America's mortgage giants

Suffering a seizure

America's government takes control of Freddie Mac and Fannie Mae

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FOR many Americans, Sunday is for church, family lunches or catching a ball game. For the country's financial authorities, it has become the day of the dramatic announcement: the takeover of Bear Stearns; the Treasury's promise in July to stand behind Fannie Mae and Freddie Mac; and, most momentous of all, on Sunday September 7th, what had recently come to be seen the inevitable culmination of that pledge: the government's seizure of the two giant mortgage agencies.

Hank Paulson, the Treasury secretary, had hoped that the July announcement would calm nerves sufficiently that he would not have to take out his "bazooka". The opposite happened. The firms' shares collapsed amid fears that investors would be wiped out in a government rescue. This severely curtailed their ability to issue much-needed capital, also infecting their mortgage-backed securities and the $1.6 trillion of debt they had issued to buy mortgages for themselves. It was only a matter of time before the government was forced to launch its largest-ever financial rescue. The action was greeted warmly on the world's stockmarkets, which rallied on the news.

Though some had wanted to see the agencies fully nationalised, obstacles stood in the way—not least that this would have required an act of Congress. So the Treasury had to get creative. The plan has four planks. First, Fannie and Freddie will be taken into "conservatorship", a watered-down form of receivership, by their revamped regulator, the Federal Housing Finance Agency, until they are once again "sound and solvent". Second, they will have access to a loan facility, secured against their assets, until the end of 2009. Intriguingly, this will also be available to the 12 Federal Home Loan Banks. James Lockhart, the FHFA's head, stressed that these bank-owned co-operatives, also designed to grease housing markets, are mostly in good shape. But they have a lot of short-term debt and the quality of their borrowers' collateral is falling. Allowing them to tap the credit line may be a shrewd precautionary measure.

The third plank highlights Mr Paulson's wish to protect the taxpayer and avoid "moral hazard". The Treasury will buy preferred shares as needed, whenever the agencies' net worth dips below zero, and this paper will be repaid ahead of their existing preferred and common stock (whose dividends are being eliminated). Lowly shareholders could yet lose everything.

Indeed, the deal could have been a lot worse for the taxpayer. In exchange for vowing to keep the firms above water, the government will receive $1 billion "fee" in preferred stock at no cost, along with warrants giving it the right to 80% of the firms' common stock at a nominal price. The two chief executives will leave. Fannie and Freddie, whose unparalleled political connections helped them to keep regulation toothless and expand on threadbare capital cushions, will no longer be allowed to lobby lawmakers.

The final piece of the plan may unnerve some taxpayers. To keep mortgage markets chugging along, the Treasury will become a buyer of last resort for bonds packaged by the agencies, purchasing them in the open market if demand slackens. Could it end up burdened with piles of toxic paper? Mr Paulson was upbeat, pointing out that since the Treasury would hold the securities to maturity it might one day reap net gains.

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But the eventual cost to the public purse is unknown and potentially huge. The Treasury says it could buy as much as $100 billion of preferred stock in each of the two firms, though it deems that highly unlikely. Ultimately, the size of the bill will depend on their ability to recover, and that is far from clear. Under American accounting standards they have adequate capital, despite the rapid deterioration of their portfolios. But on a fair-value basis, marking their assets to the current market price, Freddie is insolvent and Fannie not far off. Moreover, with house prices still sliding and foreclosures rising sharply, worse may be ahead.

The taxpayer is on the hook elsewhere, too. Bank failures, almost unheard of in recent years, are ticking up. The Federal Deposit Insurance Corporation, which steps in and covers deposits up to $100,000 when lenders go belly-up, is nervously watching its fund shrink. It, too, may soon need to tap the Treasury for funds, especially if a big bank fails. On Monday one of the most vulnerable large lenders, Washington Mutual, forced out its boss in a bid to shore up confidence. More and more pundits are predicting the return in new guise of the Resolution Trust Corporation, which was tasked with taking over and offloading duff assets in the savings and loan crisis of the early 1990s. The tab this time is likely to far exceed that institution's total losses, $124 billion by the end of 1999.

While the short-term goal is to stabilise Fannie and Freddie, thereby bringing down mortgage rates, the longer-term aim should be to avoid an expensive repeat. Mr Paulson stressed that the seizure of the agencies is merely a "time out"; it will be for the next administration and Congress to determine their future form. He is clearly in favour of scrapping their hybrid business model, which delivers profits to shareholders but leaves the public to shoulder life-threatening losses. Both presidential candidates have joined the criticism, with Barack Obama calling the agencies "a weird blend".

Winding them down is not yet an option. With private mortgage finance barely registering a pulse, Fannie and Freddie have become crucial cogs in the market. Acknowledging this, the Treasury's plan envisages allowing them to increase the size of their portfolios modestly by the end of next year. But from 2010 they will be forced to shrink by 10% a year until they reach an undefined "less risky size". Once markets recover, pressure to dismantle the firms—and nurture alternatives, such as covered bonds—will grow. Until then, conservatorship will have to do.

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