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Problem with Fannie Mae

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The Federal National Mortgage Association, commonly known as Fannie Mae, was formed as a government sponsored enterprise (GSE). Fannie Mae along with Freddie Mac used to issue mortgage-backed securities that carry corporate guarantees with respect to the credit (default) risk on the underlying residential mortgages. At the same time, it also used to invest in large portfolios of residential mortgage-related assets (whole mortgages and their own mortgage-backed securities) that are funded almost entirely (about 96–97 percent) with debt raised in the securities markets.

However, in late 2007 due to subprime mortgage crisis and its inherent internal problems, Fannie Mae faced a credit crunch after which it was placed under conservatorship. There were several reasons which could be cited as the causes of its decline. This literature review analyses the various problems which were inherent in the structure of Fannie Mae which made it more prone to the financial crisis. There are several studies done searching the reasons for its failure. Certainly, there is consensus among those studies about the main reason of this failure - Fannie Mae's unprecedented level of risk exposure to the mortgages with very little capital to support these exposures. Several studies identify the reasons of these exposures in the inherent structure of Fannie Mae. Others call it failure of regulations, while some associate this failure to the big investment banking firms which created a huge demand for the mortgages (for securitization) which were guaranteed by the Fannie Mae and Freddie Mac.

Structural Problems of Fannie Mae:

Fannie Mae was very high leveraged version of banks. It was established as a mechanism to make mortgages available to low-income families. It was originally created in 1938 as a government agency (Weiss, 2008). Like Freddie Mac, a twin that Congress chartered in 1970,

Fannie Mae eventually became a privately owned publicly traded company. Starting with bundles of mortgages purchased from mortgage originators, the GSEs created and sold mortgage-backed securities (MBSs), which delivered to holders the payments made on these mortgages. In exchange for a fee, the Fannie Mae guaranteed the interest and principal on these loans. This meant that, assuming the Fannie Mae remained solvent (or that the government came to their rescue if they found themselves in financial trouble), the only payment risk faced by the holders of these MBSs was the risk that the underlying mortgages would be repaid before they were due (known as prepayment risk) (Rotemberg, 2008). With the government's implied guarantee, the only ways Fannie Mae could have become insolvent were: if the credit losses mushroomed on the mortgages they guaranteed or held outright. This would occur if homeowners could not repay their mortgages and the prices of housing fell below outstanding loan values (Which is what happened in the subprime mortgage crisis). A second way is, if it failed to hedge its market risks adequately, and the value of its mortgage portfolios fell below the values of its outstanding debt obligations (Frame & White, 2005).

However, to minimize these possibilities, Congress capped the size of the loans that GSEs (Fannie Mae and Freddie Mac) could accept. In 2006, for example, the maximum loan for single-family homes was \$417,000. To limit their credit risk, the GSEs used standards that were similar to those of traditional originators. To secure sufficient collateral, they took only senior mortgages and generally required the loan-to-value ratio (LTV) to be below 80%. The LTV was computed as the ratio of the mortgage to the property's market value at the time of origination (Jaffee, 2008)...

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