

# Thornberg: GSE Stockholders Could Be 'SOL'

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I had a real interesting chat with Christopher Thornberg of Beacon Economics on Monday about the problems facing Fannie and Freddie and the government's steps to resolve them.

Some excerpts:

## **What is the goal of the government's recent actions in support of Fannie Mae and Freddie Mac?**

"The most important thing is to keep people that are lending to Fannie and Freddie comfortable lending. So what they have done is basically gone in and said, 'We have a plan to bail out Fannie and Freddie if their equity goes negative.' Functionally what they are saying is, 'Equity holders, you're SOL—but we'll back up the debt.'"

## **What does SOL mean?**

"Shit out of luck. Sorry."

## **Is such action necessary?**

"They really needed to do that in this market, with the private mortgage market basically against the wall. They needed to step in and do this. This is exactly the sort of circumstances that Fannie and Freddie were created [to deal] with in the first place."

## **How could Fannie and Freddie be running into credit problems? I thought they mostly bought fixed-rate mortgages to borrowers with sound credit?**

"Fannie was buying option ARMs from Countrywide. So first of all, they were not as pure and innocent and white as people thought, because they were clearly edging in a bad direction. Secondly, you have got to remember that everyone keeps saying, 'Well, this is a credit quality issue.' In other words, 'It's these people with bad FICO scores. They are mucking up the system.' Well, that is nonsense. The problem in our markets has been that people bought way too much house relative to their income, in a variety of ways. And certainly that's true even for prime mortgages, as well as subprime."

Look at it this way, Fannie and Freddie made a lot of loans in the Fresno, Calif., area, in the Bakersfield, Calif., area, [and] they made them in Riverside, Calif., [too.]. Well, prices are just plummeting, and a lot of people are under water. And even if you have a "conforming loan," if your equity is negative 20 percent, are you really going to stick around?

## **So their problems are not unique to those of other banks?**

"Oh, absolutely not. The unique part is this: These guys are [highly] leveraged. I've heard numbers of 100 to 1."

## **What does all this mean for mortgage rates going forward?**

"Well, let's say people start getting nervous. Let's say that they think that there is a possibility that maybe there is such trouble that even if the government promises to help stabilize the situation, [it won't pan out]. [People could think] they just won't have the cash to do it. I mean, you've got \$5 trillion of debt there. And obviously not all of that is bad; probably a minute portion of that. But nonetheless, a minute portion of bad debt in *that* size portfolio, with *that* kind of leverage ratio [can be real bad]. So then it becomes a question of, 'Gee, should I become a little cautious lending to them?' And that simply means that people that lend to Fannie and Freddie—[bond investors]—expect a higher premium over the treasury bill. And if they demand that higher premium, that means that mortgage rates go up. That's the big issue."

**How much could rates go up?**

"It's all totally hypothetical. We just haven't been here before. This is the first time Fannie and Freddie have been in significant trouble since they spun off."

**Do you think the concerns about Fannie and Freddie are legitimate, or do you think the market is overreacting?**

"Oh, I think it's absolutely legit. I think the market has been underreacting. You look across the board, and when you think about what's happening out there in those mortgage markets, when you are running delinquency rates of 3 and 4 percent of all mortgages in the U.S., there's a giant mess out there."

**And Fannie and Freddie have exposure to some of this mess?**

"They were dancing like anybody's business. They were horrified by the fact that their market share was sliding away. Fundamentally, understand these are profit-making beasts—and profit-making beasts under political control. And you know what? That's never a good combination."