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Mortgage Bailout Is Greeted With Relief, Fresh Questions

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Investors cheered the U.S. government's seizure of the nation's two troubled mortgage giants, with stock markets rallying in the U.S. and abroad and mortgage rates falling. But obstacles remain if the Treasury's takeover of **Fannie Mae** and **Freddie Mac** is to succeed.

Meanwhile, new details emerged of the pressures that led up to Treasury's plan to take the reins of the troubled companies. In the weeks before the government's intervention, nervous foreign finance officials barraged Treasury Secretary Henry Paulson and Federal Reserve officials to find out what was happening with the mortgage giants, according to people familiar with the matter.

Associated Press

Treasury Secretary Henry Paulson during a news conference in Washington Sunday.

Among those expressing concern were Asian investors, including the Chinese, say two people familiar with the matter. Foreign banks' concerns were among the factors that helped prompt the government's move on Sunday to take over Fannie and Freddie, these people say.

Monday's performance of short-term financial indicators -- from mortgage rates to stock prices -- suggests the Bush administration's seizure of Fannie and Freddie might work. At the same time, Treasury and its banking advisers were bombarded with questions about their big gamble. Many in the market warned that it will do little to salve the deeper wounds in the American economy and financial markets.

Wild swings in the Dow Jones Industrial Average betrayed this tension. The blue-chip index soared 347 points in the opening minutes of trading, then fell back 253 points from that peak by lunchtime before rising another 197 points. The Dow industrials finished the day at 11510.74, up 289.78.

Sweeping Intervention

Mr. Paulson's weekend announcement represented one of the most sweeping interventions in financial markets since the Depression, essentially putting the government in charge of helping finance American mortgages. Fannie and Freddie are vital cogs in the housing market, backing three-quarters of all mortgages being made in the U.S. now that bruised Wall Street banks have withdrawn from that market. They hold or back more than $5 trillion in mortgage debt. But as the housing market cratered, investors grew nervous about the companies' capital positions and their ability to weather the storm.

> **Podcast:**[1] Return on Investment columnist Brett Arends explains how the Fannie and Freddie takeover will shake out for homebuyers and taxpayers, and how investors should respond.

Under the takeover, the government replaced the companies' chief executives and shifted management control to their regulator, the Federal Housing Finance Agency, or FHFA. The government pledged to provide as much as $200 billion to help both firms ride through their expected mortgage-related losses. Mr. Paulson outlined his desire to see both companies begin to reduce the size of their mortgage portfolios beginning in 2010.

The challenges that remain are formidable, ranging from whether Wall Street banks can step into the housing-finance void that the two firms will eventually leave behind, to whether Congress can put aside years of bitter fighting to craft a future for the two mortgage giants it initially created.

If Treasury's intervention is working, mortgage rates should fall. Fannie and Freddie could begin backing more mortgages, at least temporarily. The two companies might loosen their very stringent underwriting rules. And housing demand should get a marginal boost, putting a dent in the nation's glut of unsold homes by enticing potential buyers who have been sitting on the fence because of higher interest rates.

The Treasury will be watching closely to see if the companies need a cash infusion. Under the plan announced Sunday, Treasury can make a capital injection if it determines that the companies' assets have fallen below their liabilities. Most market watchers expect that to happen eventually.

Credit markets reacted positively to the move, as spreads -- the difference between the yields on ultrasafe U.S. Treasury bonds and corporate and mortgage debt -- narrowed. As expected, spreads fell dramatically Monday on Fannie and Freddie's own bonds, as well as on those backed by pools of loans that conform to Fannie and Freddie's standards.

The government bailout of Fannie Mae and Freddie Mac may help stabilize an unsettled mortgage market, but it's also likely to cost taxpayers a bundle, Fox News's Doug Luzader reports.

Yields on 30-year agency-backed mortgage bonds dropped 0.41 points, reducing the spread over comparable Treasury bonds to 1.87 percentage points, the largest daily move since 1990, according to FTN Financial. This may translate quickly into lower mortgage rates for home buyers around the country, as banks can more easily sell the loans they make to investors in the mortgage-bond market.

But by the end of the day Monday, concerns about bank solvency and the weak economy returned. "Just because you foster an orderly market doesn't mean the market is going to prosper," says Dominick DeAlto, managing director at Robeco Investment Management, a fixed-income asset-management firm.

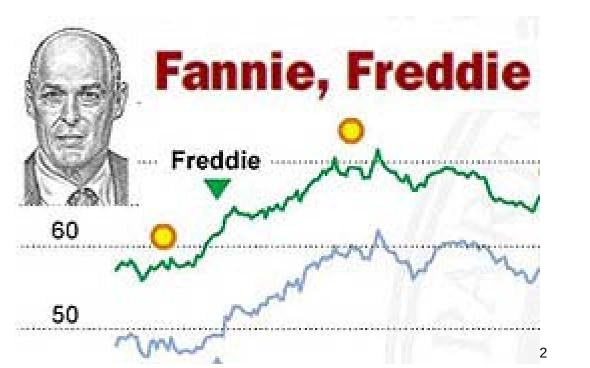
Big Savings

Even small declines in mortgage rates, however, can lead to big savings for potential home buyers. At PNC Financial Services Group Inc. on Monday, rates on 30-year fixed-rate mortgages fell to 5.875% from 6.125% at the beginning of the day, according to a company spokesman. Analysts expect the average 30-year mortgage rate could come down a quarter to a half of a percentage point in coming weeks.

Tom McCormick, chief executive of Astoria Homes, one of the largest privately held home builders in Las Vegas, said that a percentage point decline in interest rates would result in the same monthly payment on a 30-year fixed loan as if his company dropped its home prices by 10%. The homes Astoria sells have already been slashed by 30% in price in the past two years. That means monthly payments are getting close to rents, a key measure of a balanced housing market.

Looming in the near future is a fight on Capitol Hill over the future of Fannie Mae and Freddie Mac. Treasury's plan leaves unresolved their ultimate fate and gives Congress the job of figuring it out. Many Republicans want the firms privatized and severed from the government. Democrats are pushing to retain some sort of structure that provides funding for home mortgages.

The idea of an even bigger intervention -- along the lines of the Depression-era Reconstruction Finance Corp., which purchased mortgages, or the Resolution Trust



View an interactive timeline of Treasury Secretary Henry Paulson's handling of Freddie Mac and Fannie Mae.

Corp. of 1989, which disposed of assets from failed savings and loans -- has been floated by everyone from former Clinton Treasury Secretary Lawrence Summers to former Reagan Treasury Secretary Nicholas Brady. Even the Federal Reserve Bank of Cleveland has suggested creating an entity that could buy and sell distressed assets when necessary.

Much of what's gumming up Wall Street is a glut of impaired assets that investors no longer want. Many of these are mortgage-backed securities, which investors have shunned as the housing crisis has deepened. Creating a government-backed entity to buy these assets could help jump-start the market for home loans and relieve banks and other financial institutions, which are taking big hits to their balance sheets as they fall in value.

"It's appropriate for the government to help in these extraordinary circumstances because market psychology has overruled economic reality, placing our nation's well-being at risk," said Eugene Ludwig, a former U.S. Comptroller of the Currency and CEO of Promontory Financial Group, and one of the earliest and most prominent backers of the idea.

The government's takeover of Fannie and Freddie isn't enough, he says. "I do not see how you get out of this corner without significant government money, and the problem is the longer we delay this the more it costs the country," he says.

Others are concerned about shuffling bad loans around the financial system, as Japan did in the 1990s. "I worry about the Japan case," said Charlie Bobrinskoy, vice chairman at Chicago-based Ariel Investments.

Whether to structure an even bigger bailout will likely fall to the next president. Neither Sen. Barack Obama nor Sen. John McCain has explicitly called for the government to step in and buy distressed assets. Advisers to both men say it's something they would consider as they figure out ways to stem the housing fallout.

Voicing Concern

Foreign central banks had been among those voicing concerns in the weeks ahead of the government's seizure of Freddie and Fannie. The banks had steadily reduced their holdings of debt in the two firms in recent weeks as the turmoil around the firms worsened.

China's four biggest commercial banks, too, pared back their holdings in agency debt, with Bank of China Ltd., the largest holder of Fannie and Freddie securities among these banks, saying it sold or allowed to mature $4.6 billion of the $17.3 billion it held as of June 30, down from more than $20 billion at the end of last year.

Treasury tried to head off such concerns by having David McCormick, an assistant secretary for international affairs, call foreign central banks and other overseas buyers of the companies' securities or debt to reassure them of the instruments' creditworthiness. Over the weekend, Treasury officials called sovereign-wealth funds in Abu Dhabi and elsewhere in the Middle East, assuring them that they were working on financial issues involving Fannie and Freddie, says an individual apprised of the conversations.

Like many investors, foreign governments, particularly central banks and sovereign-wealth funds, believed the U.S. government implicitly stood behind Fannie and Freddie and would prop them up to prevent a failure.

But when the Treasury won approval from Congress in July to backstop the pair through an equity investment or a loan, it sparked questions among some investors about the relationship between the government and the mortgage giants.

Amid worries about the debts' backing by the U.S. government, some central banks decided to buy Treasury securities instead. That increased the spread between the rates for Treasuries and mortgages, exacerbating the crisis that officials had been trying to resolve.

In his public comments Sunday, Mr. Paulson said the "ambiguities" in the firms' congressional charters led foreign central banks and investors in the U.S. and around the world to believe the firms' debt was "virtually risk-free."

"Because the U.S. government created these ambiguities, we have a responsibility to both avert and ultimately address the systemic risk now posed by the scale and breadth of the holdings," Mr. Paulson said.

On Monday, Mr. Paulson sought to assuage the concerns of foreign officials, explaining the government's takeover in a brief call with his financial counterparts in the Group of Seven.

Japan's Finance Minister welcomed the bailout.

In a statement, the People's Bank of China said: "We believe these policies are positive, and should help stabilize the market and boost confidence." U.S. Treasury data show Chinese entities held $376 billion in agency debt as of June 2007, and some estimates place the figure at $500 billion currently. China's central bank is believed to be the world's largest single investor in the bonds issued by Fannie and Freddie.

Asked whether the central bank had been in contact with U.S. government officials about Fannie and Freddie, a spokesman declined to comment.

--Jason Leow, Aaron Lucchetti and Sudeep Reddy contributed to this article.

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