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**Market Issues & Analysis**  
**Volume II, No. 15**  
**September 10, 2008**

**The Aftermath of an Improperly Aimed “Bazooka”**  
**By Doug Dachille**

After Secretary Paulson fired his now famous “bazooka” by placing Fannie Mae and Freddie Mac into conservatorship, many market participants responded enthusiastically. Regardless of the appropriateness of the end result, an examination of the options open to the Secretary compared to the manner in which he executed his plan should actually cause deep disturbance in the investment community. Such a comparison highlights the many challenges that have been created by this unprecedented intervention.

An earlier proposal that I had advocated called for the Secretary to state that he would not exercise the use of his new powers until the regulatory capital of the agency fell below its statutory minimum. At this point, Secretary Paulson and the Director of the Federal Housing Finance Agency would determine the required amount of equity capital to be raised by the agency so that the agency could return to capital compliance.

If equity investors did not provide the required amount, their interests would be subordinated and potentially wiped out. Such a plan had numerous benefits, not the least of which is the clear feedback that it would have allowed the market to provide. Unwillingness of third party equity to participate in a further raise would be a good indication that the agencies were no longer viewed as viable by the investment community, and, therefore, alternative action was required.

Instead of proceeding along the lines of the above proposal, Secretary Paulson opted for an opaque, rather than transparent, approach to addressing the crisis of confidence in the agencies. On the basis of a Morgan Stanley analysis which identified a capital shortfall that all of the accounting experts and consultants had failed to recognize over the past few years that the agencies have been under increased accounting scrutiny, the Secretary moved swiftly to place the agencies into conservatorship.

Shareholders of Fannie and Freddie received no disclosure about the newly discovered capital and risk issues facing these entities and were denied an opportunity to come up with additional capital. If shareholders were made aware of the consequences should they have failed to provide the required capital, what would have happened? Sadly, no one will ever know the answer to this question.

The basis of the superior functioning of capital markets in the United States has been transparency, process, fairness, and law. The recent action taken by the Treasury has undermined each of these concepts.

First, Secretary Paulson failed to communicate how he would use his “bazooka.” In fact, the precise findings and methodologies used by Morgan Stanley to determine the health of the agencies is still an unknown. Second, shareholders did not have an opportunity to participate in a capital raise, and investors have no insight into how the Treasury arrived at the decision that conservatorship was inevitable.

Third, the agencies are held to an impossible double standard. They must be profitable as private enterprises, yet, according to FHFA Director James B. Lockhart, must also “fulfill their critical public mission.” One of the main components of this “public mission” is to provide affordable housing. Affordable housing loans, synonymous with subprime, are imprudent to originate in this environment.

Apparently, applying risk based pricing on guarantees and slowing origination is accepted practice for other private enterprises that experience loss, such as insurance companies, but is not an acceptable course of action for Fannie and Freddie. Finally, the legality of this action remains hazy. The extent to which shareholder rights have been violated is currently unclear, but this topic is likely to be a major issue going forward.

The challenges that have been created as a result of the action taken by Secretary Paulson are serious. While many claim that government intervention was imminent, there is a fair case to look at this intervention as eminent, as in eminent domain. The government has essentially seized the property of private citizens for the “greater good” of providing affordable housing. The following example illustrates why this is so problematic.

Imagine that you leave your house on Friday night for a weekend of vacation, with a recent appraisal valuing your property at \$200,000. A potential buyer had offered \$150,000 earlier in the day, which you declined. When you return on Sunday evening there is yellow tape and Treasury officials surrounding your home, preventing you from entering. While you are told that there is nothing wrong with home right now, the government has made a number of projections that indicate that your home is a threat to the future safety of the community. You can no longer live in the home, and, to compensate the government for the ongoing monitoring services, you will sign over 80% of the equity in the home to the government.

In the government’s opinion (based on model projections) your home will ultimately need to be demolished, and is worthless. The government arrives at this conclusion despite the fact that the home had a market value of \$150,000 as of Friday. Sadly, you will receive no compensation due to the government’s new valuation of your property. Essentially, the conservatorship of the agencies is not dissimilar from the preceding example. Restoring confidence in the sanctity of U.S. capital markets may not come easily after such action.

Of course, the main challenge remains unchanged. This action is not a magic fix for the housing market. The market has already seen the losses that the government's affordable housing program has recorded under the Federal Housing Administration (FHA), losses of approximately \$8 billion this year on a portfolio of \$500 billion. If the government had run Fannie and Freddie like the FHA over the same period the losses would have been ~\$80 billion on a portfolio in excess of \$5 trillion. This is not a good omen for taxpayers.

Increasing the number of non-performing loans and foreclosures is inevitable when lending standards are lowered. Instead of helping the housing market and home prices, such action is certain to further impair this damaged market. As private entities, shareholders could place great pressure on Fannie Mae and Freddie Mac to pursue loan workouts and prevent foreclosures.

Without this shareholder voice, will the taxpayers realize that they now bear the burden of loss and exercise their voice by demanding efficiency from the agencies? Such a result is unlikely, and, unfortunately, the likely outcome is not that we have shifted loss from private investors to the taxpayer, but is actually even more ominous. Placing these entities under government control is likely to increase losses, the ultimate in non-economic solutions.

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