

THE TROUBLES WITH FREDDIE

6/13/03

The basic questions being addressed at Freddie Mac and Fannie Mae currently are not new and they are not directed towards the financial strength of the firms. However, in today's nervous market environment in which people still remember WorldCom and Enron all too quickly there is bound to be a over-reaction to any news which includes corporate officers and disclosure.

In January 2003 after a new accounting firm examined Freddie Mac (FHLMC) the housing giant announced that it would have to restate three years of earnings. The restatement was due to the valuations placed on the complex financial instruments used to hedge the firm's mortgage portfolios. The earnings are expected to be revised upwards. The company's regulator, the Office of Federal Housing Enterprise Oversight (OFHEO) is also looking at FHLMC. This is not a new situation. Regulators and congressmen have been troubled by both Fannie and Freddie for many years because:

- (1) they enjoy tax exemptions not due other corporations,
- (2) their sheer size and importance to the housing markets,
- (3) lack the stringent reporting requirements of other companies,
- (4) they are not forced to sustain the level of capital needed by banks and other lenders, and
- (5) that both firms have strongly resisted having all their mortgage-backed securities registered with the SEC – a process which they feel would be overly burdensome.

This week the SEC has instituted a formal probe related to the COO's actions and the VA US Attorney opened criminal investigations into alleged irregularities at the firm when the Board forced out, without any public comment, the Chairman, President and CEO, and CFO. Two of the officers alleged torn pages from personal diaries and notebooks compiled during the meetings. In addition, very generous golden parachutes are being questioned for the officers. The Board has stated that none of the officers leaving had to do with accounting irregularities or accounting.

Certain Senators have called for congressional and senate hearings which will undoubtedly occur. But these hearing are focusing on changes at the regulatory oversight level, i.e. the OFHEO. These may even eventually force the two financial behemoths to be divided in to smaller agencies (economics aside).

The impact of this turmoil has been primarily on the equity of the firm. Stock in FHLMC has slide 21% in the four days since the fateful Board meeting at FHLMC. There cost of borrowing has risen because of the controversy but only by 0.12% compared to other comparable bonds.

To retain confidence in the marketplace, on 6/11/03 Freddie started a buyback program to buy back its debt thereby shoring up the price and building confidence by illustrating that it has the capital to do so. The program bought \$9.8 billion of the planned \$10billion back in two days. (45% of Freddie's debt is due within one year.)

The impact in the short term debt market for Freddie and Fannie has been minimal to date. Yields of the agencies widened relative to Treasuries each day this week. In a week, spreads on 10 year paper widened about 26 basis points and on 23 basis points on 5 year paper.

The impact of all this turmoil remains to be seen. The equity prices for the two firms will undoubtedly be hit the hardest. There is limited danger however that the two housing giants will default. Together FNMA and FHLMC own or guarantee 42% of the US mortgage market and have more than \$1.5 trillion in debt outstanding. The problem seems to be an accounting issue of statement of earnings. But unlike other firms in the past two years Freddie didn't inflate but rather understate their earnings. If the finding indicate that inappropriate accounting caused the problem the companies will probably continue keeping the mortgage market lubricated.

Leading rating agencies (S&P, Fitch and Moody's) in fact have quickly reaffirmed FHLMC's AAA rating on Monday. Congress and regulators walk a fine line on these two companies. If market values fall

sharply enormous credit market problems could occur leading to a huge systemic risk. Hurting these agencies will hurt their ability to buy home mortgages, putting upward pressure on mortgage rates. In addition, the debt markets appear to feel that the US will act to prevent disruption in the housing market and the financial institutions. Besides large public funds, insurance funds, and thrifts, over 60% of banks with less than \$100 million in assets hold FNMA and FHLMC in excess of 50% of their capital. And, 20% of banks with over \$1 billion in assets hold these two in excess of 50% of capital.¹ A run on these two institutions would cause a major disruption of liquidity at the banks. A disruption of this size would ripple throughout the housing market and the financial system and result in a likely taxpayer bailout of unimaginable proportions.

Portfolio Impacts

At this point it should be expected that additional headlines will appear regarding the proposed hearings and findings on the resignations and retirement packages of the corporate leaders, however, at this point the focus of all the attention is not credit related. This is an event which is tied to corporate resignations and parachutes, the understatement of earnings, and the call for regulatory oversight. The market can be expected to back up and react to the publicity by selling some of the firms' securities and this will have the further impact of lowering Treasury Bill and Note yields as money flows into the Treasuries.

For several weeks, with narrow spreads to the Treasuries of 3-4 basis points, we have used the opportunity to buy the US Treasury Bills and will continue to do so rather than discount notes of the troubled agencies. However, we do not recommend selling any of the positions in portfolios because of the nature of the investigations. The hearings and investigations will undoubtedly be in the news for several months but the threat of a credit crunch or a failure of the two financial giants is highly unlikely. In addition, it is normally unwise to sell into any kind of press induced panic because the prices are artificially depressed at that point as the market takes advantage of a wounded entity.

We will continue to monitor the situation very carefully and update you as more information becomes known and available. As always if you would like to discuss this in more detail please let us know and we will arrange for an extended conference call.

Linda T. Patterson

¹ According to Federal Financial Analytics