US authorities investigating but

Still no answers on Freddie Mac crisis

By Nick Beams
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A week, it is said, is a long time in politics. It can be even longer in the world of finance where billions of dollars churn through the markets every hour. That being so, it is noteworthy that ten days after the turmoil which saw the ousting of three of its top officials, there is little information on the crisis at the US home-mortgage financier Freddie Mac.

The Securities and Exchange Commission is conducting a formal investigation, having started an informal probe last January, while federal authorities have launched criminal investigations. But no details have emerged on the substance of either.

As far as the Bush administration is concerned, the only comment so far has come from Treasury Secretary John Snow who told reporters last Thursday that “this may end up being a relatively minor thing or it may end up being far more serious.”

An examination of the circumstances of the home-mortgage giant and its place within the US financial system reveal the potential for a major crisis if financial irregularities are discovered—and, moreover, even if they aren’t.

Freddie Mac (the Federal Homes Loan Corporation) and is sister organisation Fannie May (the Federal National Mortgage Association) purchase home loan mortgages from the banks, financing the purchases with the sale of securities. Set up by the government in the 1970s, both organisations are regarded as having an implicit guarantee on their debts. This enables them to pay less interest in the market on their borrowings than would otherwise be the case—on average 30 to 40 hundreds of a percentage point less than a bank would for the same loan.

Interest rates, however, are subject to fluctuations. If interest rates on mortgages fall, then the financiers who have used that mortgage as the backing for the security they have sold to financial markets are faced with a potential loss. Therefore, in order to protect themselves they hedge their operations through the purchase of financial derivatives. It is here that some of the problems reside.

Figures published in the *Financial Times* of June 13 show both the rapid growth of Freddie Mac and Fannie May, and their increased dependence on derivatives. In 1990, the two companies held $136 billion worth of mortgages. By 2001 this had risen to $,1200 billion, at least a fifth of all US mortgage debt. Their holdings of derivatives have risen even more rapidly: from $72 billion in 1993 to $1,600 billion in 2001.

The immediate cause of the problems at Freddie Mac appears to be accounting properly for the use of derivatives. Under the previous accounting procedures, income for the years 2000, 2001 and 2002 was understated, with income for the future overstated. This may be because a method was chosen to “smooth out” earnings, providing reassurance to financial markets and leading ultimately to lower interest rate costs. Fluctuating earnings create uncertainty, and uncertainty increases the “spread” on the company’s paper—the difference between the interest it offers on its securities and that which can be obtained on Treasury notes.

Although the differences themselves are small, the amounts of money involved are so large that costs can increase significantly. For example, it is estimated that widening of the gap between Freddie Mac’s bonds and comparable US Treasuries over the past week would cost the company an additional $1 million a year on every $1 billion it has borrowed.

Whatever the specific details of the situation at Freddie Mac, it is clear that US monetary policy has played a significant part in contributing to its problems.

Since the collapse of the share market bubble three years ago, the US Federal Reserve Board under chairman Alan Greenspan has been steadily cutting interest rates. Its purpose has been to prevent a collapse in consumption spending that would see the US economy move into a major recession. Housing finance has been the key mechanism in this process.

While they have had virtually no impact on business investment decisions, the interest rate cuts have led to a mortgage refinancing boom, with home owners in effect obtaining increased credit, at lower interest rates, on the increased value of their homes. However, the lower-interest rate regime means that Freddie Mac and other financiers have to use derivatives, recently described by billionaire US investor Warren Buffet as "financial weapons of mass destruction", to hedge their assets.

The potential trouble was highlighted in a comment by *Financial Times* columnist John Plender published on Monday.

"[J]ust about everybody knew," he noted, "that Freddie Mac, with its huge derivatives book, was an accident waiting to happen. And the accident is potentially sizeable. Total assets amount to $722 billion and these have to fall by only 3.4 percent in value to render the home loan giant insolvent."

Freddie Mac is not the only financial institution affected by the Fed's policies. In an article published this week, entitled "The Scary side of low rates", *BusinessWeek* noted that a further cut in rates could "decimate the money-market industry, which provides hundreds of billions of dollars to Corporate America via purchases of commercial paper." It posed the question as to whether lower interest rates would "spur growth before they inflict serious damage"

The big interest rate drops, it noted, had put particular pressures on Freddie Mac and Fannie May and while the two firms had maintained that they could handle the risks, Freddie Mac's dismissal of its president "raised questions about whether it has adequate financial controls in place."

Looking further afield, *BusinessWeek* pointed out that falling rates have lowered yields on money-market mutual funds so far that their annual 0.6 percent fees eat up almost half of their 1.3 percent annual return, leaving investors a return of just 0.7 percent. A further rate drop would put many funds, which are big buyers of commercial paper, out of business. This would force big issuers of commercial paper, such as Ford Motor Credit, to find other, more expensive, ways of raising money.

In the case of Freddie Mac, even if it has properly accounted for its derivatives and made a profit from them, it could still be embroiled in financial difficulties. This is because it may be too heavily exposed to the counterparties which hold the other side of the derivatives contract.

Notwithstanding the Enron-type methods of so-called "creative accounting," in which transactions are recorded to create a "win-win" situation, derivatives are a zero-sum game. That is, if one party profits, the other most lose. This means that if Freddie Mac has been able to benefit, the cost will be borne by the counterparty. And with just five counterparties accounting for 60 percent of Freddie Mac's derivatives contracts, this means that if one or more of them run into problems it will be embroiled as well.

There is also a significant international dimension to the crisis. The US balance of payments deficit, now running at more than $500 billion a year, is only sustained by the flow of money back into American money markets from Asia and Europe.

Because they pay slightly better than Treasuries, but are regarded as government-backed, Freddie Mac's securities and other so-called "agency debt" are an attractive proposition for major banks and financial institutions, particularly in Asia.

But as *Bloomberg* columnist William Pesek noted this week, Freddie Mac now has a "huge credibility problem in Asia". The numbers are large. In the first three months of this year alone Asian investors, many of them banks, bought over $32 billion worth of agency debt. But last week they "dumped" Freddie Mac securities.

As Pesek put it, the nightmare, which haunts US investors and Washington policymakers, that of Asian investors stampeding out of dollar assets and setting off a major financial crisis, "edged closer to reality."