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# OPINION

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## Crisis at the Agencies

There are only two realistic outcomes for Freddie Mac and Fannie Mae:

1. Raise significant equity.
2. Face nationalization.

In the first scenario, current shareholders would be massively diluted. In the second, they would be wiped out.

In Westwood's opinion, the odds of a positive outcome for these companies' shareholders are less than 50:50, even at current market prices.

Consider the following: Freddie Mac has only $16 billion of equity supporting $843 billion of on-balance sheet assets—a ratio of less than 2%. But if you scratch the surface, you will find an even worse situation. Freddie has a deferred tax asset of $16.6 billion on its balance sheet—and this asset has value only when and if Freddie Mac makes money. Furthermore, Freddie Mac has $1.4 trillion of off-balance sheet exposure, for which OFHEO requires only 0.45% of equity to be held to satisfy statutory minimum capital requirements. And the assets that actually are 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 carried its assets at current market value (10Q Core Tables, Table 7).

Fannie Mae is risky, too. With roughly $40 billion of equity supporting well over $800 billion of assets, Fannie is running on fumes— a capital ratio of around 5%. Add to this Fannie's deferred tax asset of $13 billion and off-balance sheet assets of more than $2 trillion, and you begin to appreciate the larger picture.

Capital adequacy rules are intended to ensure that institutions can weather financial storms and survive mistakes. The issue of "mistakes" has proven to be particularly relevant to Fannie and Freddie because much of the data presented in their financial statements are based on estimates. In the mortgage industry, defaults and housing values are key estimate components. Fannie and Freddie have histories of undependable accounting, and they continue to pile risk onto their already highly levered balance sheets. They are a train wreck waiting to happen.

We encourage Freddie Mac and Fannie Mae to raise capital immediately. It is unfair to burden American taxpayers with the risk of failures. The numbers speak for themselves: Fannie and Freddie have combined on- and off-balance sheet exposure of more than $5 trillion.

Freddie Mac said in May it plans to raise $5.5 billion. Fannie Mae raised $2 billion in May in a sale of preferred stock after posting a first-quarter loss. They both need to raise significantly more. And why wait until Freddie's normally scheduled earnings release? Freddie should release earnings tomorrow and start raising equity the next day.

While Freddie- and Fannie-issued securities are not explicitly guaranteed by the U.S. government, the investment community widely perceives them to enjoy its implied credit support. That Fannie and Freddie are critical to the operation of our real estate markets is beyond debate – putting them in a category that is even more serious than "too big to fail" from a systemic standpoint. The shareholders interests are due little weight in this overall calculus, they simply made a bad bet.

How can these entities raise so much needed capital? A formula rights offering is a surefire route to success.

For institutions lacking ready access to capital (without causing massive dilution, or at least giving shareholder the option to be diluted or not), rights offerings provide a solution. A rights offering is, as the name implies, an offering of rights to existing shareholders to purchase a proportional percentage of a company's securities. Its salient features include the date of exercise, the exercise price, transferability provisions and the number of shares that can be purchased. The lower the exercise price, *vis-à-vis* the then-current stock price on the exercise date, the higher the probability that the rights will be exercised.

Rights generally get exercised, unless the stock trades at or below the exercise price on the exercise date. By using a formulaic exercise price, however, Freddie and Fannie can ensure this doesn't happen. In a formulaic offering, the rights are exercisable at a percentage of the security's trading price on the exercise date. For example, a right to a stock with a 50% formula, trading at $10 on its exercise date, could be exercised for $5. If the same stock was trading at $15 a share, the rights could be exercised for $7.50 a share. Furthermore, to ensure shareholders are treated fairly, rights can be transferable—advantageous because tradable rights allow for third-party verification of value. Holders of transferable rights can sell them in the market, thereby monetizing the dilution they otherwise would suffer if such rights expired unexercised.

We suggest a formulaic offering whereby tradable rights to purchase shares at between 50% and 75% of then-current market are issued to shareholders. Any unexercised rights should be backstopped by the Government, which would agree to exercise remaining rights. This is a step short of outright nationalization that may – if sufficient capital is raised – result in a profit for the taxpayer. Since the government is going to have to step in anyway (as Fannie and Freddie cannot fail), they ought to try maximize the participation of private investors in the recapitalization of these two vital government linked entities.

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