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The New York Times

U.S. Unveils Takeover of Fannie and Freddie

By Dealbook September 7, 2008 2:10 pm

The Treasury Department seized control of **Fannie Mae** and **Freddie Mac**, the giant quasi-public mortgage finance companies, on Sunday and announced a four-part rescue plan that included an open-ended guarantee to provide as much capital as they need to stave off insolvency, according to The New York Times's Edmund Andrews.

At a news conference on Sunday morning, Treasury Secretary Henry M. Paulson Jr. also announced that he had dismissed the chief executives of both companies and had replaced them with two long-time financial executives. Herbert M. Allison, the former chairman of **TIAA-CREF**, the huge pension fund for teachers, will take over Fannie Mae and succeed the chief executive, Daniel H. Mudd.

At Freddie Mac, David M. Moffett, currently a senior adviser at the **Carlyle Group**, one of the country's biggest private equity firms, will succeed Richard F. Syron as chief executive. Mr. Mudd and Mr. Syron, however, will stay on temporarily to help with the transition.

"Fannie Mae and Freddie Mac are so large and so interwoven in our financial system that a failure of either of them would cause great turmoil in our financial markets here at home and around the globe," Mr. Paulson said. "This turmoil would directly and negatively impact household wealth: from family budgets, to home values, to savings for college and retirement. A failure would affect the ability of Americans to get home loans, auto loans and other consumer credit and business finance. And a failure would be harmful to economic growth and job creation."

Mr. Paulson refused to say how much capital the government might have to

provide, or what the cost to taxpayers might ultimately be.

The companies are likely to need tens of billions of dollars over the next year, but the cost to taxpayers will largely depend on how fast the housing and mortgage markets recover.

Mr. Paulson's plan begins with a pledge to provide additional cash by buying a new series of preferred shares that would offer dividends and be senior to both the existing preferred shares and the common stock that investors around the world already hold.

The two companies would be allowed to "modestly increase" the size of their existing investment portfolios until the end of 2009, which means they will be allowed to use some of their new taxpayer-supplied capital to buy and hold new mortgages in investment portfolios.

But in a strong indication of Mr. Paulson's long-term intention to wind down the companies' portfolios, drastically shrink the role of Fannie and Freddie and perhaps eliminate their unique status altogether, the plan calls for the companies to start reducing their investment portfolios 10 percent a year, beginning in 2010.

The investment portfolios are now slightly more than $1.4 trillion, and the plan calls for that to eventually shrink to $250 billion each, or $500 billion total.

"Government support needs to be either explicit or non-existent, and structured to resolve the conflict between public and private purposes," Mr. Paulson said. "We will make a grave error if we don't use this time out to permanently address the structural issues presented by the GSE's," he added, a reference to the companies as government-sponsored enterprises.

Critics have long argued that Fannie and Freddie were taking advantage of the widespread assumption by investors that the federal government would bail them out if they got into trouble. Administration officials as well as the Federal Reserve have argued that the two companies used those implicit guarantees to borrow money at below-market rates and lend money at above-market returns, and that they had become what amounted to gigantic hedge funds operating with only a tiny sliver of capital to protect them from unexpected surprises.

That covenant in the agreement responds to many in the Bush administration and in the private sector who had argued for years that Fannie and Freddie posed “systemic risks” to the economy because they had acquired more than $5 trillion in assets with only the thinnest of capital cushions to shield them from losses.

Treasury officials had little choice. With the credit markets still in a tailspin and investors deeply reluctant to buy mortgages with even a hint of risk, Fannie Mae and Freddie Mac currently guarantee about 70 percent of all new home loans, the director of the Federal Housing Finance Agency, James B. Lockhart, said.

Mr. Paulson said the Treasury Department would provide as much money as needed to keep the companies’ capital reserves from falling below the levels that would trigger rules that automatically put them into receivership.

In addition, the Treasury Department will create a “Secured Lending Credit Facility,” a back-up source of borrowing for the companies in the event they cannot borrow enough money on the open market to finance their main business of buying mortgages and reselling them as pools of mortgage-backed securities.

In a possibly unprecedented move into the private markets, the Treasury Department will also buy billions of dollars in Fannie and Freddie mortgage securities on the open market. This move is likely to make it much easier for the companies to finance somewhat riskier loans.

The crisis surrounding the mortgage-finance giants seeped into the presidential campaigns over the weekend, with Senator John McCain, the Republican nominee, saying on Sunday that he supported the Treasury move but also implicitly criticized the Bush administration’s oversight. “I think that we’ve got to keep people in their homes. There’s got to be restructuring, there’s got to be reorganization, and there’s got to be some confidence that we’ve stopped this downward spiral,” Mr. McCain said. “It’s hard, it’s tough, but it’s also the classic example of why we need change in Washington.”

Mr. McCain added that the two companies need “more regulation, more oversight, more transparency, more of everything, and frankly, a dramatic reduction in what they do.”

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