THE RESCUE OF FANNIE & FREDDIE

What does the federal takeover ultimately mean?

Monday, September 8, 2008, the Dow Jones Industrial Average leapt north nearly 290 points as investors cheered the Treasury Department's weekend takeover of mortgage giants Fannie Mae and Freddie Mac.

This decisive move immediately boosted the morale of stock market investors and real estate investors. In fact, you may feel the same way Treasury Secretary Henry Paulson does: on CNBC Monday, he expressed his belief that the takeover, "more than any other action that I've seen done here, has advanced the ball" in leading the real estate sector toward recovery.[1]

You could almost hear Wall Street wiping its brow and exhaling: "Whewwwww." As Moody's.com chief economist Mark Zandi put it, "This takes a major financial threat off the table."[2]

What Might This Mean for the Housing Market?

Well, mortgage rates fell half a percentage point Monday – and they could fall further in coming weeks.[3] Zandi, in fact, thinks rates on 30-year FRMs could dive to around 5.5% (they were averaging about 6.35% nationwide on the morning of September 8th).[2]

While the takeover isn't exactly a "magic wand" that will reduce the glut of unsold homes or erase America's foreclosure problem, it will restore a great deal of confidence in the housing and credit markets.

The Reasons for the Takeover.

Fannie Mae and Freddie Mac, respectively created by the federal government in 1938 and 1970, buy mortgages from banks and other lenders. They convert and resell bundled loans as mortgage-backed securities, generating money enabling banks to make new loans. Fannie and Freddie own or guarantee about half the home loans in the United States. If they had collapsed, the U.S. housing market would have faced an unprecedented catastrophe – and stock markets around

the globe would have taken a painful plunge. Fannie and Freddie absorbed $14 billion in losses within the last year, and battled rumors of insolvency all summer.[1]

Both mortgage giants will now be placed into conservatorship – a move akin to a Chapter 11 bankruptcy, in which they will be permitted to restructure their operations.

Fannie and Freddie will keep doing business as usual, but they will now operate directly under the authority of the Federal Housing Finance Agency (which was created this spring to regulate them). David Moffett, the former CFO of U.S. Bancorp, will become the new head of Freddie Mac. Fannie Mae will now be run by Herb Allison, former CEO of retirement plan administrator TIAA-CREF.[4]

The Near-Term Plan.

At the press conference on September 7, Treasury Secretary Henry Paulson cited the three goals of the takeover: "market stability, mortgage availability and taxpayer protection."[5] He presented a plan with the following short-term objectives:

- The Treasury Department will make a major stock purchase in both firms, buying as much as $100 billion in senior-preferred shares in each company so that Fannie and Freddie can stay solvent.[4]
- The Treasury will also buy new mortgage-backed securities issued by Fannie and Freddie, in order to help keep mortgage rates low.[6]
- In addition, the Treasury Department will also provide Fannie, Freddie and a dozen other federal home loan banks with secured forms of short-term financing.[4]
- Fannie and Freddie will continue to make loans "without limits".[6]
- Both companies will quit paying dividends to shareholders, thereby saving up to $2 billion per year.[6]

Paulson told reporters Sunday that buying up both firms' debt would cost taxpayers nothing, and possibly even result in a profit for taxpayers. The long-term cost of this rescue, he noted, would depend on forthcoming business conditions.[6] (For the record, the *New York Times* estimates the bailout could require tens of billions of dollars.[7])

Permission to Grow – and An Order to Shrink.

Paulson commented that the size, structure and governmental relationship of Fannie Mae and Freddie Mac need to be determined by the next U.S. President and Congress, noting that "government support needs to be either explicit or nonexistent." They are currently GSEs (government-sponsored enterprises), privately owned but publicly chartered.

Paulson said that both firms will be permitted to "modestly increase" their investment portfolios until the end of 2009 … but starting in 2010, both Fannie and Freddie will be asked to reduce their investment portfolios by 10% each year. Both companies' portfolios currently total above $1.4 trillion; the goal is to shrink them to a total of $500 billion. Additionally, Fannie and Freddie will have to pay quarterly fees to the Treasury Department beginning in 2010 for the financial support they received under the bailout plan.[7]

So a severe restructuring and reduction is in store for these quasi-public mortgage firms, which must now be held responsible for questionable accounting methods, relaxed standards, and a blind eye to a bursting U.S. housing bubble.

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