

The **GSE** REPORT™

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*Special Supplement*

**MAKING SENSE OUT OF  
S&P's GSE RATINGS**

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## MAKING SENSE OUT OF S&P's GSE RATINGS

### ***Background:***

Last year, Fannie Mae and Freddie Mac announced that they were voluntarily adopting six ways to improve their risk management and disclosure practices. This agreement was described in a document entitled, "Enhancing GSE Capital Strength, Risk Management, and Market Discipline."

As part of last year's agreement, Fannie Mae and Freddie Mac agreed to obtain and release, on an annual basis, a rating of the GSEs' "risk to the government" or independent financial strength from a nationally recognized statistical rating organization. The GSEs claim they have fulfilled this commitment and even gone beyond the voluntary agreement. While the voluntary agreement called only for an annual "point-in-time" rating, the GSEs requested that the rating be maintained on a continuous "surveillance" basis that Standard & Poors ("S&P") will report to the public if either of the GSEs' financial strength changes. These ratings do not apply to any debt securities the GSEs issue. Both companies' senior debt is rated AAA.

As part of last year's voluntary agreement, Fannie Mae and Freddie Mac also agreed to issue subordinated debt, debt obligations that are to be repaid only after the holders of senior debt have been paid. The subordinated debt is "externally rated" and publicly traded. The GSEs will issue subordinated debt in an amount that would grow, over a three-year transition period, to four percent of on-balance sheet assets. According to one report, the two GSEs might issue \$15 billion in such debt. The GSEs' subordinated debt issues that began this year are rated AA.

### ***The Myth and the Reality***

#### S&Ps "Risk to the Government" Rating:

Despite assertions by both GSEs to the contrary, it is questionable that the new S&P rating truly reflects the financial of the GSEs without its GSE status and without any tie to the U.S. government. While the recent S&P rating has not been made public, a similar S&P risk to the government rating that was issued in 1997 in response to requests from OFHEO and Congressman Baker was released. The 1997 S&P rating gave both companies AA- ratings, like the ratings that were just issued. Importantly, however, these ratings overstated their financial strength because they took into account the fact that the federal government is the implied guarantor of their debts. In the words of S&P:

*Both companies maintain capital levels that are relatively low when compared with what Standard and Poor's would expect to see at fully private companies with similar risk profiles at the "AA-" rating level.*

S&P later added:

*Their ability to issue debt instruments with “agency status” enables Fannie Mae and Freddie Mac to access the capital markets even in time of financial stress, resulting in a high level of financial flexibility not experienced by fully private companies.*

Thus, S&P’s rating was not based on their capital adequacy, but rather on their ability to issue debt, even in times of financial stress, because of their status as a government-sponsored enterprise.

### The GSEs’ Externally Rated Subordinated Debt

Under the voluntary agreement announced last year, the GSEs would issue subordinated debt, debt obligations that are to be repaid only after the holders of senior debt have been paid. The GSEs’ voluntary initiative points to a 1999 Federal Reserve Board staff study titled, “Using Subordinated Debt as an Instrument of Market Discipline.” For banks, many reforms have advocated using subordinated debt as a market test of the perceived safety and soundness of the financial institution.

For banks, this is a good idea. It turns subordinated debt holders into watchdogs because the federal government backs the insured deposits of a bank, but does not guarantee the bank’s subordinated debt obligations. It also insulates taxpayers somewhat from claims on the FDIC trust fund. Such claims would be paid only after subordinated debt holders, like shareholders, lose all of their money.

For GSEs, the issuance of subordinated debt creates only the illusion of real discipline. In reality, no market discipline is administered. The GSEs’ voluntary initiative is wrong to call such subordinated debt a “capital cushion.” Why? Investors treat existing GSE debt as though it has an implied federal guarantee, in part because the GSEs are viewed as “too big to fail.”

Technically, GSE debt is not formally guaranteed, but it trades as if it were. The new subordinated debt is viewed in the same fashion. The GSEs’ subordinated debt has been rated AA. Subordinated debt, by its very definition, is junk bond debt. The GSEs are the only entities in the marketplace that are issuing junk debt (subordinated debt) that is rated AA. The AA rating on the GSEs’ junk debt was given because of the GSEs ability to access the capital markets even in times of financial stress.

### ***Some Better Ideas***

1. OFHEO has authority currently to commission a rating. No new legislation is needed. OFHEO, not the GSEs, should –

- a. request an annual, independent rating every year in addition to risk-based capital evaluations, not in lieu of them, and
- b. establish the assumptions in the request for a rating that requests that S&P rate the GSEs as stand-alone companies without any implied or direct connection to the U.S. government.

The GSEs have the capacity to bring considerable pressure to bear on a rating agency. Unlike the usual rating in the private marketplace, there is no private investor that will be disappointed if a rating agency emerges with a rating of “risk to the government” based on “rosy” assumptions. That weakens the ability of the rating agencies to withstand GSE influence.

2. Congress could use subordinated debt to help create a genuine capital cushion and boost GSE market discipline. Congress should require each GSE to issue subordinated debt that automatically converts to equity in the event a GSE ceases to be adequately capitalized – i.e., when a GSE’s capital falls below the minimum capital standard. Investors who purchase securities with this conversion feature will be at risk if the GSE does not operate in a safe and sound manner. This will give investors the incentive to carefully monitor their investments. If the value of such securities falls, then government regulators and policymakers may have early warning that default risk is escalating. Then GSE subordinated debt could create better market discipline, and not merely an illusion.

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