Who benefits?

*The accounting scandal at Fannie Mae has been an unfolding story for the past two years. However, **David Rowe** asks whether events from the early 1990s should have provided an early warning of future trouble*

Last month's cover story in *Risk* highlighted concern about the use of derivatives by inexperienced German municipal finance departments. The article recalled the events of 1994, which was a tough year for derivatives professionals. After long boasting about the notional volume of contracts booked, many professionals retreated to describing themselves as mere financial managers. The catalyst for such atypical modesty was a string of well-publicised losses during the course of the year. Prominent among these were losses at Proctor & Gamble and Gibson Greeting Cards. The greatest of these disasters, however, was the $1.6 billion loss incurred by the treasury of Orange County California, which led to it declaring bankruptcy.

There are important parallels between the financial environment of the early 1990s and the present economic conditions – in particular, the dramatic decline of interest rates throughout 1992 and 1993. After peaking at almost 9.9% in March 1989, the monthly average federal funds rate dropped to 4.4% by the end of 1991.

By the end of 1992, it had fallen to 3% and remained remarkably stable at that level throughout 1993. This decline in interest rates prompted many investors to look for opportunities to enhance yields. It also was a period of significant innovation in financial products, as dealers competed to introduce new structures where they could enjoy at least temporary shelter from the grinding pressure on margins – sound familiar?

Into this environment stepped Robert Citron, treasurer of Orange County. Throughout much of the late 1980s and early 1990s, Citron was viewed as a wizard in the municipal finance world. He consistently generated above-average returns on supposedly secure short-term investment funds. In large measure, he did this the old fashioned way – by the use of leverage. His $7 billion investment pool was supplemented by almost twice that much in short-term borrowing, giving him about $20 billion to invest.

Obviously, leverage does not work unless the investments return more than the cost of borrowing. The typical ploy of borrowing short and investing long would have been easily recognised as an overly risky approach for an ostensibly conservative fund. As fate would have it, however, new instruments were being created that accomplished the same thing in less obvious ways. Citron invested in a variety of structured notes that offered above market yields but entailed the potential loss of capital if rates rose. These included inverse floaters and more complex structured notes with similar risk characteristics.

One aspect of this story that is seldom touched on, is the ultimate source of these exotic instruments. For the most part, they were obligations of federally-sponsored credit agencies, including the Federal National Mortgage Association, popularly known as Fannie Mae. Despite their significant market risk, the short maturity and government sponsored obligors of these instruments allowed them to fit within the letter of Orange County's formal investment guidelines. The notes were short-term and issued by highly rated obligors. This allowed these investments to be accurately described in public disclosures as, for example, "a $100 million AAA-rated FNMA three-year note".

There were two types of beneficiaries from the creation and sale of these complex agency securities. The most obvious were the investment banks who engineered them. Their role was roundly and appropriately condemned at the time, and they paid millions to settle the resulting lawsuits.

There were other beneficiaries, however, that were hardly mentioned at the time – namely the federally-sponsored credit agencies themselves. While the notes paid an above market yield, the agencies were effectively long a series of interest rate caps that were sold to the investment banks. The net result was below market funding for the agencies.

In retrospect, it is clear that these federally-sponsored agencies were operating as aggressive, profit-maximising entities seeking their own advantage, rather than meeting the mandated goal of serving the public interest. More recently, of course, Fannie Mae has been the subject of an unfolding accounting scandal involving multiple restatements of past financial results. Perhaps we all should have been warned of future problems with these agencies, based on their role in the structured note debacle of the early 1990s.

All this highlights two bits of ancient wisdom. First, always ask 'who benefits?' If even a portion of the public outrage over the aggressive marketing of structured notes had been directed at the sponsored agencies, perhaps more recent problems would have been avoided. Second, excess returns always entail excess risk. German municipalities would do well to keep both lessons clearly in mind. ■

David Rowe is executive vice-president for risk management at SunGard-Adaptiv. Email: david.rowe@risk.sungard.com