

US 'nationalises' mortgage lenders

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World share markets are bracing for a volatile day

of trading after the US Government announced it would place the major players in the home mortgage market, Freddie Mac and Fannie Mae, into "a conservatorship", essentially nationalising their activities.

The bail-out, the biggest in US history, is designed to ensure that the mortgage market continues to operate and that instability does not flow into other credit markets, after it became clear that Freddie Mac and Fannie Mae had lost the confidence of the market, had low capital reserves and were having difficulty borrowing.

But it could also cause a new wave of difficulties for some smaller institutions who hold Freddie Mac and Fannie Mae shares, particularly regional banks.

Treasury Secretary Henry Paulson, who announced the bailout at a rare Sunday news conference, justified it by saying that Freddie Mac and Fannie Mae are so "large and interwoven" into the global financial system that "a failure of either would cause turmoil around the world".

Most governments and financial institutions hold Freddie Mac and Fannie Mae securities which were once regarded as as safe as Treasury bonds.

President George Bush said US regulator, the Federal Housing Finance Agency, had determined the two companies couldn't continue to operate safely and soundly and fulfill their public mission, posing an unacceptable risk to the broader financial system and the US economy.

"Allowing the companies to fail or further deteriorate would damage our home mortgage market, and could weaken other credit markets that are unrelated directly to housing," he said.

But by implementing the plan, foreshadowed by treasury officials several weeks ago, the government has potentially exposed US taxpayers to billions in losses.

The two companies own or guarantee \$5.3 trillion in mortgages. It is unclear how many of the loans are delinquent, but 29 per cent of US home owners now have negative equity in their homes, meaning they owe more than they are worth.

Three days ago the Mortgage Bankers Association announced that the share of homes entering foreclosure in the second quarter reached 1.19 per cent, the highest in the 29-year history of its survey.

The shareholders in Freddie Mac and Fannie Mae are also facing losses, which could cause another wave of collapses among smaller regional banks.

Under the plan the US Government will take over the management of the two companies and get

rid of its boards and chief executives.

It will take ownership of preferred stock, ranking above that owned by common shareholders.

Mr Paulson said Treasury believed that most institutions holding the stock could weather the write-downs, but he also advised any smaller institutions to contact their regulators immediately if they were facing difficulties.

The government is also setting up a secured credit facility for Freddie Mac and Fannie Mae to serve as a backstop if they have difficulty borrowing funds in the capital markets.

"This facility is intended to serve as an ultimate liquidity backstop, in essence, implementing the temporary liquidity backstop authority granted by Congress in July," Mr Paulson said.

The government is also undertaking a third measure: a program to buy mortgage-backed securities.

It hopes the program will narrow the spread between mortgage and official interest rates and help bring down the rates being charged to householders.

Both US presidential candidates have welcomed the bail out, although Senator Barack Obama sounded a warning that assistance should not just be directed to "special interests".

President Bush said the move was temporary.

What are 'Freddie and Fannie': Freddie Mac and Fannie Mae were established by the US Government after the Depression to assist in providing cheap home loans. The two companies buy or guarantee mortgages from banks thereby providing liquidity and low rates in the home loan system. They then package them into securities which they sell to global investors, using the funds to buy more mortgages.

In more recent years, the companies were listed on the stock exchange, and so have private shareholders and a board. But they are still considered to have an implicit US government guarantee backing their activities. For this reason banks and other financial institutions worldwide have invested in the mortgage-backed bonds they issue, considering them nearly as safe as US Treasury bonds. If Fannie and Freddie were allowed to go under it would cause pandemonium in the global financial system.