US government bails out mortgage giants

By Nick Beams
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The crisis in the US financial system has taken a major turn for the worse with the announcement on Sunday that the US Treasury and the Federal Reserve Board are to take emergency action to prop up mortgage giants Fannie Mae and Freddie Mac.

Under the rescue plan, Congress will be asked to pass legislation to increase the line of credit to Fannie and Freddie—the amount and terms to be decided later—as well as providing the authority for the government to purchase equity if needed. In addition, the Federal Reserve Board has granted the Federal Reserve Bank of New York authority to lend directly to the two companies "should such lending prove necessary."

Announcing the measures after a weekend of hectic discussions with bankers, financial institutions and Congressional leaders, Treasury Secretary Henry Paulson said the two companies played a "central role in our housing finance system" and their "support for the housing market is particularly important as we work through the current housing correction." There were fears that had the intervention not been made Freddie Mac may have had difficulty in a planned sell-off of $3 billion in debt scheduled for today.

Like the Bear Stearns rescue operation in March, the timing of the announcement was meant to allay fears before global markets opened for the week. Paulson said the international reach of the two "government sponsored enterprises" (GSE) necessitated the unprecedented action.

"GSE debt is held by financial institutions around the world. Its continued strength is important to maintaining confidence and stability in our financial system and our financial markets," he said.

The emergency action came after a week of stock market turmoil that saw the stocks of the two firms plunge by up to 50 percent as fears grew that they were too poorly capitalised to meet losses incurred as a result of the collapse of the US housing market.

Between them Fannie and Freddie hold or guarantee more than $5 trillion out of the $12 trillion US mortgage market.

Fannie Mae—the Federal National Mortgage Association—was set up in 1938 by the Roosevelt administration to try to boost the housing market during the Great Depression. In 1968 it was given a new charter by Congress and became a publicly traded company that could seek funding from the private sector. Freddie Mac—the Federal Home Loan Mortgage Corporation—was created by Congress in 1970 as a competitor for Fannie.

Because they were set up by legislation, the two companies have been regarded as having an implicit government guarantee—a perception that has enabled them to borrow funds at lowered rates in the market. Over the past three decades, both firms have grown rapidly to the extent that their holdings and guarantee of mortgage debt is even larger than the $4,500 billion US Treasury market.

While they have not been directly involved in the sub-prime market, the rapid decline in US housing prices—the steepest since the Great Depression—has caused the two firms to suffer a loss of $11 billion over the past nine months, raising concerns about the adequacy of their capital.

Those concerns were heightened last Wednesday when the former St. Louis Federal Reserve President William Poole said the chances were increasing that the two mortgage companies would have to be bailed out. He said Freddie Mac owed $5.2 billion more than its assets were worth in the first quarter, making it technically insolvent. The "fair value" of Fannie Mae's assets had fallen 66 percent and could go negative in the next quarter, he said.

On Friday, the *New York Times* published a report that the two companies may be put into a "conservatorship" if their problems worsened. Under a conservatorship, regulators appoint a person or an entity to run the financial institution until stability is restored.

Fear about the viability of the two firms set off a round of discussions in government, financial and banking circles about emergency action. Paulson has insisted that so far as the administration is concerned it wants Freddie and Fannie to continue in their current form as "shareholder-owned companies."

This is because the alternative—a full-scale takeover or nationalisation by the government—would have vast implications for the financial position of the US. Taking on the debts and obligations of Fannie and Freddie would mean a more than 50 percent increase of US sovereign debt virtually overnight, bringing the total to the equivalent of the US gross domestic product.

In a bid to bolster confidence, the Democratic chairman of the Senate Banking Committee, Chris Dodd, told CNN on Sunday that Freddie and Fannie were both financially sound.

"What's important here are facts," he said. "And the facts are that Fannie and Freddie are in sound situation. They have more than adequate capital—in fact, more than the law requires. They have access to capital markets. They're in good shape. The chairman of the Federal Reserve has said as much. The secretary of the treasury has said as much."

Given the experiences of the past year, such "boosterism" will not cut much ice. As the *Wall Street Journal* commented caustically in response to similar remarks by Dodd last week, the senate chairman claimed that the companies were so safe that the Fed might have to rescue them.

Last Thursday Fed chairman Ben Bernanke and Paulson, appearing before the House Financial Services Committee, emphasised that the regulator of Fannie and Freddie, the Office of Federal Housing Enterprise Oversight, had found that both companies were adequately capitalised. Similar assurances were also given about Bear Stearns just days before it was taken over.

While attention has focused on Fannie and Freddie, the depth of the US housing and financial crisis has been underscored by the collapse of IndyMac Bank in California.

The Pasadena-based mortgage lender, which had $32 billion in assets, was seized by federal regulators on Friday following an 11-day $1.3 billion run on its funds. IndyMac, which specialised in Alt-A loans to borrowers who did not fully document their assets or their income, ranked as the ninth largest US mortgage lender by volume.

The collapse of the bank—the third largest failure in US banking history after the demise of Continental Illinois in 1984 and the American Saving and Loan Association of Stockton in 1988—is expected to cost the Federal Deposit Insurance Corporation between $4 billion and $8 billion. This is a sizeable chunk of its $53 billion deposit insurance fund, which is expected to be called on again as more banks go under.

Besides pointing to the sheer size of the financial crisis, the Fannie-Freddie rescue operation has underscored the speed with which it is unfolding. On Thursday, Paulson and Bernanke told Congress that they were not seeking new legislation. Just three days later, an emergency package is to be brought forward with no guarantee that further measures will not be required even in the next few days.