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TUESDAY, AUGUST 7, 2007



**UP AND DOWN WALL STREET DAILY** |  Online Exclusive  
 By **RANDALL W. FORSYTH**

**Fannie and Freddie: White Knights to the Rescue?**

**WILL FANNIE MAE AND FREDDIE MAC** slay the dragon of the mortgage credit crunch?

The stock market apparently believes so. The Dow Industrials staged another late afternoon surge Monday on rumors that the government-sponsored enterprises might be permitted to increase the volume and size of home mortgages it purchases. Those steps would presumably loosen the gridlock that has caused much of the mortgage market to seize up.

The Dow wound up 287 points, or 2.2%, to 13,469, in almost an exact mirror image of Friday's 281-point drop in reaction to the deepening crisis in the fixed-income markets, described by Bear Stearns' chief financial officer called the worst he'd experienced in the 22 years.

The biggest winners were the supposed saviors of the market -- **Fannie** jumped 10.4% while **Freddie** vaulted 7.7%. They led the entire financial sector higher, with the **Financial Select Sector SPDR** exchange-traded fund gaining 5.1% Monday -- more than half the 9.5% loss from its peak on July 23 through Friday's decline.

Our sister site, the Wall Street Journal Online, reported shortly before the 4 PM Eastern closing bell that Fannie's executives had asked the GSEs' regulator to raise the ceiling on the amount of loans and mortgage-backed securities it can purchase to provide more liquidity to the market, citing persons familiar with the situation. Spokespersons for Fannie as well as the regulator (the Office of Federal House Enterprise Oversight) declined comment.

OFHEO had curbed the GSEs' expansion of their purchases of mortgages and MBS in the wake of Fannie's and Freddie's accounting and financial problems in past years. Critics also charge that the GSEs' previous massive expansion of their balance sheets posed a potential risk to the federal government given the implicit guarantee of their obligations, while Fannie and Freddie reaped huge profits made possible from their resulting cheap borrowing costs.

A Freddie spokesman also suggested that another way to ease the current market crisis would be to allow the GSEs to buy so-called jumbo mortgages over the \$417,000 limit now applied to them. That would permit Fannie and Freddie to buy more loans in high-cost areas such as Florida and California, two states where the mortgage meltdown has hit hardest.

Letting Fannie and Freddie to expand the volume of purchases of mortgages and related securities to buy jumbo loans would be a "much more precise and effective 'ease,' or liquidity injection than would be a rate cut" by the Federal Reserve, writes T.J. Marta, chief fixed-income strategist for the RBC Capital Markets of the Royal Bank of Canada.

The turmoil in the credit markets has put the possibility of a Fed easing back on the table (see **Current Yield**, Aug. 6.) While there's virtually no chance Federal Open Market Committee will lower its target rate for federal funds (overnight interbank loans) from the current 5.25% at Tuesday's meeting, the policy-setting panel no doubt will have to address the current credit crunch.

And make no mistake about it, it is a credit crunch in the sense that new mortgages that don't fully conform to Fannie's and Freddie's criteria -- under the \$411,000 limit to borrowers with real credentials on real properties with realistic assessments -- have become incredibly difficult to obtain just in the past few days.

One major bank hiked its rate on jumbos to 8% from 6 7/8% -- overnight. From the trenches, the war stories are dire. A mortgage professional relates that only fully documented mortgages are available -- and lenders' loan committees are requesting additional documentation after the original requirements are fulfilled. Another says that "stated" loans are a thing of the past. Stated loans, he explained, were ones where borrowers simply stated their assets and income. "You're a schoolteacher and you make a half million a year? OK. Your assets are \$5 million? Fine." Other terms for these loans are no-documentation loans, or to the cynical, simply "liar loans."

Why were they made? They were the most profitable. There was little margin in the traditional 80% loan-to-value mortgage, where the loan payments and taxes comprise 28% of income, all verified with W-2s and 1040s. The real money was in 90% LTV first mortgages with "silent seconds" -- home-equity loans with second liens that provide the 10% downpayment -- usually with teaser

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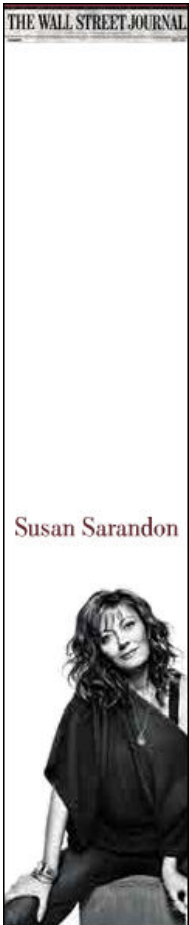
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rates and options to pay only interest.

By the market's action Monday, you'd think Fannie and Freddie would bail out all manner of hapless mortgage borrowers. For instance, [Impac Mortgage](#), a real-estate investment trust specializing in alt-A (better than subprime not really prime) mortgages, saw its share price soar 50% from its low Monday morning to the close -- \$1.70, just a four-cent rise from Friday's close after the roller-coaster trip.

More telling than the gyrations in stocks in reaction to the Fannie and Freddie rumors was the near total lack of movement in the ABX -- the index of credit-default swaps related to the asset-based securities market. This is like the dog that didn't bark in the Sherlock Holmes story.

The GSEs might add be able to ease the crisis in parts of the mortgage market next door to the neighborhood they were designed to serve. And, notes RBC's Marta, it would not result in the moral hazard that would result from a Fed ease, as when the central bank slashed rates in the LTCM crisis in 1998 or after the tech bubble burst in 2000. In the latter case, driving short-term rates down to 1% inflated the housing bubble that is now bursting.

But the ABX's lack of response strongly suggests that the stock market's bounce Monday probably resulted from some panicky buying by short sellers to hold onto recent handsome gains.

Foreclosures are likely to surge in coming months as resets on adjustable-rate mortgages reach a crescendo. By some estimates, some \$800 billion of ARMs will reset in the 12 months ending next June when their initial teaser rates run out.

All of which suggests the mortgage crisis is only beginning, notwithstanding Monday's big stock-market move.

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