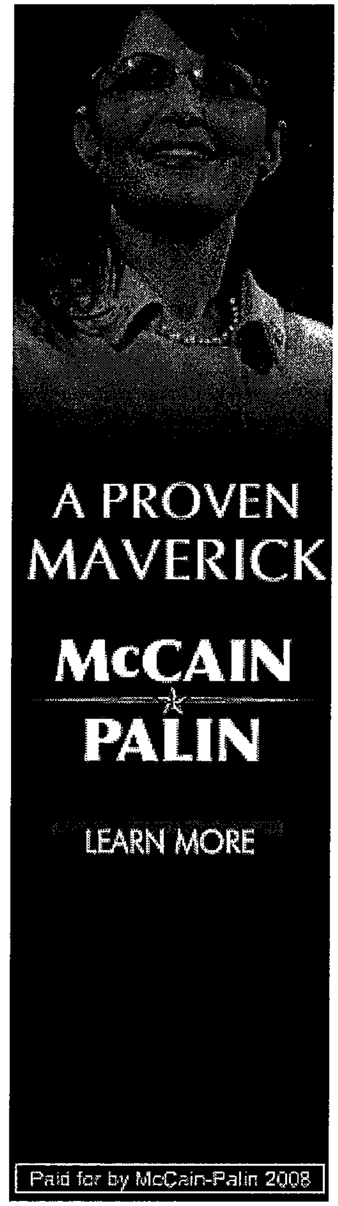
washingtonpost.com

U.S. Seizes Control Of Mortgage Giants

Takeover of Fannie And Freddie Aims To Revive Housing, Financial Markets

By Neil Irwin and Zachary A. Goldfarb
Washington Post Staff Writers
Monday, September 8, 2008; A01

Advertisement



The government seized control of Fannie Mae and Freddie Mac yesterday in a dramatic bid to restore faith in the embattled mortgage giants and arrest a vicious cycle that has driven the nation's economy into a steep downturn.

Following weeks of round-the-clock planning, Treasury Secretary Henry M. Paulson Jr. announced the takeover to try to stabilize the deeply troubled housing and financial markets. Fannie Mae and Freddie Mac, with a combined 11,000 employees, have funded more than two-thirds of U.S. home loans in recent months, and doubts over their ability to continue doing so had threatened to immerse the economy into even more turmoil.

With home loans harder to come by, buyers have recently been unable to make purchases, causing the housing market to tank further, leaving banks and other lenders with huge losses. Those losses, in turn, have made loans even harder to get.

"Our economy will not recover until the bulk of this housing correction is behind us," Paulson said yesterday. "Fannie Mae and Freddie Mac are critical to turning the corner on housing."

There is no guarantee that the takeover will work, and it comes at a potentially massive cost to taxpayers. The government has pledged to inject money in the companies in any quarter in which they would otherwise be insolvent -- up to $100 billion in total for each company.

"This is a shareholder bailout financed by the U.S. taxpayers," said Armando Falcon Jr., formerly the chief regulator of Fannie Mae and Freddie Mac.

Paulson also announced a separate program in which the government will start buying securities backed by mortgages -- $5 billion worth, initially. That will, in effect, subsidize the purchase of homes by lowering the interest rate that buyers must pay for a mortgage.

Paulson said yesterday that both the potential investment in Fannie Mae and Freddie Mac and the planned purchase of mortgage-backed securities are designed to protect taxpayers. The government has received $1 billion worth of preferred stock in each company upfront in exchange for the guarantees, for example, and government officials said taxpayers have a good chance of profiting from the purchase of mortgage bonds.

The Treasury secretary also named new executives at Fannie and Freddie. Herbert M. Allison Jr., who most recently served as chairman and chief executive of TIAA-CREF -- the pension fund giant serving employees in the academic, medical, cultural and research fields -- will take over at Fannie. David M. Moffett, previously vice chairman and chief financial officer of U.S. Bancorp, will lead Freddie.

These are the latest -- and so far, most expensive -- efforts by the government to contain a financial crisis that began in the subprime mortgage market and has metastasized to encompass all types of debt markets. The International Monetary Fund has estimated the global losses will total nearly $1 trillion before the crisis ends.

Previously, the Federal Reserve created exotic new lending programs and rescued investment bank Bear Stearns. But that action, in which $29 billion of taxpayer money was used to back the acquisition, could pale in comparison with the rescue of Fannie and Freddie, in which the funds at risk are in the hundreds of billions of dollars.

"All of the things over the past year that the Fed and the Treasury have undertaken have been intended to stabilize the mortgage and the housing markets," said Howard Shapiro, an analyst at Fox-Pitt Kelton. "What's happened over time is that a lot of things they've done really aren't working."

"If this doesn't work, there aren't too many more arrows in the quiver," he said.

The seizure of the two companies has broad implications for Washington, Wall Street and international markets.

The biggest winners are holders of Fannie and Freddie debt, including investors as varied as Asian central banks and municipal pension funds in the United States. These bonds, which have been perceived as somewhat more risky in recent months, now in effect have an explicit U.S. government guarantee behind them.

Investors in Asia responded enthusiastically to the Treasury announcement. In early trading today, they drove the MSCI Asia-Pacific Finance up 6.8 percent, the biggest jump since October 1998.

"We think it's a very positive action by the U.S. It has come from being an invisible regulator and to coming to the front lines to save the market," said Wang Zhaowen, a spokesman for Bank of China, which in recent months had trimmed its debt holdings by about 29 percent to $7.5 billion.

Meanwhile, owners of stock in the two firms have incurred major losses. The companies' new federal overseers have eliminated dividend payments by the companies. And the government has, in Wall Street terminology, crammed down current shareholders; shareholders previously had an economic interest that represented 100 percent of the value of the companies, and now their holdings represent 20 percent of the value of each company. The other 80 percent is owned by the government.

If the companies return to profitability, shareholders could end up with a smaller piece of the larger pie.

Many banks hold preferred shares of the companies. The government has ordered that dividend payments to those investors be canceled as well, which could seriously reduce their value and cause some small and midsize banks to encounter financial troubles; some analysts have even predicted that the events could cause a few dozen such banks to go under.

Government officials considered that risk as they weighed a bailout, and concluded that the banks were few enough and small enough that their losses would not cause a broad breakdown in the financial system. Banking regulators, however, will try to nurse those banks back to health, by being as flexible as the law allows them to raise new cash in an orderly way.

Rep. Barney Frank (D-Mass.), chairman of the House Financial Services Committee, said the panel would explore whether the government could act directly to help the banks.

As the housing crisis deepened this year and losses mounted at Fannie and Freddie, investors began to lose faith that the companies' debts would be safe. Across the government and financial world, there was a consensus that their failure could bring the economy and financial system to its knees. In July, Paulson asked for -- and got -- authority from Congress to infuse government money in the firms if he deemed it necessary.

In the ensuing weeks, as Treasury officials, along with investment bankers they hired from Morgan Stanley and officials from other agencies, looked into the details of the companies' financial position, they didn't like what they saw.

Sources familiar with the situation said the officials accepted phone calls from stakeholders who wanted to share financial analysis, offer ideas and discuss the possible ramifications of potential solutions.

Treasury officials also have held informal conversations with leading buyers of Fannie and Freddie debt -- including the central banks of China, South Korea, India and Taiwan -- to reassure them that the mortgage companies remained viable and would receive U.S. government support. As recently as two weeks ago, according to a source close to the talks with China's central bank, Treasury officials told leaders of that central bank that a cash infusion in the companies was in the works.

Leaders of the Chinese central bank said in those talks that they expected the U.S. government to "do whatever is necessary" to protect the creditworthiness of those investments, the source said.

Treasury officials eventually concluded that the companies' capital position was even worse than they had thought and that government cash would be needed.

On Aug. 28, Paulson discussed the likely necessity of such action in an Oval Office meeting with President Bush, Chief of Staff Joshua Bolten and top White House economic officials, and received the president's blessing to continue developing such plans.

Over Labor Day weekend, Paulson assembled a group that included James B. Lockhart III, the head of the Federal Housing Finance Agency, Fed Chairman Ben S. Bernanke, investment bankers and outside lawyers to go over their options. In three days of intensive work, they formulated the plan.

They laid it out to Daniel H. Mudd, the chief executive of Fannie Mae, and Richard Syron, his Freddie Mac counterpart, on Friday afternoon. Freddie Mac leaders quickly realized they had little choice but to accept, while the Fannie Mae board considered fighting the takeover, until they too concluded Saturday that it would be futile.

Staff writers David Cho, Binyamin Appelbaum, Anthony Faiola, Lori Montgomery and David S. Hilzenrath in Washington, Heather Landy in New York and correspondent Ariana Eunjung Cha in Shanghai contributed to this report.

View all comments that have been posted about this article.

© 2008 The Washington Post Company

Ads by Google

Mortgage - Countrywide®
No Cash Required For Closing Costs. Call Or Apply Online Now
www.Countrywide.com

Fha Mortgage
FHA Approved Home Loan Lender Low Rates And Fees. 801-250-4000.
www.ParamountEquity.com

House Payments Fall Again
$285,000 Mortgage for only $999/mo. See Rates! No Credit Check Required
www.CalculateNewPayment.com