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Capital punishment hits mortgage market

Implications of Federal Government's decision to bail out Fannie Mae and Freddie Mac aren't known yet

SUMMING IT UP

William Rutherford

In my March column, I suggested that the government might be forced to nationalize Fannie Mae and Freddie Mac as a last resort to solve the credit market problems. Both President Bush and Secretary of the Treasury Paulson said they would not be bailing out the mortgage market. By August, Paulson was asking Congress for a "bazooka" to deal with the problem. Apparently his trigger finger developed an itch.

On Sept. 8, just days after mortgage delinquencies and foreclosures surged to the highest levels in history, the Federal Government, acting through the Treasury Department, and with the Federal Reserve acting in "a consultative role," did, in effect, nationalize the Government-Sponsored Entities Fannie Mae and Freddie Mac. Saying that it was not nationalization, the government seized control of the two GSEs, and transferred control of both to the Federal Housing Finance Agency. It has been given the power to expand the two companies' mortgage portfolios by $100 billion each to a maximum of $850 billion by the end of 2009. The portfolios will shrink after that.

Presently, not all the terms of the transaction are clear, and the implications are yet to unfold, but it can be expected that American taxpayers will eventually be presented with a large bill. Much ink will be spilled in coming days over the morality of this transaction, the morality of doing it and the morality of not doing it. Nevertheless, the Treasury found itself in the position of having to act or watch a disaster of epic proportions unfold. The prospect of more write-offs for banks, and havoc in the international credit markets was too much to contemplate. Fannie and Freddie either originated or backed some $5 trillion in mortgages, nearly half of the mortgages outstanding in the U.S. During the first quarter of this year nearly 70 percent of all new mortgages originated with the two firms.

Of course the CEOs of Fannie and Freddie are unemployed today, but no doubt comforted by their $24 million severance packages. Taxpayers may have something to say about that.

Common shareholders of the two companies have seen over 90 percent of the value of their shares disappear this year, with the shares dropping to penny stock status on Sept. 8. At the same time, half of the analysts on Wall Street that covered Fannie and Freddie rated the stock a buy on the day of their demise. I am left to wonder, one more time, why Wall Street analysts are paid so much, or why they are paid at all. One also wonders why anyone pays attention to them.

Several big name mutual fund managers were big losers, holding millions of shares and buying millions more last week as the takeover was being planned. Of course, the short sellers profited greatly.

What is unknown at this point is what will happen to the preferred shareholders. It is likely that they will not be receiving their dividends, and so the value of their holdings will fall. Shares of the most recent preferred stock issuance of the GSEs sank to roughly 10 cents on the dollar. Together the two firms have nearly $36 billion in preferred shares outstanding. Many investors will lose, including banks,

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because Fannie's and Freddie's common and preferred are the only equity investments that banks are allowed to make. The preferred shares were particularly popular because banks received a 70 percent tax break on the dividends. In a recent statement, bank regulators said they were willing to work with banks to avoid insolvency. They also said that there were "a limited number of smaller institutions that have holdings significant compared to their capital."

While some banks may fail as a result of the takeover, others banks have benefited. The value of mortgage-backed securities rose after the takeover and it is estimated that the increase in value could expand credit by as much as $250 billion. Banks have already written off half a trillion dollars in loans. Furthermore, the takeover removes the risk that the two GSEs would have to suspend their purchases of mortgages. Nationwide, 30-year fixed rate mortgages dropped from 6.26 percent to 6.08 percent, according to bankrate.com. The drop will assist new homebuyers as well as those seeking to refinance. Some economists expect a further decline in interest rates before year end. Banks will no longer have to worry if there is a market for mortgages they may have on their books, as there will continue to be a secondary market for them.

The stock market reacted positively to the developments, then swooned, and then recovered to end with the Dow up 289 points on the day. However, as in the past, the initial euphoria may give way to more pessimism, and a further down leg could follow. Even so, the July lows may hold, and investors unwilling to commit to the market may find themselves standing in the station as the train leaves.

In the background is an eroding world economy that will have a negative effect on U.S. exports. The eroding global economy and especially commodity prices have raised concerns of deflation. The expected Fed rise in interest rates now seems deferred as deflation takes the stage. The rapid strengthening of the dollar could also deter U.S. export growth, but be a positive in the battle against inflation.

In earlier columns I have alluded to the long trail that we have to travel to reach the end of the housing and credit crisis. Housing prices will have to stabilize before credit and equity markets can normalize. The recent action was a giant step on that trail.

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