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Providing timely, accurate credit ratings to Institutional Investors

Testimony of Sean J. Egan, Managing Director, Egan-Jones Ratings Co.
Before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
June 25th Hearing – GSE Oversight: the Need for Reform and Modernization

Chairman Baker, members of the Subcommittee, good morning. I am Sean Egan, Managing Director of Egan-Jones Ratings Company, a credit ratings firm. By way of background, I am a cofounder of Egan-Jones Ratings Co., which was established to provide timely, accurate credit ratings to institutional investors. Our business model differs significantly from that of other ratings agencies in that we are not paid by the issuers of debt, which we view as a conflict of interest. Instead, we are paid by approximately 300 firms consisting mainly of institutional investors and broker/dealers. Unlike the major rating firms, we provided early warnings to investors on major debacles such as Enron, WorldCom, Global Crossing, Genuity, and ABB. We are based in the Philadelphia Pennsylvania area, although we do have employees that operate from other offices.

The three areas I would like to briefly address today are the GSE's current status, their development, and our proposed reforms.

GSE's Current Status

Fannie Mae (Fannie) and Freddie Mac (Freddie), (collectively the GSE's) started life under the protection of the Federal government and were given a line of credit from the US Treasury. When the GSE's were relatively small, the $2.4 billion line of credit from the US Treasury was adequate. As can be seen in the below chart, the GSE's capital (including the US Treasury line of credit) was adequate compared to other financial institutions.

	2000	**2001**	**2002**
Fannie Mae			
Total Assets ($BB)	675	799.8	877.5
Shareholders' Equity ($BB)	20.8	18.1	16.3
Equity/ Assets	**3.1%**	**2.3%**	**1.9%**
Fixed Charge Coverage (x)	1.2	1.2	1.2
Return on Avg. Assets (%)	1.0	1.1	0.7
Freddie Mac			
Total Assets ($BB)	459.3	617.3	721.7
Shareholders' Equity ($BB)	14.8	15.3	24.6
Equity/ Assets	**3.2%**	**2.5%**	**3.4%**
Fixed Charge Coverage	1.1	1.2	1.3
Return on Avg. Assets	0.8	1.2	1.2

Fannie's shareholders' equity has declined from $20.8 billion as of December 2000 to $16.3 billion as of December 2002 while assets have grown from $675 billion in Dec. 2000 to $887 billion in Dec. 2002. As the GSE's grew, they were not able to grow their capital base sufficiently to keep pace with the rapid asset growth; what used to be high leverage has become excessive.

Below is a comparison of the GSE's credit ratios to other firms' ratios.

	Moody/S&P Ratings	**Return on Avg Assets**	**Return on Perm Cap(%)**	**Fixed Charge Cov (x)**	**T Debt/ Cap (%)**
FANNIE MAE	Aaa/AAA	0.7	0.7	1.2	98.1
FEDERAL HOME LOAN MORTG CORP	Aaa/AAA	1.2	1.2	1.2	97.4
COUNTRYWIDE FINANCIAL CORP	A3/A	2.8	3.4	2.7	89.2
SLM CORP	A2/A	2.3	2.4	2.0	96.0
ADVANTA CORP	B2/B	0.1	0.2	1.3	56.4

Egan-Jones Ratings currently rates Fannie Mae (FNM) at "A+", which is approximately 4 notches below S&P's and Moody's "AAA" and "Aaa" ratings (Egan-Jones uses the same rating categories as S&P in the investment grade segment). Attached is a history of our ratings and below are comments from a June 10, 2003 report on FNM

> Far from a "AAA" - FNM is not fully backed by the US and has only a sliver of equity. The general rule for banks is to maintain equity at 8% of assets; FNM has only 1.96%. Also FNM has greater volatility than some banks because of its business focus and the absence of loan prepayment penalties. Although FNM claims it is hedged there are few perfect hedges. Still unresolved is the support FNM will get from the Federal Government if it gets into trouble. FNM's prospectuses state that the Federal Government is under no obligation to support FNM, but most investors assume it will, [but probably up to only $2 billion.] The assumption of the US's guaranteeing all of FNM's debt and shareholders' getting the upside is likely to change.

Egan-Jones Ratings currently rates FRE at "A", which is approximately 5 notches below S&P and Moody's "AAA" and "Aaa" ratings (Egan-Jones uses the same rating categories as S&P in the investment grade segment). Attached is a history of our ratings and below are comments from a June 10, 2003 report on FRE.

> FRE is not a "AAA" credit and the replacement of its top three officers and restating its financials is not comforting. The items of

> greatest concern are the prepayment of high rate mortgages (which are replaced at a reduced rate), the non-callable status of some liabilities, hedging costs, and low equity. Although FRE's prospectuses state that the Federal Government is under no obligation to support FRE, most investors assume it will. The model of the Government's guaranteeing FRE's debt and shareholders' getting the upside is likely to change. Perhaps FRE will go the way of SLM Holdings [i.e., Student Loan Marketing Association].

A reasonable question would be why one rating firm, Egan-Jones, would rating the GSE's at "A" and A+" whereas Moody's, S&P, and Fitch would rate the GSE's at "AAA". Our view is that 1) there is substantial pressure for the major rating firms to maintain high rating for major issuers and 2) little penalty if the rating ultimately proves to be wrong. Regarding the pressure to maintain a high rating, Moody's, S&P and Fitch obtain approximately 90% of their revenues from issuers such as the GSE's.

> Over the years, S&P and Moody's have rated more than $500 billion in Freddie Mac debt and earned tens of millions of dollars in fees.
> Wall St. Journal, June 12, 2003

Unlike Moody's, S&P, and Fitch, Egan-Jones is not paid by issuers for its ratings. Regarding the lack of penalty if Moody's, S&P, and Fitch's ratings prove to be drastically wrong, since there are relatively few alternatives, the major rating firms face few penalties. Up until early this year, the three major rating firms were the only firms recognized by the SEC and DBRS, which was recognized in March 2003, has little market presence in the U.S. Over the past three years there have been numerous examples of investment grade firms filing for bankruptcy protection on short notice. Enron was rated investment grade four days before its filing, National Century was rated Aaa two months before its filing, WorldCom was rated at the Baa/BBB level three months filing, and the California utilities were rated at the A level 16 days before defaulting. Despite these failures, the major rating firms have regularly grown their revenues because of the restrictions on competition.

The GSE's Development
Enron, Worldcom, Global Crossing and the current situation with the GSE's highlight some structural deficiencies in our financial system. Although the GSE's state in their prospectuses that their support from the US Treasury is limited to $2.2 billion, the major participants in the financing process have told investors otherwise.

> When **Freddie Mac**'s stock fell Monday on news of a management ouster and audit delay, UBS Warburg analyst Gary Gordon quickly

> weighed in with his support: He deemed the management change a "positive" and reiterated a "buy" rating on the shares. Even as Freddie Mac's stock slid 16% to $50.26 a share that day, he reiterated his price target of $105. As it happens, **UBS** ranks No. 1 in underwriting Freddie Mac's mortgage-backed securities over the past year and a half. While fees for such issues aren't disclosed, UBS was the lead manager on $84 billion of Freddie Mac mortgage securities in 2002 and 2003, according to Thomson Financial, which tracks securities activity. Of the five Wall Street firms that cover Freddie Mac and received the biggest slice of its mortgage-backed securities business in 2002 and 2003, only one downgraded the stock this week. Besides UBS, **Credit Suisse Group**'s CSFB, **Citigroup** and **Lehman Brothers** all reiterated their ratings for Freddie Mac. **Bear Stearns**, which ranked second in mortgage-backed securities business with Freddie Mac, lowered its ratings on the stock, to "peer perform" from "outperform."
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> Heard on the Street, WSJ Online, June 12, 2003

The large rating firms hold themselves as independent, a misnomer since they receive 90% of their compensation from issuers and the GSE's happen to be two of the largest issuers. S&P, Moody's and Fitch maintain ratings of "AAA/ Aaa" on the GSE's.

While accountants often are criticized for the quality and thoroughness of their work, that is a secondary issue here. The basic problems are insufficient capital and a changing business environment. Both GSE's have experienced the early prepayment of assets and difficulty in reinvesting proceeds at previous rates. Hedging helps, but there are few perfect hedges, and the significant size of the GSE's makes extensive hedging problematic. The regulatory environment could be characterized as lax and inconsistent; it is difficult to excuse regulators' having allowed the GSE's financial leverage to become so great.

Proposed Reforms

Although the GSE's have been and will continue to be important contributors to the financing of home mortgages, their significant size does not provide an excuse for not addressing the problems in the market. We recommend action in the following areas:

1. Establishment of a Regulatory Body – Heretofore the GSE's have acted with minimal overview of their activities while encouraging the view that they are supported by the federal government. If the GSE's retain any support from the federal government, then adequate controls have to be put in place addressing issues such as capitalization, asset acquisition practices, hedging practices, servicing firm reviews, asset and liability diversification, tenor of asset and liabilities, interest rate risks, portfolio

sensitivity analyses, workout procedures, capital raising procedures, operating systems, documentation review, local tax (property, school, and sewer) payment monitoring, and management development. The regulator should have experience examining large, complex financial institutions and be insulated from the GSE's extensive lobbying efforts.

2. Restrict Growth/ Rebuild Capital – Unless the federal government is willing to increase its credit line to the GSE's to approximately $70 billion each (at least 8% of total assets), the GSE's need to increase capital if they are to survive in their form.

3. Encourage the Development of Additional Funding Sources – Concentrating funding for a critical sector such as housing with two firms (according to Bloomberg, the GSE's own or guarantee approximately 40% of the US mortgage market) is unwise regardless of the quality of management of the two firms. Just as the commercial and investment banking fields have a variety of capable firms, the mortgage sector should likewise have a variety of significant competitors.

4. Enhance Rating Firm Independence – all the current SEC-recognized rating firms receive most of their compensation from issuers and have fallen short in protecting investors. If the NRSRO system is retained, then (i) recognize some rating firms that are independent from issuers and (ii) over time, restrict SEC-recognized rating firms from receiving compensation from issuers.

Comment on Legislative and Regulatory Actions
Although some (particularly the GSE's) have encouraged a policy of benign neglect toward the GSE's, we believe the problem will grow if it is not addressed. The markets are confused about the condition of the GSE's currently; although the major rating firms have issued "AAA" ratings, investors have been burnt by Enron and WorldCom, which had strong investment grade ratings prior to their failure. Markets dislike uncertainty, and therefore legislation on the GSE will provide more clarity to confused investor

Appendix

Egan-Jones and its Rating of the GSE's

Below is a listing of Egan-Jones's rating actions on Fannie Mae and Freddie Mac. Note, Egan-Jones is not paid by issuers for its ratings. The corporate bond investment unit of Freddie has been a client of Egan-Jones for the past several years, while Fannie is not a client. Freddie pays our normal subscription price and represents less than 1% of Egan-Jones' revenues.

Fannie Mae's Senior Unsecured Ratings

Date	Egan-Jones*	S&P	Moody's	Fitch	Action
4/10/2001	AA (neg. watch)	AAA	Aaa	AAA	EJR issued neg. watch (AA)
2/20/2002	A+ (neg. watch)	AAA	Aaa	AAA	EJR cut rating to A+ (neg. watch)
9/24/2002	A+	AAA	Aaa	AAA	EJR affirmed A+ rating
1/15/2003	A+	AAA	Aaa	AAA	EJR affirmed A+ rating
3/10/2003	A+	AAA	Aaa	AAA	EJR affirmed A+ rating
6/10/2003	A+	AAA	Aaa	AAA	EJR affirmed A+ rating

Freddie Mac's Senior Unsecured Ratings

Date	Egan-Jones*	S&P	Moody's	Fitch	Action
5/22/2000	AA (neg. watch)	AAA	Aaa	AAA	EJR issued neg. watch (AA)
1/30/2001	AA (neg. watch)	AAA	Aaa	AAA	EJR affirmed neg. watch (AA)
2/20/2002	A+ (neg. watch)	AAA	Aaa	AAA	EJR cut rating to A+ (neg. watch)
3/10/2003	A	AAA	Aaa	AAA	EJR cut rating to A
6/11/2003	A	AAA	Aaa	AAA	EJR affirmed A rating (dev. watch)

Appendix