



MEETING DATE: 8/18/2008  
ITEM NO: 15

**COUNCIL/AGENCY AGENDA REPORT**

DATE: AUGUST 14, 2008

TO: MAYOR AND TOWN COUNCIL/  
CHAIR AND MEMBERS OF THE REDEVELOPMENT AGENCY

FROM: GREG LARSON, TOWN MANAGER/EXECUTIVE DIRECTOR 

SUBJECT: ACCEPT STATUS REPORT AND CONSIDER DISPOSITION OF FANNIE  
MAE AND FREDDIE MAC FEDERAL HOME LOAN COUPON NOTES  
INVESTMENT STRATEGIES

RECOMMENDATION:

Accept Status report and consider disposition on Fannie Mae/Freddie Mac and Federal Home Loan Bank coupon notes investment strategies. Council should consider one of the following strategies:

1. Continue with Treasurer's and staff recommendation to maintain its current "hold to maturity" strategy in accordance with the Town's investment policy; or
2. Continue hold to maturity strategy for Federal Home Loan Bank notes and sell selected holdings of Fannie Mae/Freddie Mac yielding less than 4.25%, totaling approximately \$2.3 million and explore opportunities to reinvest in other government sponsored enterprises that yield approximately 3.85%; or
3. Continue hold to maturity strategy for Federal Home Loan Bank notes and sell all holdings of Fannie Mae/Freddie Mac totaling approximately \$8.2 million and invest proceeds in alternative instruments such as U.S. Treasury notes or other government sponsored enterprises.

PURPOSE:

The purpose of this report is to inform the Council about the status of the Town's Fannie Mae/Freddie Mac investments in light of recent economic and market developments. The report provides an overview of recommended investment strategies and associated fiscal implications,

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Reviewed by: \_\_\_\_\_ Assistant Town Manager/Deputy Director  Town Attorney/General  
Counsel \_\_\_\_\_ Clerk Administrator/Secretary  Finance  
\_\_\_\_\_ Community Development

## MAYOR AND TOWN COUNCIL/CHAIR AND MEMBERS OF THE REDEVELOPMENT AGENCY

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as discussed with the Council Finance Committee. Staff is seeking Council direction regarding the preferred investment strategy and implementation steps.

DISCUSSION:**CURRENT STATUS OF FANNIE MAE/ FREDDIE MAC AND FEDERAL HOME LOAN BANK INVESTMENTS**

The following page provides a summary of the Town's current holdings in Fannie Mae and Freddie Mac "coupon notes," as of July 31, 2008. These investments are corporate bonds that pay a fixed, semi-annual interest rate. Also included is a summary of Town holdings in Federal Home Loan Bank notes, a regional bank cooperative which are not actively being discussed in the market or financial press at this time.

| <u>Institution</u>            | <u>Amortized Cost</u> | <u>Yield to Maturity</u> | <u>Maturity Date</u> | <u>Days to Maturity</u> | <u>Fair Market Value</u> |
|-------------------------------|-----------------------|--------------------------|----------------------|-------------------------|--------------------------|
| FannieMae                     | \$ 199,216            | 3.866%                   | 09/15/08             | 77                      | \$ 200,250               |
| FannieMae                     | 248,158               | 3.974%                   | 09/15/08             | 77                      | 250,313                  |
| FannieMae                     | 199,552               | 3.936%                   | 11/17/08             | 140                     | 200,626                  |
| FreddieMac                    | 296,403               | 4.313%                   | 01/12/09             | 196                     | 301,593                  |
| FannieMae                     | 242,400               | 3.930%                   | 03/16/09             | 259                     | 250,548                  |
| FreddieMac                    | 300,198               | 4.359%                   | 07/30/09             | 395                     | 304,218                  |
| FreddieMac                    | 298,332               | 4.527%                   | 07/30/09             | 395                     | 304,218                  |
| FreddieMac                    | 149,687               | 4.180%                   | 09/01/09             | 428                     | 151,857                  |
| FreddieMac                    | 298,683               | 4.237%                   | 09/01/09             | 428                     | 303,714                  |
| FreddieMac                    | 299,331               | 4.431%                   | 01/25/10             | 574                     | 305,862                  |
| FreddieMac                    | 1,008,560             | 4.007%                   | 12/24/10             | 876                     | 1,005,990                |
| FannieMae                     | 1,516,485             | 4.874%                   | 04/15/11             | 988                     | 1,563,285                |
| FreddieMac                    | 1,522,350             | 5.375%                   | 07/20/11             | 1115                    | 1,531,500                |
| FannieMae                     | 1,260,300             | 4.562%                   | 01/02/13             | 1616                    | 1,260,550                |
| <b>Total FNMA/Freddie Mac</b> | <b>\$ 7,839,654</b>   |                          |                      |                         | <b>\$ 7,934,523</b>      |
| FHLB                          | \$ 1,498,035          | 5.298%                   | 03/13/09             | 225                     | \$ 1,498,035             |
| FHLB                          | 1,493,400             | 5.226%                   | 06/12/09             | 316                     | 1,493,400                |
| FHLB                          | 1,507,665             | 4.957%                   | 06/11/10             | 680                     | 1,507,665                |
| FHLB                          | 1,487,205             | 4.960%                   | 08/10/10             | 740                     | 1,487,205                |
| FHLB                          | 1,509,255             | 4.743%                   | 03/09/12             | 1317                    | 1,509,255                |
| FHLB                          | 2,038,360             | 4.170%                   | 08/15/12             | 1476                    | 2,038,360                |
| <b>Total FHLB</b>             | <b>\$ 9,533,920</b>   |                          |                      |                         | <b>\$ 9,533,920</b>      |

The Town currently holds approximately \$7.8 million (10% of the Town's investment portfolio of approximately \$76.7 million) in Fannie Mae and Freddie Mac investments. As of July 31, 2008, the sale of these investments at fair market value would yield a gain of \$96,000.

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According to MBIA Asset Management, investments that have shorter maturity dates and lower yields are currently expected to either result in a small profit, breakeven, or potentially incur a small loss of principal if sold in the near term due to the fluid nature of the market coupled with a general rise in interest rates over the past two weeks.

### **OUTLOOK ON FANNIE MAY AND FREDDIE MAC INVESTMENTS**

The following section provides an overview of the benefits and challenges of Fannie Mae and Freddie Mac Investments, including the Federal Home Loan Bank.

#### **Fannie Mae**

Fannie Mae is a government sponsored enterprise (GSE) that facilitates the availability of capital used in providing financing for mortgages nationwide. Fannie Mae has dramatically increased the cost to guarantee mortgage-backed securities by roughly 50% on average. Mortgage profits have widened on new loans and underwriting standards have tightened. As new loans replace the old, it is anticipated that additional profits and returns on capital will grow. Analysts for Morningstar reported that "Fannie Mae's implicit government guarantee is becoming more concrete day by day." Bloomberg Investor's Report indicated that investors continue to buy these notes and recently announced that Fannie Mae sold \$3.5 billion in new Three Year Notes, yielding 4.22 per cent.

However, experts stated that the velocity of housing turnover and refinancing may continue to decline, leaving troubled loans on Fannie Mae's books and reducing opportunities to increase its revenue stream. Further disruption could result in government intervention to prevent massive market impact. According to Bloomberg Investors, since December 2007, Fannie Mae has raised \$14.4 billion in new capital to offset credit losses as delinquencies rise and the rate of recovery on foreclosures slides. Freddie Mac has raised \$6 billion since late last year, and is struggling to raise another \$5.5 billion in stockholder equity investments according to investment sources.

#### **Freddie Mac**

Freddie Mac is considered an integral part of the mortgage market, committed to providing liquidity to the mortgage market, and is planning to purchase \$20 billion in new fixed and adjustable rate mortgages. Experts use the term "the only game in town" because of their unique position as a GSE. The risk of fluctuating interest rates is offset by Freddie Mac's strategy in which it pairs its loan assets with its borrowings from the financial market that possess similar interest rates and maturities.

Despite its unique position as a GSE, Freddie Mac has been the subject of much speculation, given its recent loss which was three times higher than analyst's expectations. Experts believe that Freddie Mac's significant use of derivative instruments complicates the financial analysis of the firm and increases the level of uncertainty in the performance of its business.

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**Federal Home Loan Bank**

The Federal Home Loan Bank's (FHLB) function is to loan funds to its member banks. These funds are then available to be loaned out from its member banks to their communities in the form of mortgages and small business loans. These loans are considered well "over-collateralized" and have never experienced a single loss on its advances to its member banks since their inception. Additionally, Standard and Poors recently issued a rating digest indicating an AAA rating due to FHLB's role in the U.S. Mortgage market, excellent asset quality, conservative risk-adjusted capitalization, and its low funding costs. Although the relationship is indirect, there will always be some degree of exposure given FHLB's association with home loan financing. However, should the FHLB system experience financial distress, Standard and Poors reports that "the federal government would have a strong incentive to provide financial support to ensure the stability of the housing and capital markets."

**Other Considerations**

The recent adoption of the Federal Housing and Economic Recovery Act is evidence of an implicit government guarantee to prevent a system-wide collapse and housing market chaos. Sharp losses at Fannie Mae and Freddy Mac over the past week and continued concerns about the U.S. credit market have increased the chance that government funds would be needed. According to the Wall Street Journal Forecasting Survey, there is a 59% probability that the Treasury Department will have to step in to bail out Fannie Mae or Freddie Mac. However, a bailout which would likely involve a government equity stake in Fannie Mae or Freddie Mac would not necessarily undermine the value of the Town's investment.

**RECOMMENDED STRATEGIES**

**Town Treasurer and MBIA Asset Management**

The elected Town Treasurer and MBIA Asset Management concur that the current "buy and hold to maturity philosophy" as stated in the Town Investment Policy is the best course of action for the Fannie Mae and Freddie Mac notes and recommend no change to the holding and investment strategy for Federal Home Loan Bank notes. The recommended strategy is based on the following assumptions:

- New federal legislation allows the U.S. Treasury to buy unlimited shares of stock and debt of Fannie Mae (FNMA) and Freddie Mac (FHLMC) to bolster capital.
- The Treasury Department significantly increased the lines of credit to FNMA and FHLMC from \$2.5 billion to an estimated \$300 billion.
- FNMA and FHLMC have access to the Federal Reserve discount window to meet liquidity needs, as needed.
- FNMA & FHLMC own or guarantee over 80% of all residential mortgages in 2008. As a result, economists strongly speculate that that government may be counting on FHLMC and FNMA to pull the housing market out of the recession.

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- FNMA and FHLMC benefit from the *implied* guarantee of the government acting as a Government Sponsored Enterprise (GSE). Recent activity indicates that the guarantee is real.
- The Town only invests in the AAA rated senior unsubordinated debt of FNMA and FHLMC, these ratings remain unchanged. The Town does not own equity or subordinated debt, which could be negatively impacted by the downturn in the housing market.

**Town Council Finance Committee**

The Council Finance Committee recommends a modified “buy and hold to maturity” approach. This approach would require Council to request that the Elected Treasurer sell approximately \$2.3 million of Fannie Mae/Freddie Mac investments that return an effective yield of less than 4.25% to the Town. The remaining \$6 million in Fannie Mae and Freddie Mac notes would be held to maturity. This action would decrease the Town’s exposure in Fannie Mae/Freddie Mac investments, but retain higher yielding notes, earning interest for Town operations.

MBIA Asset Management believes the sale of these shorter term maturities would result in a break even, small gain, or small loss on principal. The Treasurer indicated that the net proceeds could be reinvested in other GSEs, such as the Federal Farm Credit Bank for an annual return of approximately 3.9%. The Council Finance Committee recommends no change to the holding and investment strategy for the Federal Home Loan Bank notes.

**Town Staff**

Staff recognizes the current uncertainty in the housing market and the concerns of the Council Finance Committee. While there is some level of risk in the “hold to maturity” approach, staff supports the recommendation of the Treasurer and MBIA Asset Management Advisory Services. However, staff agrees that the risk of loss could be reduced or mitigated by the proposed sale of some of the maturities and reinvesting in other notes, as recommended by the Finance Committee. Staff also recommends no change to the holding and investment strategy for the Federal Home Loan Bank notes.

**CONCLUSION**

As part of its investment strategy, the Town has prudently used diversification to achieve returns that contribute to the financial stability of the Town. This result has been accomplished by using a variety of financial instruments, including U.S Treasury notes, investments in the Local Agency Investment Fund, government-sponsored enterprises like Fannie Mae and Freddie Mac notes, and highly rated corporate notes, all of which have varying degrees of risk as allowed by state law.

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It is staff's position that the Town's portfolio is properly balanced in part by the Fannie Mae/Freddie Mac notes, which consistently provide the Town competitive returns. While holding these investments does have some risk of uncertainty, the "buy and hold to maturity" philosophy continues to be a sound approach in portfolio management. However, given the current economic uncertainty, Council may wish to explore other investment alternatives as suggested by the Council Finance Committee.

FISCAL IMPACT:

The estimated fiscal consequences of each alternative strategy are presented in the following table for Town Council's consideration.

| Alternative Strategies  | Estimated Interest Earnings | Principal Gain/(Loss)   | Comments   |
|---|-----------------------------|---|--|
| <b>Treasurer and MBIA-"Buy and Hold" Approach</b>   | \$ 878,000                  | None, full principal paid upon maturity of investment.  | Assumes no loss of principal due to failure of FNMA or Freddie Mac   |
| <b>Finance Committee "Modified Buy and Hold" approach</b>   | \$ 872,000                  | Potential small gain, break-even scenario, or potential small loss of invested principal.             | Shorter term lower yielding investments in FNMA and Freddie Mac are subject to risk of loss of principal as interest rates rise. |
| <b>Sell entire position in FNMA and Freddie Mac notes and reinvest in average 3.4% investments.</b> | \$ 655,000                  | Likely an overall "one-time" gain of approximately \$40-70K depending upon prevailing interest rates. | Not a current recommendation of Town Treasurer, Finance Committee or staff.  |