

## Fannie, Freddie blind to the bubble

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Saturday, September 6, 2008

(09-06) 17:06 PDT WASHINGTON, (AP) --

Mortgage giants Fannie Mae and Freddie Mac — despite their robust cadre of economists and mortgage experts — failed to heed warnings that the most dramatic housing bubble in U.S. history would burst.

The companies — particularly Freddie Mac — didn't raise enough cash to reassure Wall Street that they would be able to withstand a severe downturn in U.S. home prices.

Federal regulators after scouring the companies' books with aid from investment bank Morgan Stanley — believe the companies pushed accounting conventions when calculating their financial cushion against losses, a person briefed on the matter said Saturday. The person declined to be named because details of the government's actions were not yet public.

As their losses started rising at alarming rates over the past year, investors gradually lost confidence, forcing the government's historic takeover of the two companies, which could be announced as soon as Sunday and was expected to include the ouster of top executives.

Rep. Barney Frank, D-Mass., the chairman of the House Financial Services Committee, said in an interview Saturday that the companies' financial picture was better than investors assumed, but "it just plainly became clear that elements of the market wouldn't accept that."

Investors have had reasons to feel jittery.

On Friday, the Mortgage Bankers Association said that more than 4 million American homeowners with a mortgage, a record 9 percent, were either behind on their payments or in foreclosure at the end of June.

Also on Friday, Nevada regulators shut down Silver State Bank, the 11th failure this year of a federally insured bank. In July, regulators seized IndyMac, which had \$19 billion in deposits. And earlier this year, the government orchestrated the takeover of investment bank Bear Stearns Cos. by JPMorgan Chase & Co.

Treasury Secretary Henry Paulson has been in contact in recent weeks with foreign governments that hold billions of dollars of Fannie and Freddie debt to reassure them that the United States recognizes the importance of the two companies.

Nevertheless, the Bank of China said in late August that it cut back its portfolio of the Fannie and Freddie's debt by about one quarter since the end of June.

Washington-based Fannie and McLean, Va.-based Freddie are the engines behind a complex process of buying, bundling and selling mortgages that remains a mystery to millions of Americans whose home loans pass through this system. Together Fannie and Freddie hold or guarantee about \$5 trillion in mortgage debt — about half of the nation's total.

They traditionally backed the safest loans, 30-year fixed rate mortgages that required a down payment of at least 20 percent. But in recent years, they lowered their standards dramatically, matching a decline fueled by Wall Street banks that backed the now-defunct subprime lending industry.

Armando Falcon, who clashed frequently with the companies during his six years as Fannie and Freddie's chief government regulator, said in an interview last month that the companies' woes are similar to the downfall of other major corporate titans like Enron and WorldCom earlier this decade. "It boils down to a whole lot of greed and arrogance," he said.

The companies, he said, took advantage of the perception on Wall Street that the government would stand behind them in a time of crisis, as is now the case.

With that implied government backing, the companies generated large profits for years, but ultimately took on too much risk, causing



investors to lose faith in their ability to navigate the historic housing bust.

Economists who long warned the housing boom could not last are baffled that the companies were not better prepared for what they saw as an inevitable downturn.

"How could you look at an enormous rise in prices and not think there was a potential for them to fall?" said Christopher Thornberg, a principal with Beacon Economics in Los Angeles.

Another longtime proponent of the housing bubble concept is Dean Baker, co-director of the Washington-based Center for Economic and Policy Research. He recalls several occasions when he debated top Fannie and Freddie economists, who dismissed the idea that U.S. home prices could decline.

"Even if they didn't want to listen to me, they should have at least thought this could be a possibility," he said.

Plummeting home prices are the key to Fannie and Freddie's troubles. As prices fall — as much as 25 percent over the past 12 months in Las Vegas, Miami, Phoenix and Los Angeles — the value of mortgages the companies hold on their books drops. That means Fannie and Freddie are recovering far less money through foreclosure sales.

While a government intervention had been expected for weeks, its timing came as a surprise.

The companies had been able to raise money through regular debt sales, but analysts say the Treasury Department likely grew concerned that foreign investors were pulling back.

"The main goal is to inject confidence into the foreign debt markets to ensure that the flow of capital to the mortgage market continues," said Howard Glaser, a Washington-based mortgage industry consultant who has worked for both Fannie and Freddie.

Freddie Mac in particular has had investors and analysts fearful for months. The company, led by CEO Richard Syron, promised to raise \$5.5 billion earlier this year to shore up its finances, but failed to do so, and its sinking share price has since made it all but impossible for the company to raise that money from private investors.

Fannie Mae executives are likely to have resisted the proposed takeover because the company's financial condition isn't as dire as its sibling company, said Bert Ely, an Alexandria, Va.-based banking industry consultant.

But the government would still have to take over both companies, he said, to allow them to borrow money at the same rates.

"In order to level the playing field between the two companies, you've got to take over both of them," said Ely, a longtime critic of the two companies.

Fannie Mae was created by the government in 1938, and was turned into a shareholder-owned company 30 years later. Freddie Mac was established in 1970 to provide competition for Fannie.

While Fannie and Freddie generally had higher standards for lenders than the subprime mortgage companies that started going belly-up at the end of 2006, the duo lowered their standards during the housing boom and bought securities linked to riskier loans.

Even as the subprime mortgage market collapsed, Fannie and Freddie kept backing risky so-called Alt-A loans, which were made to borrowers with solid credit but little proof of their incomes, or small or no down payments.

For Fannie and Freddie, these Alt-A loans made up roughly 10 percent of their portfolios but accounted for more than half of their credit losses in the second quarter. The souring loans were concentrated in California, Florida, Nevada and Arizona, where speculation was rampant, prices soared and homeowners stretched to the financial limit to afford a home.

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