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Loan-Agency Woes Swell From a Trickle to a Torrent

By CHARLES DUHIGG

The word began spreading across Wall Street trading desks on Monday morning: Fannie Mae and Freddie Mac, the giant companies at the heart of the nation's housing market, might be in trouble.

The tumult, which continued on Thursday, started with a cautionary analyst's report, one that might have caused few ripples in normal times. But these are not normal times. Within minutes, the price of the companies' shares was plunging, sending shock waves through the financial markets, the economy and Washington.

Fannie Mae and Freddie Mac are so big — they own or guarantee roughly half of the nation's $12 trillion mortgage market — that the thought that they might falter once seemed unimaginable. But now a trickle of worries about the companies, which has been slowly building for years, has suddenly become a torrent.

Virtually every home mortgage lender, from giants like Citigroup to the smallest local banks, relies on Fannie Mae and Freddie Mac to grease the wheels of the mortgage market. Virtually every Wall Street bank does business with them. And investors around the world own $5.2 trillion of the debt securities backed by the companies.

Even as senior Washington officials struggled on Thursday to reassure worried investors and discussed a government intervention that could cost taxpayers billions of dollars, the companies' stock prices plummeted again in a rush of selling, this time to their lowest level in 17 years. Freddie Mac closed down 22 percent, at $8, and Fannie Mae fell 13.8 percent, to $13.20.

"There is a real panic about these companies on Wall Street right now, and sometimes a blaze like that grows almost without reason," said Tom Lawler, an economist who worked at Fannie Mae for over two decades before leaving in 2006 to become a consultant. "There wasn't really any new news to set off this crisis. The stocks just started falling, and didn't stop."

What set off this storm, and what happens next?

The cause of this week's huge declines remains somewhat unclear. Though each rumor and concern about the company was batted down as it arose, their overall volume was amplified by Fannie's and Freddie's enormous obligations.

On Monday, when the analyst report from Lehman Brothers hit the market, Fannie Mae plunged 16 percent. More than 68 million shares changed hands that day — three times as much as average. Volume jumped again on Tuesday, as the stock stabilized, and then exploded on Thursday, to 134 million, as the shares plunged once again.

Perhaps the biggest single risk facing Fannie Mae and Freddie Mac, and with them financial companies and taxpayers, is that investors might simply lose confidence in the companies, leaving them unable to pursue their core businesses — buying home loans from banks and repackaging them for sale to investors.

That buying and repackaging is the lifeblood of the American housing economy, because it provides the capital that banks and other financial institutions use to write new loans.

As long as investors are confident that Fannie Mae and Freddie Mac are relatively financially healthy, then companies, banks and other institutions will continue lending them billions of dollars each week.

But, as the companies' stock prices decline, wary investors have begun charging higher premiums for those loans. Since January, that premium, measured by the difference between what the companies pay for debt and what the United States government pays, has more than doubled, to nearly nine-tenths of a percentage point for Fannie Mae. Spread over billions of dollars in borrowing, that increase will cost the companies dearly.

If that spread ever became too pronounced, Fannie and Freddie could end up in the disastrous situation of paying so much for loans that it would become unprofitable for them to borrow. It has happened before: as interest rates soared in the 1980s, Fannie Mae's borrowing costs rose above what it was earning on its mortgages, and the company lost $1 million a day before it was able to right itself.

Should that happen again, Fannie and Freddie could suspend buying some loans — which could bring much of the American housing economy to a standstill. Or the companies could continue doing business, but losing money on many of their deals, which would continue to undermine investors' confidence in the stocks.

Another risk is that, as investors lose confidence in Fannie and Freddie, buyers will begin demanding discounts on the repackaged loans the companies sell. Those repackaged loans, known as mortgage backed securities, are guaranteed by Fannie and Freddie. As the companies' stock prices fall and their financial health declines, investors may become worried that Fannie and Freddie cannot honor those guarantees.

Investors might therefore demand prices that are too low for Fannie, Freddie and banks to make any money on the deals. In which case, banks may simply stop creating new loans.

"If people lose faith in Fannie and Freddie, then the whole system freezes up, and nobody can buy a house, and the entire housing market can crash," said Paul Miller of the Friedman, Billings, Ramsey Group in Arlington, Va. "There's a fine line between having faith and losing it, and sometimes it's unclear when it has disappeared. But when investors cross that line, bad things happen very quickly."

No one is suggesting that line has been crossed yet. Freddie Mac and Fannie Mae can still borrow at relatively low rates. And even though the companies' stocks continue to decline, there is no evidence that the mortgage backed securities guaranteed by the firms are selling at discounted rates.

But nervousness is still rippling through the economy.

For homeowners and home buyers, it is likely that the decline in Fannie's and Freddie's stocks will result in higher interest rates on all kinds of loans.

"As it gets harder for Fannie and Freddie to borrow money, it's going to push up mortgage interest rates," said Karen Shaw Petrou, managing partner of Federal Financial Analytics, a consulting company. "And this general gloom will prolong the credit crisis, which means it's harder to get student loans, auto loans and basically any type of borrowing."

Moreover, a shaky Fannie and Freddie could increase the volatility in housing prices.

"This is the last thing we need right now," said Brett Barry, an agent at Realty Executives in Phoenix. "The market is like an elevator with the cable cut lose. It is accelerating downward."

For Wall Street and the nation's banks, the declines in the stock prices of Freddie and Fannie pose more dangerous risks.

Although banks are typically prohibited from concentrating their money in the stock or bonds of any one company, those regulations create an exemption for debt issued by Fannie Mae and Freddie Mac, which have long been considered the safest of investments.

As Fannie's and Freddie's stock prices decline and they are forced to issue new bonds at higher interest rates, their old bonds become worth less. And as Fannie's and Freddie's old bonds decline in value, the many small and regional banks holding the bonds will likely be forced to declare losses.

Moreover, because Fannie's and Freddie's older bonds are so widely held, as those bonds decline in value, many people will see their portfolios decline.

"Fannie and Freddie's counterparties are global," said Steve Persky, chief executive at Dalton Investments, a $1 billion fund in Los Angeles. "People said Bear Stearns was too large to fail. But Fannie and Freddie are exponentially larger."

Finally, for taxpayers and the United States government, the risks posed by Fannie's and Freddie's declining share prices are potentially overwhelming.

As government officials discuss various rescue plans — including taking over either or both companies in a conservatorship, others are pushing for more immediate action.

"We are potentially looking a crisis in the face, and we must not allow this to happen," said William Poole, who retired in March as president of the St. Louis Federal Reserve. "The government must intervene."

If a bailout were to occur, it would most likely make it more expensive for the United States government to borrow money in the future, since the government's potential obligations, which currently stand at about $9 trillion, would rise by an additional $5 trillion.

Moreover, such a bailout would potentially put taxpayers on the hook for billions to offset Fannie's and Freddie's losses.

"The major banks are taking write-downs of 20 percent to 50 percent of their assets," said Sean Egan, managing director of Egan-Jones Ratings, an independent credit ratings firm. Just a 10 percent write-down in the value of Fannie Mae's assets would be "a loss of $150 billion that taxpayers would need to offset. So you're talking about the cost of another Iraq war."

Fannie Mae and Freddie Mac, for their parts, say such talk is dangerous. Both companies say they have capital on hand that exceeds what is required by their regulator.

But people are still worried.

"I don't think anything has happened in the last week to warrant the kind of anxiety we're seeing," said Senator Mel Martinez, Republican of Florida and a former secretary of housing and urban development.

"But the market does what it wants," he added. "All we can do sometimes is grab on and hope we don't get thrown off the ride."

Eric Dash contributed reporting.

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