

The Fannie-Freddie Takeover: Plan Skirts Housing's Biggest Troubles; Rescue Won't Fix Falling Home Prices, Rising Foreclosures

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Abstract: "The takeover of Fannie and Freddie helps, but I don't think there will be a direct impact on stabilizing house prices," says Larry Sorsby, chief financial officer of Hovnanian Enterprises, a Red Bank, N.J., home builder, which reported its eighth consecutive quarterly loss last week.

Full text: The government takeover of Fannie Mae and Freddie Mac likely will help ease mortgage rates for home buyers, say economists, home builders and housing experts. But it won't cure the housing market's biggest ailments: falling home prices and rising foreclosures.

"This is another marginal step in the right direction," says Richard DeKaser, an economist at National City Corp., a large Cleveland bank. "But it doesn't resolve the glut of homes on the market or remove pressure on prices."

The housing market is stuck in a vicious cycle. It started with an oversupply of homes that eventually caused prices to plummet. Falling prices led to waves of foreclosures, as homeowners ran into problems refinancing their mortgages or selling their houses. Banks are reluctant to lend when home values keep sinking and defaults are rising, curbing housing demand further and fueling more price drops and defaults.

Investors and economists feared that a collapse of Fannie and Freddie would greatly exacerbate the downward spiral by essentially freezing the mortgage market. "The government's move takes that serious disruption to the financial market off the table," says Mark Zandi, chief economist at Moody's Economy.com.

Mr. Zandi says that while the takeover of the mortgage giants won't immediately stop the home-price slide, it should limit price declines to 5% to 10% over the next year, rather than the doomsday scenario of additional declines of 15% to 20% that some economists were predicting if Fannie and Freddie failed or pulled back dramatically.

"That's a big plus and means the financial system has gone a long way in writing down what it needs to," says Mr. Zandi, who until recently was among the housing market's biggest bears.

The most immediate change could come in the form of lower mortgage interest rates. They have remained relatively high -- above 6% -- for much of the past year amid credit-market troubles.

Among its many steps to shore up the mortgage market, Treasury is planning to buy Fannie- and Freddie-issued mortgage-backed securities from the market under a new program to help reduce the gap, or "spread," between yields on these securities and Treasury bonds. That should help lower interest rates on new home loans, making them more affordable for borrowers.

The higher spread means that investors perceive more risk in Fannie and Freddie's securities and therefore are demanding a higher premium in order to buy those securities. The cost of that higher premium can get passed along to the individual home buyer in the form of higher mortgage rates.

In early August, spreads on 30-year mortgage securities rose to 2.5 percentage points above Treasuries, close to their highs in March when worries about a marketwide meltdown were rampant. A year ago that spread was 1.6 percentage points, according to data from FTN Financial. Despite several rate cuts by the Federal Reserve in the past year, the interest rate on 30-year fixed-rate mortgages rose to 6.48% in August 2008 from 5.76% in January, according to Freddie data.

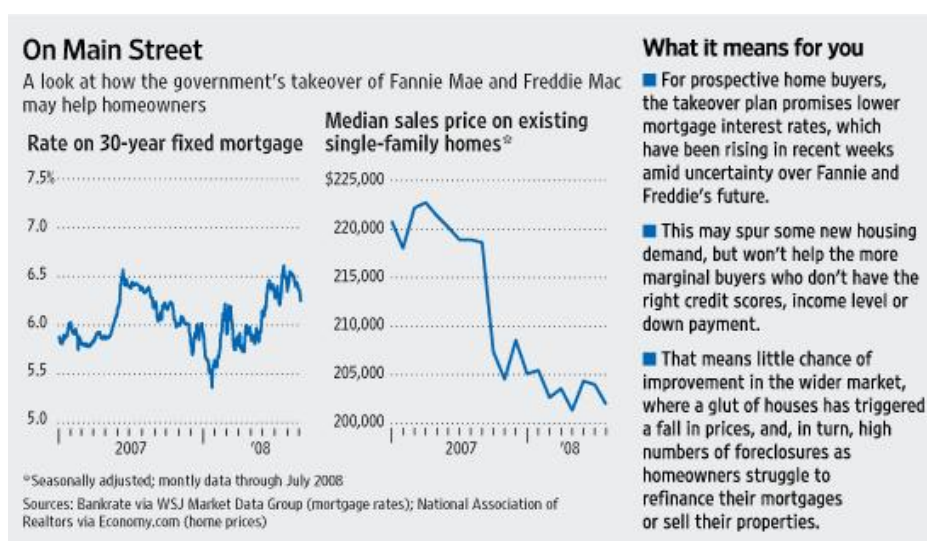
Lower mortgage rates may spur some new housing demand, but they won't likely alleviate buyers' concerns about home prices. "The takeover of Fannie and Freddie helps, but I don't think there will be a direct impact on stabilizing house prices," says Larry Sorsby, chief financial officer of Hovnanian Enterprises, a Red Bank, N.J., home builder, which reported its eighth consecutive quarterly loss last week.

Even amid Fannie and Freddie's recent turmoil, Mr. Sorsby says, most of his company's buyers who have decent credit scores, a job and a 5% down payment have been able to obtain mortgages, but the more marginal buyers -- a large segment of the potential home-buying public -- remain shut out of the market.

Mr. Sorsby and some economists doubt the newly bolstered mortgage companies will expand mortgage availability by loosening credit standards for subprime buyers.

Nor are lower mortgage rates expected to relieve many homeowners seeking to refinance their loans before their current rates reset at higher levels. Often, their biggest obstacle to refinancing is that their houses are worth less than their loan amounts or their credit profile is shoddy. The Federal Housing Administration is seeking to refinance such "underwater" borrowers facing resets, but its FHASecure program is aimed at families with strong credit histories, which could leave out many subprime borrowers.

"For those who are confronting mortgage resets, their options are greatly limited today," says Mr. DeKaser, the National City economist.



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