treasury Department (although they will have to provide collateral, primarily in the form of agency mortgage-backed securities). As with the Treasury's purchasing power, this arrangement is set to expire at the end of next year, but is also likely to be extended.

Initial Market Response

Initial responses to the government's actions have been positive, as it has been broadly seen as a sign that some of the uncertainty surrounding the credit crisis has been lifted. Global equity markets in general (and financial stocks in particular) rallied on the news, as did agency and mortgage-backed securities. Treasury yields climbed slightly (as their price correspondingly fell) on the assumption that the government would need to issue more Treasury bonds to cover the Treasury Department's plans.

Longer-Term Outlook

The actions taken by the Treasury ensure that Fannie Mae and Freddie Mac will continue to have a positive net worth by essentially using the "full faith and credit" of the United States government as a backstop to the balance sheets of the two companies. This means the debt issued by Fannie Mae and Freddie Mac now enjoys the explicit backing of the US Treasury.

As a result, investors have already started rotating out of Treasuries into agency debt and mortgage-backed securities, a trend that we expect will persist for some time. The yield spread (meaning the difference in yield) of agency and mortgage-backed debt above Treasuries has already narrowed and, over time, we expect that weakness in Treasuries and strength in agency debt and mortgage-backed securities will continue as the government issues more Treasuries to support the two agencies.

As such, we continue to believe that Treasuries are overvalued at current yields and recommend that investors focus on higher-quality spread investments, particularly mortgage-backed securities. For cash investors, this action has only reinforced the notion that GSE debt - held widely in money market funds - is an extremely secure investment. This move improves the liquidity of these instruments and expands the pool of very-low-risk securities available to money market funds.

In addition to the impact on the valuation of agency and mortgage-backed debt, there are other aspects of this move that investors should consider. The Treasury has been clear that one of its motivating factors behind its decision was to provide support to the broader housing market. It expects that shoring up Fannie Mae and Freddie Mac will ultimately lead to lower mortgage rates, which should help to stabilize the residential real estate markets. Falling home prices have been a key contributor to recent economic weakness.

Other areas of the market also have been affected by this decision. Higher-risk fixed income assets that have no fundamental connection to Fannie Mae and Freddie Mac (such as commercial mortgage-backed securities and bank debt) also rallied on the news, a sign of how critically important Fannie Mae and Freddie Mac are to the overall functioning of the financial system.

Currently, the status of Fannie Mae and Freddie Mac themselves is somewhat unclear. Essentially, the government's actions amount to a takeover of Fannie Mae and Freddie Mac, although the companies will still be listed on the New York Stock Exchange. Ultimately, it will be up to Congress to determine if the companies will, at some point, be re-privatised, kept as government-controlled entities or phased out in favour of some to-be-determined alternative. Given the prevailing political environment, most observers expect Congress will not act on these questions until next year.

The issues surrounding mortgage-backed securities and the wider housing and credit market problems are far from resolved, and continue to bear close watching. While we believe this event should help the ailing housing market, the US and global economies are still weak, and risks remain to the downside. We will continue to monitor the situation closely.

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