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OPINION

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Fannie Mae, Freddie Mac Shares Overpriced
Freddie Mac is Already Insolvent

Treasury Secretary Henry Paulson and Fed Chairman Ben Bernanke accomplished several goals over the weekend. Freddie Mac and Fannie Mae will have sufficient liquidity to continue making loans in the near term, and their debt costs will remain low, thus ensuring mortgage capital remains available to potential and current homeowners. The success of today's offering of $3 billion of bonds by Freddie is evidence that the Treasury's announcement has given comfort to the debt capital markets. Despite possibly short covering and some money flowing into the GSE's shares this morning, the massive reversal in the share prices of Fannie and Freddie as of 1:00 this afternoon, indicates that the Treasury announcement was ultimately evaluated clearly by equity investors in the GSE's, who have voted with their feet – fearing massively dilutive forced equity raises or direct investment by the government.

But two critical questions remain:

1. Will taxpayers shoulder the inevitable GSE losses?
2. Can shareholders possibly emerge unscathed?

This article addresses these issues and debunks some common misunderstandings about the beleaguered agencies.

Taxpayers may still shoulder burden. Whether taxpayers will shoulder losses can be predicted by one simple question: Is the total of agency loan-loss reserves and shareholder equity sufficient to cover all of Freddie's and Fannie's losses and liabilities? This is uncertain, especially in an environment of continually falling home prices.

Let's get past the political rhetoric; Fannie and Freddie don't have enough equity. Regulators must strongly encourage the agencies—in particular, Freddie Mac—to raise equity. If the agencies fail to tap private sources, the government may wind up owning some or most of them.

Freddie is insolvent; Fannie is running on fumes. Fannie and Freddie are not in the same boat. By more than one measure, Freddie Mac has negative net worth. On March 31, Freddie had only $16 billion of equity to support more than $800 billion of on-balance sheet assets—

a ratio of less than 2%. And if you scratch the surface further, you will find an even worse situation: Freddie has a deferred tax asset of $16.6 billion on its balance sheet—and this has value only if and when Freddie makes money. Further, Freddie Mac has $1.4 trillion of off-balance sheet exposure, for which the Office of Federal Housing Enterprise Oversight (OFHEO) requires only 0.45% of equity to be held to satisfy statutory minimum capital requirements. The assets actually on Freddie Mac's books are not marked to current market value, which is lower than accounting rules allow. Dig into financial statements, and you will find that Freddie reports it would be insolvent, with $5 billion of negative net worth, if it carries its assets at current market value.[1]

Fannie is carrying its financial assets at a level that approximates fair value, and the deterioration of its equity from generally accepted accounting principles (GAAP) largely stems from a write-up in the value of liabilities. Fannie has also recently raised more than $4.7 billion of equity (which is not reflected in the following tables for comparability reasons):

Amounts in millions of dollars (as of March, 31, 2008)	Fannie		Freddie	
	GAAP	Fair Value	GAAP	Fair Value
Shareholders' Equity	38,836	12,210[2]	16,024	-5,200[3]

Consider the following:

Amounts in millions of dollars (as of March, 31, 2008)	Fannie	Freddie
On-balance sheet assets	843,227	802,992
Mortgage credit book of business[4]	2,827,370[5]	2,149,689[6]
Equity capital	38,836[7]	16,024[8]
Ratio of GAAP equity to assets	4.6%	2.0%
Ratio of GAAP equity to mortgage credit book of business	1.4%	0.7%

Here's a Midwesterner's commonsense question: Is this enough equity when your business consists of buying and guaranteeing mortgages? How about when you conduct these activities in markets falling by 20% or more?

[1] Source: Freddie Mac, *First Quarter 2008 Financial Results Financial Statements and Core Tables,* March 31, 2008. Table 7, Page 13.
[2] Source: Federal National Mortgage Association, *Form 10-Q,* May 6, 2008. Table 32 (page 53).
[3] Source: Freddie Mac, *First Quarter 2008 Financial Results Financial Statements and Core Tables,* March 31, 2008. Table 7, Page 13.
[4] Includes both on-balance sheet and off-balance sheet amounts.
[5] Source: Federal National Mortgage Association, *Form 10-Q,* May 6, 2008. Table 37 (page 62).
[6] Source: Federal National Mortgage Association, *Form 10-Q,* May 6, 2008. Table 8A (page 14).
[7] Does not include subsequent events, including capital raised by Fannie Mae.
[8] Includes $16.6 billion of net deferred tax asset.

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