Measure of Fannie Mae's Risk Widens on Home Refinancings

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A key measure of interest-rate risk at Fannie Mae widened sharply last month, boosting part of the bond market but raising new questions about the effects of the home-refinancing boom on Fannie's own finances.

In its monthly release of financial data, the giant government-sponsored mortgage company acknowledged that what is known as the "duration gap" between its mortgage assets and debt liabilities ended August at the highest level the company has ever reported publicly, "reflecting the recent sharp drop in mortgage rates." But the company said it can handle the added risk, and its profit projections remain the same. Nevertheless, the disclosure somewhat rattled Fannie investors. As of 4 p.m. in New York Stock Exchange composite trading Monday, Fannie Mae shares fell $1.72 to $70.98 each.

The disclosure creates "a general level of concern when you see a huge financial institution reporting what seems to be a mis-hedging of their assets and liabilities," says Robert Young, a mortgage analyst at Salomon Smith Barney. "It looks like a pretty sizable gap."

Fannie Mae's current predicament is related to the recent refinancing boom. With mortgage rates at their lowest levels in a generation, more borrowers are paying off their mortgages early and taking out new ones with lower rates. When that happens, Fannie replaces those mortgages with new loans that could have lower interest rates -- creating a possible mismatch between the mortgages it now owns and the debt on its books.

The duration gap is one way the company measures its success in matching its mortgage assets and its liabilities. The gap swung from negative nine months in July to negative 14 months in August. That doesn't mean that the company is in trouble. But it does mean Fannie Mae's huge $747 billion loan portfolio has greater exposure to a sudden shift in interest rates. Fannie Mae likes to have the duration of their assets and liabilities more closely matched; its stated target is to maintain a duration gap of within plus or minus six months.

Bond-market investors care about the disclosure because it suggests Fannie Mae will have to take steps to get its assets and liabilities back in line, with possible implications for the rest of the bond market. Treasury prices rose Monday, in part on expectations that Fannie Mae might soon become a big buyer of longer-dated Treasury debt in a move to better hedge its portfolio. At 4 p.m. EDT, the 30-year Treasury bond rose 6/32, or $1.875 per $1,000 invested, to 109 21/32. The yield, which moves inversely to price, fell to 4.751%. Meanwhile, after rising for most of the day, the 10-year Treasury note ended down 1/32, to 103 26/32, yielding 3.904%.

The news pressured the 10- and 30-year Treasury yields to new lows for the year -- about 3.85% and 4.73%, respectively -- earlier in the session. With interest rates falling consistently during the past six months, some investors are closely following interest-rate-related disclosures from large financial institutions, because changes in rates can greatly affect their earnings. Sharply shifting interest rates played a role in the near collapse of Long-Term Capital Management, the massive hedge fund that needed a bailout from a number of major Wall Street firms in 1998 to keep the fund afloat and help protect the global financial system. Like its smaller sibling Freddie Mac, Fannie Mae makes much of its money by issuing debt and then using that capital to buy mortgages from lenders to hold in its portfolio. The company pockets the difference between the interest it pays to borrow and the interest it collects on the loans it owns.

But sudden shifts in interest rates can turn that strategy upside down. In a worst-case scenario, the company could have a mismatch between its assets and liabilities that causes it to lose money if interest rates suddenly move in an unfavorable direction. That is what happened during the 1980s, when the company at one point was losing $1 million a day and was technically insolvent.

Today, Fannie Mae is far more sophisticated, and it more effectively manages its interest-rate risk through instruments such as callable debt and derivatives. The duration gap could lead to more worries if interest rates stay low for an extremely long period of time. But for now, says Kevin Jackson, a mortgage-bond strategist at RBC Dain Rauscher in Chicago, "I don't think [Fannie Mae is] in any trouble."

He and others noted that Fannie Mae has a wide variety of options at its disposal to bring its portfolio back into line. It could issue more shorter-term debt. It could reconfigure its balance of derivatives. It could also more aggressively buy long-term mortgages or Treasurys to add duration to its portfolio, though buying more

Treasurys could roil the bond market by driving down Treasury yields. That could in turn send mortgage rates even lower, resulting in more refinancings. Fannie Mae said it isn't a big buyer of Treasurys.

Fannie Mae said it isn't unusual for the company's duration gap to swing outside of its target range, especially during a refinancing boom. The company said in a statement that it intends to rebalance its portfolio "quickly, but in a manner and at a pace that does not put undue demands on the market."

A company spokeswoman added that any negative impact from the large duration gap is at least partially offset by the fact that the refinancing boom has created more loans than usual for the company to buy. Last year, the company reported record earnings despite a large refinancing boom and a temporary jump in its duration gap.

Although Freddie Mac measures its duration gap differently than Fannie Mae, rendering comparisons difficult, a company spokeswoman said Freddie Mac's duration gap is less than one month.

Risk Data at Fannie Mae Spur Regulator to Step Up Oversight

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The federal regulator of Fannie Mae said it is heightening its supervision of the mortgage-finance company after a measure of the company's interest-rate risk widened sharply in August. In a letter sent to two lawmakers Monday, the director of the Office of Federal Housing Enterprise Oversight said he had met with senior Fannie Mae executives and is requiring weekly reports from OFHEO examiners on the company's exposure to interest-rate risk. He also said he had instructed Fannie Mae to keep regulators apprised of any challenges associated with returning its interest-rate risk measure to more acceptable levels, and warned that his office "may take additional action" if "there are adverse developments with management's effectiveness" in doing so.

The letter came after Fannie Mae said in a monthly financial disclosure that its so-called duration gap, which measures its success in matching its assets and liabilities, swung from negative nine months in July to negative 14 months in August, due to low interest rates and heavy refinancing activity. The wider duration gap doesn't indicate any immediate trouble for the company, but it does suggest Fannie Mae's $747 billion loan portfolio has greater exposure to a sudden shift in interest rates. OFHEO Director Armando Falcon said he thinks Fannie Mae executives are moving "appropriately and aggressively to address the current level of risk," but that the issue is still a cause for concern. "My attention will remain heightened over the next several months," he said in the letter to Reps. Richard Baker (R., La.) and Paul Kanjorski (D., Pa.)

Fannie Mae officials said Monday that the company's duration gap historically widens during refinancing booms and falls outside its preferred parameters of plus or minus six months about one-third of the time. The company said the increased duration gap hasn't influenced earnings projections.

Fannie Mae is a government-sponsored company that buys mortgages from lenders to help increase the flow of capital through the mortgage market. In 4 p.m. composite trading Tuesday on the New York Stock Exchange, Fannie Mae's stock was down $4.73, or 6.7%, to $66.25.

Can Fannie Make Repairs To Its Investment Portfolio?

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A few weeks ago, only bond geeks worried about the "duration gap."

Now, all of Wall Street is glued to how mortgage giant Fannie Mae, a critical cog in the financial system, will fix its investment portfolio. Fannie Mae last month disclosed that the gap between the expected life of its liabilities and its assets -- the much-watched duration gap -- had stretched to a record level, potentially putting the company at risk if its rates continue to tumble.

Already, the possibility of a Fannie Mae crunch has roiled the bond market, as traders bet the company will have to aggressively buy securities to hedge against its stretched portfolio. Fannie Mae's problems also are attracting attention from economists and policy makers, who already are worried about a wider housing-industry collapse.

Fannie Mae has several options to dig itself out of its interest-rate hole. However, the high profile of the company's problems could make a resolution tougher. Because Fannie Mae is so big, if it begins making waves in the derivatives market or buying up bonds, other Wall Street players could rush to beat it to the punch, hoping to profit from a desperate buyer in the market. "We're wary of speaking about our options because we don't want to open ourselves up to front running" by investors, said a Fannie Mae spokeswoman.

Calm Approach

For all the market's nervousness, Fannie Mae executives say they are confident they can adjust their portfolio, though they concede there are risks in whatever they do.

"I don't feel any additional pressure," says Peter Niculescu, the head of portfolio management at Fannie Mae. "We want to take actions to narrow the duration gap quickly."

Fannie Mae is under the gun because of the recent refinancing boom. The government-sponsored company profits by raising money at low rates and investing it in higher-yielding home mortgages. But as interest rates have plunged in recent months, sparking a record surge in home refinancings, Fannie Mae's mortgage investments are under pressure. At the end of August, the investments were on pace to mature 14 months before Fannie Mae's debt is paid off.

That means that unless Fannie Mae adjusts its portfolio or rates rise enough to slow down refinancings, the company's profits would be pressured as it pays off its outstanding debt. If rates continue to fall and refinancings rise, the problem gets tougher.

Broad Implications

"The duration gap is large enough to get the market's attention," says Amy Falls, global fixed-income strategist at Morgan Stanley. "Management of this issue has implications for the entire bond market, as well as their earnings."

So how can Fannie Mae fix things? Traders say Fannie Mae already has been terminating certain derivative contracts, such as interest-rate swaps, that do poorly when rates falls. By doing this, Fannie Mae is extending its portfolio's duration. Fannie Mae also can begin entering swaps or options that pay off when rates fall.

But tumult in the markets may make it harder for Fannie Mae to solve its problems quickly. Wall Street traders are suffering losses and are less willing to take the other side of many transactions in the derivative and credit markets, raising the cost for anyone trying to adjust a large portfolio. That's especially true for Fannie Mae, which has an investment portfolio of almost $750 billion, by far the biggest in the market.

Debt Buyback

Fannie Mae also could buy back more of its debt, something it did last Tuesday when it purchased almost $1 billion of securities, and replace it with low-rate, short-term debt. That might actually give a boost to Fannie Mae's earnings. The danger there would be if rates suddenly rose, and Fannie Mae was stuck with short-term debt that needed to be refinanced at higher rates.

Another option: The company could buy long-term Treasurys to replace the mortgages it is losing due to refinancings. Since Treasurys can't be refinanced, such a move would add duration to Fannie Mae's portfolio. But Fannie Mae has always shied away from buying Treasurys, which carry lower yields than mortgages, and executives say they don't plan to start now.

For all the buzz about what Fannie Mae will do, executives say the option they prefer is to more or less operate in a business-as-usual mode. If interest rates stabilize, or even snap back, Fannie Mae might be able to bring its portfolio in line just by buying new mortgages in the course of normal business. These new mortgages would be unlikely candidates to be refinanced anytime soon because they would carry lower rates. Under this scenario, in just a few months "the problem disappears," Mr. Niculescu argues.

This strategy has worked in the past. After the Sept. 11, 2001, terrorist attacks, for example, interest rates plunged and refinancings soared, putting Fannie Mae's duration gap at 10 months. But rates soon jumped, as the outlook for the economy improved, and refinancings slowed down, solving Fannie Mae's problems. The danger here is if rates stayed low, and the duration gap remained wide, putting pressure on the company to aggressively shift its portfolio. If the duration-gap issue continues, it could affect Fannie Mae's earnings growth, which has been soaring in recent years, but not the stability of the company, Mr. Niculescu says.

Fannie Says Risk Narrowed; Critics Seek More Disclosure

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Fannie Mae said an important measure of the company's interest-rate risk narrowed in September, easing concerns that it was struggling to weather a massive surge of mortgage refinancing. But a top Federal Reserve policy maker kept the heat on, pressing for more financial disclosure from the company and calling on Congress, as others have, to focus more attention on Fannie Mae's growing size and leverage.

The government-sponsored company, which buys mortgages from lenders to boost the flow of capital in the housing market, has suffered unusually intense scrutiny lately. Two weeks ago, the company rattled markets when it disclosed that its so-called duration gap, a measure of its success at managing interest-rate risk, ballooned to minus-14 months in August due to heavy refinancing activity. A negative duration gap effectively means that Fannie Mae's assets are paying off faster than its debts.

In an unexpected move Tuesday, however, Fannie Mae said its duration gap narrowed to minus-10 months in September, suggesting it is improving its position. The company normally announces its duration-gap figures in the middle of the month, but it released its September data just hours after the month ended because of "greatly heightened interest" from investors and others, according to a statement.

Although a minus-10 month duration gap is outside of the company's preferred parameter of plus- or minus-six months, the move toward a smaller gap relieved investors. At 4 p.m. Tuesday in New York Stock Exchange composite trading, Fannie Mae jumped $5.68, or 9.5%, to $65.22. The gain was the largest one-day percentage gain for the company since Oct. 21, 1987. The Treasury market slumped, as investors unwound positions they had bought in anticipation of Fannie Mae's possible need to buy Treasurys and related investments to better hedge its portfolio.

The fact that Fannie Mae was able to reduce its gap "shows their business model is working," said Robert Napoli, an analyst at Minneapolis-based US Bancorp Piper Jaffray. In an appearance on CNBC Tuesday, Fannie Mae chairman Franklin Raines said the company reduced its gap in large part by buying more mortgages, which would have had the effect of extending the life of Fannie Mae's loan portfolio. Market analysts speculated that the company also reconfigured some of its positions in derivatives markets.

Fannie Mae isn't out of the woods yet, though. Some analysts noted that a 10-month gap is still too wide for comfort, and with interest rates staying low, the refinance boom doesn't appear to be fading.

Meanwhile, following a speech Tuesday, Federal Reserve Gov. Susan Bies reiterated concerns that Fannie Mae and its smaller sibling, Freddie Mac, don't disclose enough information about the securities they issue. "Fannie and Freddie and GSEs are a growing issue," Ms. Bies said at the Carnegie Endowment for International Peace Tuesday. She noted that while the federal government doesn't guarantee Fannie's or Freddie's debts, investors assume that they do, which enables the companies to borrow at lower interest rates. She said the companies are growing so large that a time will come when the earnings Wall Street has come to expect will "require increasing leverage... . We have to deal with that issue, and Congress needs to focus on it."

Although Ms. Bies was speaking for herself, not the Fed, which has no regulatory role over Fannie and Freddie, many Fed officials, including Chairman Alan Greenspan, share her concerns about investors' perception of a government guarantee.

Ms. Bies praised Fannie and Freddie and their regulator, the Office of Federal Housing Enterprise Oversight, for deciding earlier this year to require the two companies to adhere to the same financial-disclosure requirements as other publicly traded companies do. But she pressed them to go further and follow the same disclosure requirements for the securities they issue. She said analysts depend on information about the individual mortgages that underlie such securities, such as the interest they pay, the value of the properties and the geographical breakdown of the mortgages. "If someone securitizes a mortgage in the private market, they tell much more about the type of underlying mortgage collateral than Fannie and Freddie do," Ms. Bies told reporters.

Fannie Mae spokeswoman Janice Daue said the company already discloses "a great deal of information." She added, "this issue was thoroughly reviewed by Congress and the administration earlier this year. Both determined that the current [securities] exemption benefits the market."

Fannie Mae News Hurts Treasurys

Dow Jones Newswire, August 13, 2003

Duration Gap Swings to Top Of Company's Target Area

Already on soft footing after the Federal Reserve kept its federal-funds-rate target at 1% Tuesday, Treasurys fell sharply Wednesday as news from mortgage company Fannie Mae and stronger-than-expected data weighed on securities across the fixed-income universe. But the selling failed to push the yield on the actively traded 10-year benchmark through 4.60%, the upper reaches of its current trading range, to the relief of many in the market who feared another round of volatile trading could be lurking around the corner.

"The market is desperately trying to consolidate...and the Fannie Mae story today is not allowing it to," said Bill Hornbarger, fixed-income strategist at A.G. Edwards & Sons in St. Louis. "With yields up [1.5 percentage points from their lows], you'd expect the market to stop and trade sidewise for a while," he added.

At 4 p.m., the benchmark 10-year note was down 1 13/32 points, or $14.0625 per $1,000 in face value, at 97 15/32. Its yield rose to 4.567% from 4.39% Tuesday. The 30-year bond's price was down 1 28/32 points at 98 26/32. Its yield rose to 5.46% from 5.327%.

Fannie Mae said that its duration gap, which measures how well cash flows from its assets and liabilities match its mortgage portfolio, swung seven months to plus six months -- the top of its target range -- in July from minus one month in June. Fannie Mae's target is plus or minus six months.

A positive duration gap suggests that cash flows from its assets will outpace the stream of payments it owes its debt holders. This could increase Fannie Mae's need to adjust its interest-rate exposure.

Speculators, those who take a short-term view of the market, were largely behind the selling, betting that Fannie Mae will need to shed duration as rates rise. The agency-debt market was hit first by these investors who then turned on interest-rate swaps, mortgages and Treasurys, traders said. But flows were orderly compared with the near-panic meltdown in fixed-income markets two weeks ago, they said.

Nearly a year ago, Fannie Mae made "duration gap" a household name among investors when it announced a record negative 14-month crack in its mortgage portfolio and sent Treasury prices soaring. At the time, speculators believed the Fannie Mae would buy Treasurys to lengthen its duration. Instead, the company ended up hedging with swaps and other securities.

Wednesday, Jason Lobo, a spokesman for Fannie Mae, said the company doesn't use Treasury securities to rebalance its duration gap.

Mr. Lobo said Fannie Mae purchased new mortgages to manage its duration gap in July, demonstrated by the 41.1% record annualized increase in its mortgage portfolio. "We can issue more funding that has shorter or longer terms, or we can cancel or add options or swaps that adjust the duration of our funding," he added.

Sentiment in the bond market also was hit by strong economic data published early in the day. The Commerce Department said July retail sales rose a stronger-than-expected 1.4%, following upward revisions to both June and May figures. Wall Street had anticipated a 1% gain.

The data, however, weighed more heavily on Treasurys when the 10-year note broke through 4.50% and traders worried that forced selling from mortgage accounts would emerge as bearish sentiment deepened.

When interest rates rise, mortgage investors must sell longer-dated securities, such as Treasurys, to rebalance their portfolios. Such selling whipped through the market two weeks ago, causing the yield on the 10-year note to soar to nearly 4.60% before recovering.

John Canavan, a market economist at Stone & McCarthy in Princeton, N.J., said, "There seems to be some concern in the market that despite the Fed's best intentions... if the economy gathers momentum as some of the very recent numbers suggest, the Fed may not be able to keep rates at 1% for as long as they would like."