US government takes over mortgage giants to stave off financial meltdown

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In the biggest government intervention in the American economy since the Great Depression of the 1930s, the US Treasury Department announced Sunday that it is effectively nationalizing the two mortgage giants Fannie Mae and Freddie Mac.

Timed to precede the opening of the stock markets in Asia, the announcement that the two firms are being placed in "conservatorship" left no doubt about the depth of the economic crisis confronting American and world capitalism.

"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," said Treasury Secretary Henry Paulson Jr., at a Washington press conference. "A failure would be harmful to economic growth and job creation. That is why we have taken these actions today."

Indeed, the bankruptcy of these two companies points to the bankruptcy of American capitalism. Between them they are responsible for funding more than two thirds of all home mortgages in the US.

While politicians from both parties as well as most media reports have tried to portray the plan as assistance to beleaguered homeowners, it is clear that the intervention will do nothing to ameliorate the crisis confronting millions of average working people.

As the *New York Times* acknowledged Sunday, "The plan to bail out the firms will probably do little to stop home prices from falling further. And foreclosures are almost certain to rise.

"The bailout will give the mortgage industry a stability that we haven't had in a couple of years," Rich Cosner, president of Prudential California Realty told the Associated Press. "But frankly no, it won't help (struggling borrowers) to refinance."

Its real aim is to bail out the banks which bought Fannie's and Freddie's unsecured debts as investments with the understanding that the US treasury ultimately stood behind these so-called "government-secured enterprises."

The immediate cost of the bailout will be borne by taxpayers as well as shareholders, who will see their investments wiped out. Part of the plan announced Sunday authorizes the government to buy up existing assets at a nominal price of less than a $1 a share. A significant portion of these investments are held by mutual funds handling 401K plans that constitute the sole retirement savings for large sections of the American workforce.

Moreover, the terms of the takeover is expected to precipitate at least some new bank failures. The FDIC (Federal Deposit Insurance Corporation) issued a statement Sunday affirming that "while many institutions hold common or preferred shares of these two government-sponsored enterprises, a limited number of smaller institutions have holdings that are significant compared to their capital." How "limited" this number was, the agency did not say.

The plan announced by Paulson calls for the investment of up to $200 billion in government funds to prop up the two mortgage giants.

The real cost, however, could prove significantly higher. William Poole, the former president of the Federal Reserve Bank of St. Louis, said Sunday that the government could be compelled to spend as much as $300 billion to rescue the two companies.

The action marks the third time since the beginning of the year that the US government has been force to bail out a major financial institution in order to stave off a threat of imminent collapse of the US and global banking system.

Last March, the injection of $29 billion from the US Federal Reserve was used to subsidize the takeover of Bear Stearns by JPMorgan Chase. And in July, the government was granted authority to inject cash into the Fannie Mae and Freddie Mac, while the two government-backed private companies were allowed to borrow money directly from the Fed.

Together, the two companies had recorded $14.9 billion in net losses over the past four quarters as a result of rising foreclosures and plummeting home prices.

In selling the plan last July to the Senate Bank Committee, Paulson argued, "If you have a bazooka in your pocket and people know it, you probably won't have to use it." The idea was that by creating this safety net, private investors would be reassured and would lend money to the two companies, which together own or back more than $5 trillion in home mortgage debt.

As it turned out, the "bazooka" had the opposite effect, convincing investors that Fannie and Freddie were headed for bankruptcy and federal takeover. As a result, their share prices continued to plummet, having lost 80 percent of their value this year.

In after-hours trading Friday, after rumors of an imminent takeover began circulating on Wall Street, Fannie Mae stocks fell by another 21.9 per cent and Freddie Mac's by 20.9 per cent.

One of the triggering factors in the government intervention was apparently the dumping of Fannie-Freddie holdings by Asian and other foreign investors. Bank of China, the country's third-largest bank, announced at the end of August that it had shed some $3.14 billion in debt holdings from the two companies over the previous two months. Other central banks were apparently following suit.

Russia's central bank, meanwhile, reportedly dumped some $40 billion in Fannie Mae, Freddie Mac and Federal Home Loan Bank securities over the course of this year and further cuts were expected.

The flight from investment in these government-backed companies clearly raises the specter that a similar pull-out could be threatened from US government securities. At present, the US economy is dependent upon foreign investors, principally in Asia, purchasing up to $20 billion in US agency debt monthly.

Implicitly threatening just such a pullout, China's leading economist, Yu Yongding, a former senior advisor to the central bank, commented last month: "If the US government allows Fannie and Freddie to fail and international investors are not compensated adequately, the consequences will be catastrophic. If it is not the end of the world, it is the end of the current international financial system."

Significantly the bond rating agency, Standard & Poors, felt compelled to issue a statement Sunday affirming that the takeovers—adding $5 trillion in debt to Washington's balance sheets—would not result in the downgrading of the US government's sovereign credit rating.

The depth of the crisis and the scope of the government intervention was underscored by the fact that Paulson briefed not only President Bush before announcing the plan, but also Democratic and Republican candidates Barack Obama and John McCain, as well as senior congressional leaders.

Both candidates voiced their backing for the intervention, while criticizing the government's past handling of the two mortgage companies.

"These entities are so big and they are so tied into the housing market that it is probably true that we have to take steps to make sure they don't just collapse," Obama told an audience in Terre Haute, Indiana.

"I think that we've got to keep people in their homes," McCain declared in an interview aired Sunday on the CBS news program "Face the Nation." He continued: "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."

Obama proclaimed that the takeover should not be used to "protect investors and speculators who relied on the government to reap massive profits," while McCain denounced "executives were making hundreds of—some billion dollars a year while things were going downhill." The Republican candidate acknowledged, "This is the kind of cronyism, corruption, that's made people so justifiably angry."

All of this is empty demagogy. The speculation, cronyism and corruption that pervaded the operations of Fannie Mae and Freddie Mac are emblematic of the parasitism and criminality of the America's ruling financial elite as a whole.

Moreover, this bipartisan unity in support of the bailout is the clearest expression of the unconditional subordination of both major political parties to the fundamental interests of America's financial oligarchy.

One of the deciding factors in the government's intervention Sunday was an audit of the two companies performed by advisers hired from Morgan Stanley. While initial reports are sketchy, it appears that the auditors found that the two firms were employing Enron-style accounting methods to hide the real depth of their crisis, failing to write down the value of securities backed by subprime loans.

As a result, the amount of capital that the companies had to protect themselves from losses—extremely limited by any standards—was in actuality far less than had been presented. Their ability to raise new capital had clearly dried up with the dizzying drop in share prices in recent months.

"Freddie Mac had made accounting decisions that pushed losses into the future and postponed a capital shortfall until the fourth quarter of this year, which would not need to be disclosed until early 2009," the *New York Times* reported. "Fannie Mae has used similar methods, but to a lesser degree, according to other people who have been briefed."

Both of the mortgage giants had been involved in previous accounting scandals. Freddie Mac underwent a shakeup in 2003 after it was revealed that earnings figures had been falsified to the tune of $5 billion, while at Fannie Mae, the company was accused of "accounting errors" totaling $6.3 billion. Both Freddie and Fannie were forced to pay fines and replace their chief executives, but no criminal investigations were initiated and no substantive change was initiated in the companies' operations.

As the *New York Times* described these operations, the two firms used the implicit government commitment to bail them out "to borrow money at below-market rates and lend money at above-market returns," turning them into "what amounted to gigantic hedge funds operating with only a sliver of capital to protect them from unexpected surprises."

Fannie Mae was set up by the federal government in 1938 as part of the New Deal to inject capital into a mortgage market mired in the Great Depression. It was a public agency with the explicit mission of providing government credit so that average families could buy homes.

In 1968, it was turned into a private but government-sponsored corporation with the aim of getting mortgage debt off of the government's books under conditions in which the Vietnam War was creating growing fiscal pressures. Freddie Mac was created in 1970 as a similar "government sponsored enterprise." By the 1990s, the two agencies became central to the speculative housing bubble that underlay the profit boom on Wall Street that preceded the current crisis of the world financial system.

The government's choice of new chief executives to head the two firms it has taken over makes clear whose interests it intends to defend. Placed at the helm of Fannie Mae was Herbert Allison, a former vice-chairman at Merrill Lynch, and to head Freddie Mac, it tapped David Moffett, a former CEO at US Bancorp and current senor advisor to the Carlyle Group.