TURNED ON ITS AXIS

by Steve Brown

The world keeps turning, but it seems to have shifted on its axis. Shares of housing giants FNMA and FHLMC have fallen 80% since August and are now trading at $7.24 and $4.22, respectively. Stock prices of FNMA and FHLMC have fallen so precipitously that investors believe the government will be forced to place both companies into conservatorship. That's right - FNMA and FHLMC could be placed into conservatorship. We are talking about two government sponsored enterprises that guarantee or own more than $5T of debt. Wow, did you ever think you would see this in your lifetime?

No one is talking outright failure here, as these two are literally too big to fail, but the potential impact is definitely worth discussing. Recall that Congress created FNMA in 1938 and FHLMC in 1970 with a stated goal to ensure home financing was readily available for low to middle income Americans. Consider that if a takeover were to occur, it would mean taxpayers would step into that role and be on the hook for guaranteeing nearly 50% of all the mortgages in the country.

While the spillover to banks isn't entirely known, any equity owned in these behemoths would likely be worth very little or nothing at all if a conservatorship occurred. Preferred stock investments would probably have to be written down further, with banks taking an even deeper permanent impairment. Bond holders might be better off; as they would theoretically have priority in an insolvency situation, but it is expected equity holders would take the brunt of the impact.

For the investor community at large, look for volatility to continue until the government gets a better handle on things and investors believe the worst is over. Spreads could compress between Treasuries and Agencies, as investors realize they become roughly the same thing.

Consider these critical facts as well: These 2 companies issued about 75% of all new MBS in 2008, so they are an integral piece of community bank liquidity through the investment portfolio; their total debt issued at just over $5T is more than the $4.6T in dept sold by the U.S. Treasury; and central banks across the world accept FNMA and FHLMC as collateral, which could add more pressure to an already stressed financial system.

Of interesting note, analysts calculate FNMA and FHLMC would have to take pretax writedowns of about $77B before the Treasury would be forced into a rescue.

If the government did take over FNMA and FHLMC, it would most likely do so by forming a new corporation and dumping in their combined assets. It would then probably subcontract out to a 3rd party and gradually liquidate the assets in years to come (as it did with Bear Stearns).

No matter how this plays out, community bankers would be well served to document exposures, keep a close eye on home construction projects, understand liquidity options and closely monitor industry news. The depth of this problem is so big, experts now say it may push the bottom in housing prices further out by another 18 months. That talk has also put pressure on home builder stock prices and on banks with significant home lending exposures.

It appears that until the world of finance eventually tips back on its normal axis, we will all have to remain very aware and nimble indeed.

BANK NEWS

Foreclosures

Filings jumped 53% in June from a year ago, although compared to May, filings fell 3%. States with the highest foreclosure filing rates were NV, CA and AZ.

Repercussions

An FDIC takeover of IndyMac would add pressure to the system, since the FHLB has a collateral call on $10B in Advances. Given expected valuation of IndyMac's portfolio, there would be a substantial call on FDIC to make depositors whole.

Loans

In March, 5% of severely delinquent loans at the top 5 thrifts were provided loan modifications. That month's loan modifications totaled 22,343 or roughly half that of foreclosure proceedings initiated.

Chopping Block

Lawmakers and the Treasury have recommended eliminating the OTS or merging it with the OCC.

Business States

According a recent study, TX is this year's top state for business with VA, UT, ID and CO following in the top 5. Rankings were based on 10 categories, including access to capital, business friendliness and the local economy.