FANNIE MAE AND FREDDIE MAC

by Steve Brown

Over the past 3 days, we found out that FNMA and FHLMC are indeed, "too big to fail." The Fed and the U.S. Treasury worked the weekend and announced a plan last night (to be approved by Congress) to provide additional liquidity and the temporary ability to purchase equity in either company "as needed." Market players did the math on Friday and realized that both FNMA and FHLMC (with a combined $1.6T of debt outstanding and a guarantee for over $4T of mortgages) now have a major negative mark-to-market position. This not only creates problems for accounting, but both entities will need another $10B in capital to shore up reserves at a minimum (and probably triple that if the economy gets worse).

Whether Gov't lending takes place via the Discount Window or through a new facility - it doesn't much matter. It also matters little if the Fed increases its mere $2.25B guarantee in both companies or just goes ahead and makes an equity infusion. At this point, it is also not worth the debate (it will be later) over how the "moral hazard" of shoring up failing companies creates other risk. The biggest point here is that for the 2nd time in past 4 months, the U.S. financial markets have come precariously close to a debilitating shock.

In the coming weeks, there is little doubt that the greatest effects from the Fannie and Freddie problem will be a further deterioration of global financial confidence in the U.S. This means a continued weak dollar, higher rates on Treasury and Agency obligations and less global liquidity.

The other immediate takeaways are that the U.S. Treasury still thinks that the GSEs should exist going forward "in their current form, as shareholder-owned companies." It also appears that the Gov't does not intend to ask FNMA or FHLMC to decrease the current size of their portfolios (which would help bank asset prices).

For bank balance sheets, their price on GSE bond investment holdings remained stable. Spreads decreased some 14bp, as the market assumed a full Gov't guarantee, but yields increased 20bp. Immediately, banks should access their exposure to both GSEs and increase their risk monitoring. Should the Gov't support package come to fruition, the move would result in an excellent opportunity for banks to purchase both FNMA and FHLMC mortgages, as they would improve in price, probably similar to where GNMA mortgages trade.

However, these items are all relatively minor to the big picture for banks. The number one tactic that community banks must employ right now is to increase marketing to make sure depositors and investors are aware of bank financial stability and FDIC insurance guarantees. The increased headline risk of FNMA and FHLMC could call into question the stability of the U.S. banking system and raises questions across the board. This effect is made even greater, considering that this week marks the start of 2Q bank earnings releases which are expected to be poor.

Bad news stories such as the one the WSJ ran today on IndyMac (saying that depositors "in general,...will eventually get 70% to 80% of their funds returned") will create additional deposit run off and make it harder for banks to raise capital.

In addition, there will likely be additional volatility around Fed Chair Ben Bernanke's semi-annual Humphrey Hawkins testimony next Tuesday (Chair Cox from the SEC is also being called to testify in this forum for the 1st time in history). Given the recent events, we look for Bernanke to be more dovish, thereby flattening the interest rate curve (shifting rates down).

More volatility and uncertainty is ahead and it pays for community bank CEOs to increase risk management and communication with employees, shareholders and customers, in order to mitigate some of the risk.

BANK NEWS

IndyMac Failure

Regulators seized IndyMac Bancorp Friday. The $32B asset company is the 2nd largest bank to fail in history, behind Continental Illinois in 1984, which had $40B in assets. According to the FDIC, roughly 95% of the $19B in deposits was insured, leaving about $1B uninsured. Of the uninsured amount, approximately 10k customers could lose up to $500mm. The FDIC, meanwhile, said the failure is expected to cost $4B to $8B. IndyMac is the 5th bank to fail this year.

Problem List

The FDIC said it is closely watching 90 financial institutions that it has on its "problem list," up from 76 in the 1Q. Total assets of these institutions are $26B. It is interesting to note that IndyMac was not on this list a short 3 months ago, according to news accounts.

Funding Inflows

Credit unions reported deposits (i.e. shares) grew 6% over the past 12 months. By major category in the 1Q of 2008, share certificates jumped 13.2%, while money market shares soared 13.7%. Many credit unions continued to pay money market rates above 3% and raised $32B of net new deposits overall during the 1Q, the highest level on record. Despite the faith in credit unions, look for more to fail this year as well. Unlike banks, credit unions lack the ability to raise additional capital.