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Fannie Mae and Freddie Mac:

what equity investors need to know

Comments by Ray Soifer at a conference sponsored by the American Enterprise Institute, “*Are Fannie and Freddie adequately disclosing what investors need?*”

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At this conference, Ray Soifer was asked to discuss two papers: Fannie Mae's and Freddie Mac's Financial Disclosures: How Do They Stack Up, by Bert Ely, and Fannie Mae's and Freddie Mac's Voluntary Initiatives: Lessons from Banking by W. Scott Frame and Larry D. Wall. The papers may be found on AEI's web site, <http://www.aei.org>.

As Frame and Wall outline in their paper, in October 2000, the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") announced six voluntary initiatives, in which they agreed to issue subordinated debt on a regular basis, meet certain liquidity standards, enhance their disclosures of interest rate and credit risk, obtain and disclose annual credit ratings, and implement a risk-based capital standard. Since this conference is primarily about reporting and transparency, this discussion will concentrate mainly on those issues from the viewpoint of market discipline.

Fannie and Freddie are stockholder-owned, government-sponsored enterprises (GSEs) whose common shares are listed on the New York Stock Exchange. By law, they are exempt from the securities registration and public disclosure requirements of the SEC. However, Ely suggests that, as GSEs, Fannie and Freddie face broader issues of accountability than do purely private-sector institutions, which may impose additional requirements for public disclosure. I shall leave that subject to the other speakers, except to comment that banks and thrifts also must satisfy disclosure requirements, imposed by their banking supervisors, that go beyond those established by the SEC.

The Stock Market as Disciplinarian

As with the vast majority of publicly-traded companies, the most influential market disciplinarian over Fannie and Freddie is the price of their common stock. I can assure you that their senior executives, many of whom hold large positions in shares and options, check it every day. Indeed, many of you will be familiar with the credit risk models of Moody's KMV and other such firms, widely used by commercial banks and fixed-income investment funds, which use movements in common stock prices as a predictor of credit defaults. These comments, then, will focus on the information needs of equity analysts and equity investors.

You can see from the biographical information you were given that I spent many years as a brokerage-house equity analyst, covering large financial-services companies – in the spirit of full disclosure, *not* Fannie and Freddie, which, I like to think, gives me a position of objectivity from which to consider the issues here. In the present climate, I know it's dangerous to admit having worked as a Wall Street analyst; but at least that isn't as risky as being one today. There are some accountants in the room, and you have my sympathy as well. That said, though, if it's stock prices we care about, it's the needs of equity analysts and their institutional clients with which we need to concern ourselves.

What Equity Analysts Need, and Why

The equity analyst following Fannie and Freddie tries to estimate their future earnings per share, and how they may be affected by different economic and interest-rate scenarios. Typically, these detailed estimates go out for a period of one to two years, accompanied by a less-detailed analysis resulting in a predicted five-year growth rate.

Since credit risk is less significant to Fannie's and Freddie's earnings than to most other financial institutions, in building their earnings models analysts focus primarily on revenue trends and interest rate risk, which are very much interrelated since economic conditions and interest rates strongly affect homebuying and refinancing activity. Expense management and operating efficiency are not overlooked either.

The analyst also needs a clear understanding of Fannie's and Freddie's business strategies, and sufficient familiarity with their management to develop an informed opinion about its quality, strengths and weaknesses. Risk management, especially that of interest-rate risk, is of critical importance, but so is the appropriateness of the company's strategic planning to current and future business conditions, and management's ability to implement its strategy effectively. Given the unique position of Fannie and Freddie in the US financial system, this includes an assessment of political risk and management's response.

From these considerations, analysts develop views about sustainable long-term growth and future cost of capital. From those, their earnings estimates and comparisons with alternative investment vehicles, will come their opinions about the prices at which Fannie's and Freddie's shares should be trading, and those famous Buy/Hold/Sell recommendations.

The Stock Market's View of Fannie and Freddie

If the equity market is the best market disciplinarian, what does it currently think about Fannie and Freddie? The accompanying table compares the common shares of Fannie and Freddie with those of several other large US financial services companies which are substantial participants in housing finance, using some commonly-employed valuation indicators. Broadly speaking, the market is valuing Fannie's and Freddie's shares comparably with these private-sector entities – more or less, as if these GSEs were high-quality thrifts.

In terms of the forward price/earnings ratio, i.e., share price divided by estimated EPS for the next four quarters, we see that Fannie and Freddie are currently trading toward the high end of the valuation range for thrifts and mortgage bankers, but below the shares of a highly-rated commercial bank such as Wells Fargo. The estimates used in this table, by the way, are the Wall Street consensus figures compiled by Thomson Financial/First Call.

Many equity market participants also look at the PEG ratio, which is the forward P/E ratio divided by the estimated five-year growth rate. The faster earnings are likely to

grow, they reason, the higher the multiple of current earnings they would be willing to pay. By this measure, Fannie and Freddie would seem to be trading in line with the thrift industry as a whole, below Golden West but above Washington Mutual.

The five-year growth rate estimates in this table may strike you as erring on the side of optimism – as if Wall Street analysts were never guilty of *that*. Typically, analysts' estimates of the current quarter's earnings tend to be pretty realistic, even conservative, but their forecasts tend to get more rosy as they move out in time – not unlike the estimates of the federal budget that emanate from Washington. However, since all of these 5-year growth forecasts should probably be deflated by similar amounts, any distorting effect on our own analysis would cancel out.

In passing, it should be noted that shares of thrift institutions have traditionally traded at lower valuations than those of their commercial-bank competitors. Some of this differential probably results from the market's presumption of greater interest-rate sensitivity on the part of the thrifts, some from the larger fee-income component of commercial-bank revenues as compared with net interest, and some from historical factors: investors frequently value stocks in comparison with the stocks' own past trading patterns, so differences such as this tend to be somewhat self-perpetuating. Also, it should not be overlooked that thrifts and commercial banks still tend to be followed by different groups of analysts, whose ideas about valuation reflect their own experience. So much for the efficient market hypothesis, but anyone who has lived through the last few years doesn't believe in that anyway.

The stock market values the financial services industry, in general, at a substantial discount to the broad market averages such as the S&P 500. To a considerable extent, this discount is a consequence of the industry's lack of transparency. Once, during my days as an analyst, I was traveling with our firm's food-industry analyst, who happened to be recommending the stock of Kellogg's, the cereal company. I asked him, "How can you tell if a new cereal product will be successful?" "Simple," he replied. "I taste it." Well, you can't taste a bank, or a GSE. The quality of its risk management is the most critical factor determining its performance, and to the outside analyst, its portfolio is virtually a black box. The analyst is almost totally dependent upon the company's disclosure. That is why the subject of today's conference is so important.

The price-to-book value ratios of Fannie and Freddie look fairly lofty compared with the private sector. Some of this probably results from their low cost of capital, but I think that it mostly reflects the fact that equity investors value shares mainly in relation to predicted earnings rather than net asset value.

As you know, Fannie's and Freddie's equity ratios are somewhat lower than private-sector banks and thrifts. This is not, by itself, a meaningful indicator of capital strength – indeed, together with Farmer Mac, Fannie and Freddie are currently unique among the world's major financial institutions in their capital adequacy being regulated on the basis of stress-tested risk scenarios – but is included here as a way of explaining why their price-to-book ratios come out as high as they do.

Building Shareholder Value: The Role of Disclosure

Now that we've thought about what equity analysts and shareholders do with the information they receive, and what they currently think about Fannie and Freddie, let's relate that to their needs for disclosure.

All stockholder-owned financial institutions, including Fannie and Freddie, are in the business of taking risk. For a given institution, the most appropriate levels and distribution of risks are not zero, but those which for it is best positioned and most capable of managing for optimal returns. Shareholder value depends not on minimizing risk, but on pricing it properly so as maximize the institution's risk-adjusted return.

For the institution wanting to build shareholder value, even earning a high risk-adjusted return is not enough. Investors must be persuaded to give those earnings a consistently high valuation. That, in turn, requires building understanding and confidence. The right disclosure policy, combined with an effective communication program, can go a long way toward doing that.

The Shipley Group's Recommendations

The Working Group on Financial Disclosure, commissioned by the Fed, OCC and SEC and chaired by Walter Shipley, the retired chairman of Chase Manhattan, issued a report in 2001 in which it made a number of specific recommendations about the reporting of market and credit risk, which Frame and Wall discussed.

More generally, however, the Working Group recommended that risk disclosure should be consistent with an organization's approach to risk management. Disclosures should explain how risk within a firm changes over time, and should evolve with innovations in a firm's risk management practices.

The Working Group recommended that there should be as strong a link as possible between the framework relied upon by senior management to evaluate the risks and returns of the business and the information that is disclosed. Such a linkage provides insight into management practice, financial performance and risk discipline, while also helping to ensure that the information disclosed will be meaningful.

It went on to note that because well-run firms may have very different, but equally valid, approaches to risk management and monitoring, meaningful comparisons across firms will be difficult to achieve and, indeed, are not as important as presenting the best currently available view of each firm's risk profile – and, I would add, its risk management process and risk-adjusted returns.

I also commend to you a speech by Governor Bies of the Fed to the Institute of International Bankers, in New York, on June 10, 2002, in which she made many similar points. As you know, before being appointed to her present position, Governor Bies

spent many years dealing with financial accounting issues, in banking and other industries.

Interest-Rate Risk

As is noted in both papers, there are substantial differences between the interest-rate risk disclosures of Fannie and Freddie, and between their respective disclosures and those of private-sector banks and thrifts. I would suggest, though, that as Fannie and Freddie continue to improve their risk disclosure, we view these differences in the light of the Working Group's recommendations. To the extent that they reflect real differences in the way these institutions manage risk, the information they contain is highly relevant and useful.

Fannie, for example, is concerned with managing the effect of market risk on its reported net interest income, while Freddie manages the market value of its portfolio. The disclosures that result from these different approaches to risk management are correspondingly different, but each provides the analyst with insight into the respective institution's management philosophy and practices.

Ely quotes a Goldman Sachs research report that "differences in philosophy are expressed and must be understood at the margin." I could not agree more. Each institution has a responsibility to explain its methodology fully, as well as the results achieved.

The gap analysis which the paper suggests, however, does not go far enough. As are most such presentations by banks and thrifts, it is correct only as of a point in time, does not quantify the risk in meaningful profit-and-loss terms and does not analyze the effects of changes in the interest rate environment. Nor does it present the results actually achieved.

J.P. Morgan Chase, another financial institution for which hedging and derivatives transactions are very important to the bottom line, provides a more helpful disclosure of its market risk management, including interest rate risk, at pp. 55-57 of its 2001 Annual Report. Time does not permit a full description, but here are a few highlights. Results are presented in terms of both Value at Risk and stress testing. Average, minimum and maximum risk amounts for the period are presented. A histogram of daily market-risk-related revenue, positive and negative, is shown. Unlike many other banks, J.P. Morgan Chase's market risk disclosure covers its entire portfolio, not just the trading accounts. Finally, all terms used are defined with sufficient precision to enable the analyst to compare these results against those of other institutions that may, for example, calculate VAR differently.

Another good example of market risk disclosure is that of Deutsche Bank, in its Annual Report on Form 20-F. Deutsche Bank, by the way, now does all of its financial reporting, and its internal bookkeeping as well, in US GAAP. See pp. 235-241 and 244-246.

Counterparty Risk

Deutsche Bank also provides a good example of counterparty risk disclosure, at pp. 204-207. Not only is counterparty risk broken down by maturity and credit grade, but the probabilities of default for each grade are provided as well. Very importantly, exposure is presented by credit risk amount, in addition to the rather meaningless notional amounts of derivative positions still inexplicably required by the SEC.

In common with other banks, Deutsche Bank and J.P. Morgan Chase disclose credit risk, including that associated with counterparties, as of a point in time. Averages and trends would be better. The Basel Committee on Banking Supervision has proposed such a change, as part of Pillar 3 of its New Basel Capital Accord. That, however, is still very much a work in process; the next exposure draft is expected in 2003.

FAS 133 and IAS 39

As has also been noted, Fannie and Freddie both report operating earnings which exclude the effect of FAS 133, which requires the marking-to-market of various hedging positions, while private-sector institutions generally do not. Wall Street, as reflected in the earnings figures collected by Thomson Financial/First Call, generally accepts Fannie's and Freddie's approach, since by the nature of their businesses, FAS 133 exerts a larger influence upon the GAAP earnings of Fannie and Freddie than those of commercial banks and thrifts – although more on Freddie than Fannie owing to their different approaches to risk management that I have already mentioned.

It should also be mentioned that the International Accounting Standards Board is currently working on proposed amendments to IAS 39, which would require financial instruments to be marked to fair value through the income statement and is expected to be implemented by 2005. The EU Council of Ministers recently voted to require all EU-based companies, even those traded in the US, to adopt IAS by 2007. In the wake of Enron, we're seeing heightened interest in the convergence of accounting principles between the US and Europe, so FASB is likely to revisit the entire issue of fair-value accounting between now and then.

Economic Capital

The papers and comments you have heard this morning have touched on credit risk and market risk. While most observers would agree with Fannie's and Freddie's management that, for them, market risk is the more significant of the two, just how much more significant is it, in quantitative bottom-line terms? The sum of individual market and credit risks does not add up to the risk of the portfolio as a whole, since diversification and correlation effects must be taken into account.

The tool for doing that kind of analysis is economic capital, which I am given to understand that both Fannie and Freddie use internally, at least to some extent, but is not yet reflected in their external reporting. Although the banking industry's reporting of

economic capital, and the associated return, is still at an early stage of development, once again a review of Deutsche Bank's Form 20-F will produce some good ideas.

Let me stop there, and thank you for inviting me to participate today. I look forward to Ed Golding's response, and to the discussion to follow.