# CLEANING UP FNMA AND FHLMC

by Steve Brown

Last Friday the Treasury announced it was "taking the next step toward responsibly winding down Fannie Mae and Freddie Mac, while continuing to support the necessary process of repair and recovery in the housing market." There was also mention made in that press release to adjustments to preferred stock purchase agreements, conservators & transition. We will cover the impact to community banks, but first recall that both FNMA (FN) and FHLMC (FH) were taken over and placed into conservatorship during the depths of the financial crisis back in late 2008. As part of that process, both were required to hand over 10% of their profits to the Treasury (as a dividend). Following this announcement, both are now required to hand over 100% of their profits. In addition, both will have to reduce their investment holdings ($1.2T combined) at a 15% annual rate vs. the 10% required since conservatorship. Those are the big pieces of this announcement, but what does it really mean for community banks? First, it means you don't have to worry about their capital position getting any weaker, since this move effectively (although not explicitly) absorbs them into the Treasury. Taking this capital concern off the table has instantaneously improved the credit risk profile of both agencies, as their rich uncle has now become their rich dad. Investors see things this way too, as agency spreads have tightened sharply (on Friday yields contracted about 25% alone), pulling the yield on outstanding FN/FH debt much closer to Treasury levels. It would appear we are done implying that FN/FH have Treasury support and have now made it clear. The simple fact that the power of the Treasury is now there to directly and fully support both agencies should also translate into a change in capital risk weight on their debt from 20% to 0% for banks. We hope regulators announce this change soon, because it seems to go hand in hand with this change in circumstances and would also serve to boost bank risk-weighted capital ratios. In future years, as FN/FH wind down, they will issue fewer bonds. Since community banks buy lots of callable and bullet agency securities and so many already sit in their investment portfolios, this piece is important to understand. As supply issued and outstanding declines, spreads should get even tighter to Treasuries. In fact, given the current maturity profile, 90% of all FN/FH outstanding debt will mature in the next 6Ys. As this happens, returns will decrease, giving community banks a less attractive investment alternative in agency callables and bullets. One benefactor from reduced FN/FH supply will be the FHLBs and Farm Credit to name a few. These remaining agencies will get the benefit of seeing direct bond issuance competitors disappear from the marketplace and they will get an opportunity to step into the void. Look for community banks seeking yield but wishing to stay safe (from a credit perspective) to move funds from maturing FN/FH bonds into the FHLB or Farm Credit as maturities occur. This will not be a panacea, however, as increased demand will more than offset expected needs, so these agencies will also likely see their spreads tighten vs. Treasuries in coming years. As for the mortgage-backed securities (MBS) world, things are mostly status quo. This announcement does not mean FN/FH will no longer guarantee new issuance (they will), it just means that guarantee is 100% rock-solid (as it is effectively backed by Treasury now) and they cannot buy their own paper (to hold as an investment). This could increase MBS supply in the market slightly, however it should not be that big a deal, since neither FN nor FH have purchased any of their own securities since being placed into conservatorship in 2008. We will continue to monitor things for you and report back if anything else major occurs on this front. In the meantime, enjoy your renewed full faith and credit in FNMA and FHLMC.

## BANK NEWS

**M&A**

Western Alliance Bancorp ($7.0B, AZ) will buy Western Liberty Bancorp ($180mm, NV) for $55mm in cash and stock, or about 0.74x tangible book. Western Liberty is the parent company of Service1st Bank of Nevada.

**Source of Strength**

A regulatory proposal that will require thrift, ILC and limited purpose holding companies to support troubled operating institutions will be released next week. It will be similar to the requirement that BHC's already face.

**US Bank**

The Bank was upgraded from "A" to "A+" by S&P with its short term A-1 rating reaffirmed.

**FINCEN**

Jennifer Shasky Calvery, who headed up the Justice Dept.'s asset forfeiture and money laundering unit, will become the new director of Financial Crimes Enforcement.

**Muni Risk Off**

Berkshire Hathaway terminates $8.25B in municipal guarantees in the form of credit default swaps thereby sending a signal that Warren Buffet & Co. has turned more bearish on municipal risk.

**Upgrading**

First Financial Bank ($6.4B, OH) will upgrade about 135 ATMs in IN, KY and OH with new NCR machines.

**Closing Branches**

According to its financial reports, Bank of America has closed a net 262 banking centers since the beginning of 2011. That puts it well on its way to meeting plans outlined by CEO Moynihan who wants to cut 750 over the next few years. The bank is taking the action as it seeks to cut $5B in operating costs.

**Phone Fraud**

Pindrop Security analyzed 1.3mm phone fraud incidents that occurred in the first half of 2012 and found such fraud is up 29% over the prior year period; cell phone fraud nearly tripled to 14% from only 5% last year and on average there is one fraudulent call for every 186 people in the country on an annual basis.