

# U.S. Seizes Mortgage Giants

Government Ousts CEOs of Fannie, Freddie;

Promises Up to \$200 Billion in Capital

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**In its most dramatic market intervention in years, the U.S. government seized two of the nation's largest financial companies, taking direct responsibility for firms that provide funding for around three-quarters of new home mortgages.**

Treasury Secretary Henry Paulson announced plans Sunday to take control of troubled mortgage giants Fannie Mae and Freddie Mac, **replace the companies' chief executives and provide up to \$200 billion in capital to restore the firms to financial health.** The Treasury's plan puts the two companies under a conservatorship, giving management control to their regulator, the Federal Housing Finance Agency, or FHFA. In return for agreeing to provide as much equity capital as needed later to cover losses stemming from mortgage defaults, **the Treasury gets \$1 billion of preferred stock in each company without providing any immediate cash.**

**With that, the U.S. mortgage crisis entered a new and uncharted phase, potentially saddling American taxpayers with billions of dollars in losses from home loans made by the private sector. Bush administration officials, backed cautiously by legislators on both sides of the aisle, argued that the cost of doing nothing would be far greater because of the toll on the economy of falling home prices and defaults in the \$11 trillion U.S. mortgage market.**

Mr. Paulson noted that more than \$5 trillion of debt and mortgage-backed securities issued by Fannie and Freddie is owned by central banks and other investors world-wide. "Failure of either of them would cause great turmoil in our financial markets here at home and around the globe," Mr. Paulson said.

By taking this action, the government has seized control of the vast bulk of the secondary market for home mortgages, where these loans are sold to investors, and will have a more direct responsibility than ever for solving the housing crisis. The intervention also marks the failure of the public-private experiment that was created to boost home ownership among Americans. Though Fannie and Freddie were created by Congress to help prop up the housing market, they have long been owned by private shareholders seeking to maximize profits.

**The federal takeover of mortgage giants was initially welcomed by banks and market watchers**

**outside the U.S. as a way to dispel some of the uncertainty roiling the world's financial markets. The intervention could eventually be a boon for Wall Street, by providing a boost to the moribund mortgage industry and by perhaps diminishing the influence of Wall Street's two largest competitors in the market packaging and reselling mortgage-backed bonds.**

The move is also likely to nudge down interest rates for consumers and help prevent a deepening of what is already the worst housing bust since the 1930s. Despite steep interest-rate cuts by the Federal Reserve, the cost of a typical 30-year fixed-rate mortgage has remained well over 6% for most of the past year. To bolster the mortgage market, Treasury said it will buy, on the open market, at least \$5 billion of new mortgage-backed securities issued by Fannie and Freddie.

The government rescue of Fannie and Freddie is likely to leave a trail of billions in losses for stock holders, including some major banks. But it protects the investments of bondholders, including mutual funds, foreign central banks and government investment funds that own large amount debt issued by the two companies. Investors such as Pacific Investment Management Co., the large Newport Beach, Calif., bond manager, that have loaded up recently on mortgage-backed bonds could benefit as Treasury purchases of such securities drive up their values.

It is unclear how much the government's intervention will ultimately cost taxpayers. In exchange for agreeing to provide as much capital as needed to the companies as they cope with heavy losses on mortgage defaults, the Treasury will acquire \$1 billion of preferred shares in each company. It has obtained warrants that give it the right to a stake of 79.9% for a nominal sum. The Treasury's preferred shares will be senior to those earlier issued, meaning the government will have the first right to receive dividends.

The new overseers will also eliminate dividends on billions of common and preferred stock, moves that are expected to drive down the price of those shares, which have already dropped precipitously this year. The issue of additional preferred shares will dilute common shares.

"The common shareholders seem to be in worse shape than they were on Friday," said Robert Napoli, an analyst at the securities firm Piper Jaffray in Chicago. "The preferred shareholders have much more hope of retaining significant value over the long run."

Andrew Brenner, a senior vice president at MF Global Inc., a brokerage firm, said Fannie and Freddie common shares are likely to fall 50% to 75% in light of the government moves and preferred shares could fall about 30%.

That prospect is especially disturbing for some commercial banks and thrifts, which are among the biggest holders of Fannie and Freddie preferred stock. The Office of Thrift Supervision, a government agency that supervises savings and loans, said that roughly 2% of the 829 companies it regulates had a concentration in common or preferred shares of Fannie Mae and Freddie Mac that surpassed 10% of their Tier 1 capital. Regulators said Sunday they would work with banks that hold large exposures to Fannie Mae and Freddie Mac "to develop capital-restoration plans" if necessary.

The Treasury's move doesn't answer what could be the \$5 trillion question of what ultimately happens to Fannie and Freddie. Under the conservatorship of their regulator, the companies will still have their shares listed on the New York Stock Exchange, but management control goes to the regulator until it deems the companies financially healthy. Congress ultimately will have to decide in what form Fannie and Freddie will be relaunched or whether they will be replaced by different types

of entities.

The Treasury plan limits the size of each company's mortgage portfolios to a maximum of \$850 billion as of the end of 2009. After that, the Treasury intends for the mortgage holdings to shrink about 10% a year until they reach about \$250 billion at each company.

Wrangling over the future shape of Freddie and Fannie will likely be kicked to the next Congress. Already the majority Democrats are pushing back on elements of Treasury's plan. "Good luck on that," said Massachusetts Rep. Barney Frank, chairman of the House Financial Services committee, when asked about the Treasury's plan to start reducing the firms' portfolios beginning in 2010. Mr. Frank called it a "more of a sop to the right" than a real policy prescription and said it wasn't going to happen.

**Many economists and analysts believe the government had to wade deeper into the mortgage market because for now "private markets are just not willing to put up the capital" for home mortgages at prices U.S. consumers could afford, said Susan Wachter, a professor of real estate and finance at the University of Pennsylvania's Wharton School. Without government support for the mortgage market, home prices would fall much farther, exposing the country as a whole to greater economic strain, Ms. Wachter says.**

The stunning turn of events for Fannie and Freddie are remarkable considering the two companies for so long shunned the riskiest type of mortgages, only to embrace those mortgages late in the game in an effort to regain market share from Wall Street rivals.

As early as 2005, Fannie executives publicly expressed concerns about growing risks in the mortgage market. In May of that year, Thomas Lund, a Fannie Mae executive vice president, said that lenders should be concerned if borrowers straining to afford homes were given loans allowing for low payments in the early years but storing up much higher ones for later. "In many cases the consumers may not understand all the risks," he said.

Yet both companies expanded their exposure to riskier loans. At both Fannie and Freddie, so-called Alt-A loans, a category between prime and subprime, accounted for roughly 50% of credit losses in the second quarter, even though such loans accounted for only about 10% of the companies' business. Alt-A mortgages include loans made with less than full documentation of borrowers' income or assets.

"Business they thought was prime is turning out not to be prime because of limited documentation of income and declining home prices," said Guy Cecala, publisher of Inside Mortgage Finance.

**As these and other loans -- including many in areas such as California and Florida that are among the hardest hit by the housing crisis -- started to go bad, the companies made a series of missteps. They failed to raise enough capital late last year, when investors were still fairly bullish on their prospects, to see them through the current storm. The companies have recorded combined losses totaling about \$14 billion over the past four quarters, eating deeply into their meager capital holdings. Most analysts expect them to report sizable losses for at least another couple of years as the costs of foreclosures mount.**

**Fannie and Freddie's credit problems are largely a reflection of the overall weakness in the housing market. Some 9.2% of mortgages on one-to-four family homes were at least a month overdue or in the foreclosure process in the second quarter, according to the latest survey of**

**the Mortgage Bankers Association. That is the highest percentage in the 39 years that the trade group has been doing the surveys.**

"Make no mistake, anybody in the mortgage business is going to see much higher losses than they thought they would a year ago because we've had the worst housing market and the largest home price declines that anybody has seen," said Thomas Lawler, a housing economist in Leesburg, Va., who formerly worked for Fannie.

Both companies are also heavily exposed to some of the mortgage industry's most troubled players. Countrywide Financial Corp., now part of Bank of America Corp., was the largest provider of loans purchased by Fannie Mae, accounting for 29% of its business in 2007, according to Inside Mortgage Finance, and was the second largest source of loans for Freddie Mac, with a 16% share.

At Fannie, Herb Allison, who formerly served as chairman of the investment company TIAA-CREF, succeeds Daniel Mudd. Freddie's chief executive, Richard Syron, was replaced by David Moffett, who has been vice chairman and chief financial officer of US Bancorp.

Mr. Syron may walk away with an exit package that could total as much as \$15 million, says David Schmidt, a senior consultant at James F. Reda & Associates LLC, a compensation consulting concern in New York. That includes a pension and deferred compensation, about \$3.7 million in severance pay and a possible payment of \$8.8 million to compensate for forfeiting recent equity grants.

Mr. Mudd's exit package, including stock he already owns, could total \$14 million, Mr. Schmidt estimates. That includes \$5 million in pension and deferred compensation, \$4.2 million in severance pay and \$3.4 million of restricted stock, based on Friday's closing price. That value of that stock could fall sharply, however.

**Courtesy of JB Goodwin**