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The next bailout: Homeowners

Federal government help for Bear Stearns and other Wall Street firms increases the chance that assistance for those facing foreclosure will be approved.

By Chris Isidore, CNNMoney.com senior writer
Last Updated: March 27, 2008: 6:57 AM EDT

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NEW YORK (CNNMoney.com) -- The federal government is keeping Bear Stearns out of bankruptcy. Are you next?

Momentum for federal assistance to struggling homeowners, a non-starter with the Republican administration and many members of Congress only a few months ago, has picked up steam in Washington.

The tipping point came March 16, when the Federal Reserve agreed to back up to \$30 billion in Bear Stearns (BSC, *Fortune* 500) losses as part of JPMorgan Chase's (JPM, *Fortune* 500) fire sale purchase of Bear Stearns. (The Fed cut its guarantee by \$1 billion earlier this week when JPMorgan boosted its offer for Bear.)

"I think there's a growing populist feeling that if you're going to bail out Bear Stearns you better bail out individuals," said Greg Valliere, political economist with the Stanford Group, a Washington think tank.

And some consumers clearly are in an uproar about the bailout. According to a Reuters report, about 60 protesters entered the lobby of Bear Stearns's New York headquarters Wednesday and made a fuss about how consumers needed more help from the government than Wall Street investment banks.

The Bear Stearns deal isn't the Fed's only direct exposure to the problems in the financial markets either.

The Fed also announced earlier this month that it would make billions in loans directly to Wall Street firms at the Fed's so-called discount rate, a right previously reserved for commercial banks. In addition, the Fed has said it will now accept troubled mortgage-backed securities as collateral on up to \$200 billion in loans to Wall Street.

But some economists think the Fed's moves are only the beginning. Mark Zandi, chief economist with Moody's Economy.com., said he thinks the Fed is telling the presidential administration that more needs to be done to fix the mortgage mess.

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S&P 500	1,384.03	▼ -6.30 / -0.45%
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U.S.Dollar	1 euro = \$1.589	▲ 0.008

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Using FHA to help borrowers

Valliere said that the idea gaining the most support is a plan from Senate Banking Chairman Chris Dodd and House Financial Services Chairman Barney Frank. Both are Democrats.

The proposal, likely to be introduced soon after Congress returns from the Easter recess next week, would have the Federal Housing Administration guarantee hundreds of billions of new, lower-cost loans to troubled homeowners. Many borrowers would see their total principal on these new mortgages reduced under this program.

According to an outline of this bill, homeowners could receive \$30 billion in mortgage interest subsidies. But it's uncertain just how much this proposal will ultimately cost taxpayers because it depends on what will happen to the housing market going forward.

The bill would also benefit mortgage lenders and investors in many mortgages since it could prevent a wave of foreclosures. While lenders and mortgage holders would receive less than what is currently owed on the loans with the biggest risk of default, they would receive significantly more than they could hope to recover if the loan goes through the foreclosure process and the home is sold at a sharp discount. In other words, something is better than nothing.

With this in mind, some economists believe the Dodd-Frank proposal could cost more than \$100 billion. This is obviously a pretty large number and because of this, there is a debate over whether taxpayer money should be used to bail out the relatively small percentage of homeowners that have run into problems paying their mortgages.

Some opposition to bailout

A poll by CNN in December found Americans almost evenly split on the idea of using federal dollars to help out struggling homeowners, with 51% supporting some kind of help and 46% opposed.

The poll also found that 51% believed the borrowers who were in trouble had only themselves to blame, while 46% believed they were victims of bad lending practices. The tide was overwhelmingly against helping out mortgage lenders, with 72% opposed and only 26% supporting.

But that poll was taken before job losses and other signs that the U.S. economy had fallen into recession. Congress has also stepped in since then with a \$170 billion economic stimulus package that won wide bipartisan support, while the Federal Reserve has slashed interest rates three times this year to try and get the economy back on track.

On March 17, the day after the Bear Stearns deal was announced, Dodd told reporters he believed there was now "a greater deal of receptivity to this idea" from the Fed and presidential administration than there was before the Bear Stearns bailout.

The support for the mortgage bailout won't be as widespread as it was for the economic stimulus package, nor will it be enacted nearly as quickly as that bill, which went from early discussions to being signed into law in just about a month.

"It's going to be a tougher sell, just because this is messy, complicated. Giving a tax rebate is simple," said Zandi. "But it may be just as important if not more important, to the economy."

Where the administration stands

The idea of mortgage lenders agreeing to cut the amount owed to them has already won support

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from the Office of Thrift Supervision, the agency which regulates savings and loans firms. Fed Chairman Ben Bernanke also said in a speech earlier this month to community bankers that he is in favor of such a plan.

But neither the OTS nor Bernanke called for the FHA or other federal agency to take a direct role in negotiating new mortgages.

The administration hasn't commented directly on the Dodd-Frank plan. But President Bush said Tuesday that if there needs to be further action taken to help the economy, the administration will take it.

Treasury Secretary Henry Paulson expressed some caution Wednesday over some of the proposals now being floated by Democrats. But he said the administration is interested in finding solutions to help homeowners who can't afford mortgage payments that are resetting higher.

Paulson also suggested the administration is looking for ways to deal with the Democratic-controlled Congress on the issue.

"We will continue to pursue policies that strike the right balance: that do not slow the housing correction, yet also help avoid preventable foreclosures and unnecessary capital market turmoil," he said.

What the presidential candidates think

Sen. Barack Obama is one of the co-sponsors of Dodd's bill, and his rival for the Democratic nomination for president, Sen. Hillary Clinton, said she also supports it.

However, Clinton proposed a step beyond his plan Monday. She suggested having the FHA become a temporary buyer of so-called "underwater mortgages" -- loans where the principal is now more than a home's value.

Clinton has also talked about a new housing stimulus package to provide \$30 billion directly to states and local governments to buy foreclosed or distressed properties. The cities and states could then resell the properties to low-income families or convert them into affordable rental housing.

Sen. John McCain, the presumptive Republican presidential nominee, also expressed a willingness to look at Democratic proposals in a speech about the economy Tuesday.

"I will not play election year politics with the housing crisis," he said. "I will evaluate everything in terms of whether it might be harmful or helpful to our effort to deal with the crisis we face now."

McCain cautioned he wasn't ready to sign onto a bailout, though.

"I have always been committed to the principle that it is not the duty of government to bail out and reward those who act irresponsibly, whether they are big banks or small borrowers," McCain said.

But Zandi, who is an economic advisor to McCain, said he believes McCain will support some kind of assistance to homeowners and borrowers.

"I think he...understands that the problems in the housing market are broad and deep and threaten the broader economy, and that there may be a role for the federal government to stem those losses," said Zandi, who cautioned he was not speaking on behalf of the McCain campaign.

Stanford Group's Valliere also said he doesn't believe McCain will be able to resist the growing tide to support federal help to troubled homeowners.

"You have to respect McCain's intellectual honesty on this but the Frank-Dodd bill is a steamroller that can not be stopped," he said. ■

First Published: March 26, 2008: 2:13 PM EDT

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