WESTWOOD CAPITAL, LLC

OPINION

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Comment on the U.S. Treasury's Impending Announcement on the Rescue of Fannie Mae and Freddie Mac

For most of the year, Westwood Capital has led the cry that Fannie Mae and Freddie Mac were effectively insolvent. We consistently argued Freddie and Fannie should suspend all dividends. And while Freddie and Fannie still had the chance, we told all who would listen that the two massive agencies should raise capital. We suggested rights offerings as a last-ditch effort to bring private-sector capital into Freddie and Fannie and protect taxpayers.

Yesterday, government officials informed Freddie and Fannie executives that they would be placed into conservatorship. But many questions remain: How will the move affect mortgage loan availability and the way capital markets function? Who is to blame for this unprecedented debacle?

In truth, there will be no material effect on mortgage availability during the current tumultuous period. If anything, conservatorship ensures mortgage capital remains available. The government has stated that Freddie and Fannie will continue to guarantee and purchase mortgages as usual. And we do not believe that Washington will risk reducing mortgage availability in our weak housing market.

The $5.2 trillion Freddie/Fannie debt is safe, and we believe the government will honor its implicit guarantee. But the fate of preferred and common stockholders is decidedly less rosy.

It's unclear whether Freddie and Fannie will continue to issue debt in conservatorship. We urge the government to fund the debt directly. This would, of course, increase the stated amount of outstanding government debt, but as we all know, that is purely semantics. For some time, we've asserted it was silly for Freddie and Fannie to issue debt at positive spreads to Treasury obligations when the debt was effectively guaranteed by our government. The positive spreads at which such notes have been issued have resulted in a massive transfer of wealth from American taxpayers to debt holders, many of which are overseas entities.

Much of Freddie's and Fannie's preferred equity is held by banks and insurance companies, which places the Treasury in a precarious position: If the value of preferred shares is wiped out, massive amounts of capital will be eroded from our financial system. Westwood believes strongly that preferred shareholders should not be protected by taxpayers. Instead, if an insurance company or bank holds Freddie and/or Fannie preferred shares, regulators should force them to reduce the carrying value immediately to zero. If this leaves an affected institution with a capital deficiency, it should be forced to raise capital or cease operations—a measure that can be accomplished over time to minimize economic dislocation.

Any potential payments to preferred and common shareholders should be made only after all of Freddie's and/or Fannie's obligations have been satisfied in a manner that protects the U.S. economy and taxpayers (*i.e.*, after recouping all losses funded by Treasury, plus a market return on any monies advanced). Government officials erred when they allowed an immediate payout in the Bear Stearns resolution. Monies JP Morgan paid to shareholders should have been held in escrow, available to cover portfolio losses and market-rate fees for government assistance. Only after a failed institution's plight is fully resolved should its shareholders receive cash.

So, why do we find ourselves in such a mess? The answer is really quite simple: Freddie and Fannie never should been allowed to exist in Never-Never land—a dystopia where taxpayers bore risk and shareholders enjoyed rewards. Freddie and Fannie are bona fide political monsters, and their lobbying efforts should have been prohibited. Furthermore, Freddie and Fannie for years have recruited executives from the government's payroll, and such service is inappropriate experience for running a mortgage company (unless said company intends to woo the government). And the promise of a cushy post-government existence at Freddie or Fannie may have caused many officials to succumb to conflicts of interest.

The regulatory capital guidelines governing Freddie and Fannie were written at a time when everyone believed homes don't decrease in value. The guidelines, in fact, were written to protect Freddie and Fannie from interest-rate risk. But trees do not grow to the moon. When we discovered housing bubbles can burst, powerful government officials publicly stated that Freddie and Fannie were adequately capitalized, as they were in accordance with capital guidelines. Well, guess what? Those guidelines were patently ridiculous, and the officials we elected either ignored that fact, lacked the experience necessary to be concerned or misled voters.

Our rating agencies also drank the punch. Both institutions' preferred stock is rated investment-grade by all three major rating agencies as of this writing.

Len Blum and Daniel Alpert are Managing Directors of the New York investment bank Westwood Capital, LLC, and its affiliates. They are frequent commentators on the housing and credit crises on the CNBC and Bloomberg networks, as well as in leading periodicals.