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MoneyWise

HOME REFINANCING RESOUNDS ; LOW INTEREST RATES KEEP A BOOM ECHOING THROUGH THE MORTGAGE MARKET; REFINANCING SAVES MORE OVER TIME

Rick Moriarty Staff writer

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So you've heard your colleagues at work bragging about the unbelievably low rate they just got on their new mortgages, and you're wondering if it's time for you to refinance, too.

With mortgage rates reaching lows not seen since the early 1950s, it just might be time for you to join the "refi" craze - even if you refinanced a couple of years ago.

The average rate for a 30-year mortgage recently dipped to 5.1 percent, according to the Mortgage Bankers Association of America. For a 15-year mortgage, it was 4.6 percent.

Homeowners are racing to banks and mortgage brokers to take advantage of the low rates. Some will save hundreds and even thousands of dollars in mortgage payments annually. Others are shortening the terms of their loans to pay them off sooner.

The Mortgage Bankers Association forecasts that \$3 trillion in mortgages will be written this year, beating last year's record- setting mortgage volume by more than half a trillion dollars.

The association estimates nearly \$2 billion of that total, or 65 percent, will be due to mortgage **refinancings** - up from refinancing volumes of \$1.5 trillion in 2002 and \$1.2 trillion in 2001.

It's easy to see why. The savings from refinancing a mortgage at a lower rate can really add up.

A homeowner who obtained a \$100,000, 7-percent mortgage with a 30- year term just a year ago would be paying \$665 a month in principal and interest. Refinancing at 5.2 percent would lower the person's monthly payment to \$549 - a savings of \$116 a month, or \$1,392 a year. Over 30 years, the homeowner would save a total of \$41,760.

Steven and Anne Culhane of Manlius could be poster children for refinancing. They recently refinanced two 15-year mortgages on their three-bedroom colonial into a single, 30-year loan and lowered their monthly payments by \$940.

Anne, 39, a broker's assistant at Gallinger Real Estate, said she and her husband, a music teacher at East Syracuse-Minoa High School, had been paying \$1,800 a month on the two mortgages, which had a combined balance of \$132,000.

One of the mortgages, obtained when they bought the home in 1994, carried an 8.5 percent interest rate. The other, which they obtained in 1996 to finance a remodeling and expansion of the home and to consolidate credit card debt, had a 13.5 percent rate.

They replaced both mortgages in early May with a 6.5 percent loan that they obtained at Commonfund Mortgage Corp. Even after rolling \$4,000 in closing costs into the loan, their monthly payments are a much more manageable \$860.

"It's like a huge weight off our shoulders," Anne said.

How do you decide whether refinancing is right for you?

Experts say there are two main things to consider: The money you can save on your payments and how long you expect to live in the house.

First, compare the interest rate you are paying on your mortgage with current rates and calculate how much lower your monthly payment would be with the lower interest rate.

Check around with a few lenders to see what rate you can get. Some will give you their rates over the phone, and most post their latest rates on their Web sites.

Any bank or mortgage broker will calculate what your monthly payments would be if you refinance. But you can do it yourself by using any of the many mortgage payment calculators on the Web, such as the one at:

www.interest.com/calculators

You just type in an interest rate and the amount you wish to borrow, and the calculator will figure your monthly payments.

Next comes the only hard part to refinancing: figuring out how long you will live in the house.

Why is that important?

Because you need to know that to determine how long it will take for the savings you derive from refinancing to exceed the cost of obtaining the new loan.

Those costs are known as closing costs, because you usually pay them when you and the lender close on the loan. They can include an application fee, an appraisal fee, a credit report, a title search and title insurance, a property survey, a legal fee, a mortgage recording fee and any number of miscellaneous fees.

In Syracuse, the average closing costs on a \$100,000 mortgage are \$2,500 to \$3,000, mortgage lenders say. Some lenders advertise "no closing cost" mortgages, but they may charge higher interest rates than you could otherwise get.

In some cases, the mortgage company that issued your existing loan will cut you a break on closing costs if you refinance through them. Be sure to ask.

Most people do not pay the closing costs out of pocket. Instead, they roll the costs into the mortgage - in other words, they borrow a little bit more to pay those costs. It raises the borrower's monthly payments, but only by about \$14 to \$20.

"They don't feel it that way," said John Harris, regional sales manager for M&T Mortgage Corp.

A general rule is that it should not take more than two years to get back your closing costs. But if you know you will be in the house for more than that, there's no reason not to refinance even if the pay-back period is longer than two years.

With mortgage rates so low, many people will be staying in their homes longer than they otherwise might because they will not want to give up their low-rate mortgages, said Harry Cooper, a vice president of Commonfund Mortgage.

"You're not going to sell a home that has a 5 percent mortgage to grab an extra 300 or 400 square feet," he said.

For most people, it makes sense to refinance if they can lower their rate 1.5 to 2 percentage points, said Tim Smith, sales manager at Syracuse Securities.

Smith said refinancing might be a good idea even for people who think they will be moving in two or three years. But instead of obtaining a fixed-rate loan, they should consider an adjustable-rate one, he said.

The average rate on one-year adjustable-rate mortgages is 3.1 percent, according to the Mortgage Bankers Association. The risk to such mortgages is that their rates can go up every year, but the risk would be minimal for someone planning to move in two or three years, Smith said.

Even if refinancing makes sense for you right now, you might be thinking that waiting a little will pay off because rates could drop even more. But experts say waiting could cost you if rates go up.

"I wouldn't be sitting around waiting for them to go lower," said Smith. "How much lower can they go?"

Caption: PHOTO Marilu Lopez-Fretts/Staff photographer REFINANCING AND extending the time on the mortgage on their Manlius home allowed Anne and Steve Culhane to shave \$940 a month off their payments. They consolidated two 15-year loans, one of which had been used to renovate the home they share with their children Kaitlyn, 14; Shannon, 6; and Davis, 9. GRAPHIC: Falling rates. Color. The Post-Standard. Note: For text see microfilm.

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Dow Jones & Reuters

THE WALL STREET JOURNAL

Freddie, Fannie Dodge New Rules; Congress Fears Upsetting Housing

By **John D. McKinnon**

1,553 words

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A1

English

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WASHINGTON -- Despite a billion-dollar accounting scandal at Freddie Mac, the government-sponsored mortgage industry giant and its big sister Fannie Mae have escaped major legislative consequences for now.

Thanks mainly to fears that a heavy-handed response to the improper accounting would upset the housing market -- the still-fragile economy's biggest bright spot -- friends and foes alike say the companies likely will maintain the government privileges that have fueled their phenomenal growth and the ire of their critics.

Calls for reining in Freddie Mac and Fannie Mae have come from such prominent economists as William Poole, the St. Louis Federal Reserve Bank president. Mr. Poole in March warned of a potential "crisis" should the huge mortgage companies fail and called for the government to sever its ties with them.

Still, unless Freddie Mac's accounting scandal mushrooms enough to alter the political landscape, the companies' success at beating back the opposition just when they seemed most vulnerable would provide fresh evidence of their renowned lobbying ability and the impact of their outsize political contributions.

A principal lobbying target in recent weeks has been Louisiana Republican Rep. Richard Baker, chairman of the House Financial Services Committee's capital markets subcommittee. A longtime critic of the companies, Mr. Baker has aggressively argued that their lucrative connections to the federal government should be ended. But after Freddie and Fannie allies and top Bush administration officials urged him to avoid roiling the housing market, he agreed to hold most of his fire, introducing legislation last month that would beef up government oversight of the two companies but do little else. The bill includes none of Mr. Baker's more drastic prior proposals.

Fannie and Freddie are even less threatened in the Senate, where Banking Committee Chairman Richard Shelby, an Alabama Republican, says he's not yet sure any legislation is needed.

Freddie Mac is clearly chastened by the accounting irregularities, having forced out three top executives and going to great lengths to clean up past accounting errors. But neither it nor Fannie Mae is ready to give up its dominant role in the mortgage industry. The companies own or guarantee \$3.1 trillion in mortgages, or 45% of residential debt outstanding in the U.S.

Congress chartered the companies decades ago to shore up the home-loan industry by giving local banks a mechanism to sell mortgages. The companies buy mortgages from retail lenders and package them into securities that are sold to Wall Street investors, dispersing the risk of retail lending and freeing up capital for more loans.

Over the years, Congress gradually privatized Freddie and Fannie, but it has allowed them to retain significant government-backed advantages, as so-called government-sponsored enterprises. These include a direct line of credit from the Treasury and exemptions from some Securities and Exchange Commission rules and other regulations. They also are exempt from some state and local taxes. Under their congressional charters, the companies' boards include presidentially appointed members, giving them added government-endorsed cachet.

Publicly traded since 1970 and 1989, respectively, Fannie and Freddie rely heavily on such privileges, which foster a widespread belief that the government would back the companies' debt in the event of a catastrophe.

That implied backing allows them to borrow at bargain rates -- almost as low as what the Treasury gets when selling bonds. Federal Reserve Chairman Alan Greenspan has expressed concern "about the economic distortions created by the implied subsidies."

Rep. Baker, a former real-estate broker, sees parallels between the government's current laissez-faire attitude toward the companies and its hands-off approach to the savings-and-loan industry before it collapsed in the 1980s.

There are significant differences, including the government's explicit guarantee of S&L deposits with deposit insurance. But critics cite disturbing similarities between the GSEs of today and the S&L's of the 1980s: Both borrow money (often short-term) from investors to lend to homeowners (often long-term). Both may have to take ever-greater risks to grow. Both rely on investors who expect the government to intervene if the risks go sour. And both present Congress with tensions between finance and politics that are easier to defer than to resolve.

Critics point to Freddie Mac's recent problems with accounting for derivatives -- exotic financial instruments used to hedge risks -- as further evidence that structural changes are needed. Federal prosecutors, the SEC and the Freddie's and Fannie's regulator are poring over the company's books in search of evidence of fraud in the accounting snafu. Investigators are looking at whether improper accounting was used in order to smooth the company's earnings over time. Freddie has said it expects to have to restate earnings by boosting past profits between \$1.5 billion and \$4.5 billion.

Rep. Baker in prior years proposed eliminating the companies' Treasury line of credit and ridding their boards of presidentially appointed members. But his latest bill would merely strengthen oversight of the companies' financial soundness and have the Treasury take over that job from the Department of Housing and Urban Development. It would also give regulators more power to curb the companies' expansions into new businesses.

The companies' critics are disappointed that the opportunity for more-drastic action appears to have been lost. "I would like to see the Baker bill go further," said J.C. Watts, a former Oklahoma congressman who heads a group called FM Policy Focus that is funded by banks and other financial services industry competitors. Mr. Watts praised the Baker bill as a good start, but added, "Why should they have preferential treatment when it comes to the SEC? Why should they have these implicit guarantees?"

It's unlikely Congress will go much further. Heading toward an election year, President Bush and the Republicans who control the House and the Senate are desperate to keep the housing market humming. Legislation that cuts the companies' government ties could undermine that market, at least temporarily, by making it more expensive for them to borrow -- costs that inevitably would be passed on to consumers via higher interest rates.

In lobbying members of Congress over the past several weeks, Fannie and Freddie have been hitting that point hard. During a recent members-only meeting of Republicans on Mr. Baker's subcommittee, Rep. Robert Ney of Ohio -- one of the companies' close allies -- warned that the housing sector needed to be protected at all costs. Mr. Baker said Treasury officials and others in the administration have sent similar messages.

"People were saying, 'Something must be done,' but also 'Let's be measured in the response' " he says. "We don't want to contribute to upheaval."

"It's not surprising that the discussions to date have not gone in the direction of the charter, status or mission of the GSEs, because of the importance of the housing sector to the economy and the important role that the GSEs play," says Fannie Mae spokeswoman Janice Daue.

At a hearing before Rep. Baker's subcommittee later this month, Treasury officials are expected to back assuming oversight responsibility from HUD.

Mr. Baker and his political foes are watching the two companies' stock and debt prices closely to gauge Wall Street's reaction to his bill. Mr. Baker says he's encouraged by the lack of significant decline. People close to Fannie Mae and Freddie Mac say it's still too early to tell.

Critics say that lawmakers' preoccupation with market impacts suggests that the companies have become politically invincible. "I think these two agencies are so large and so politically powerful that no amount of

regulation and no regulator is effectively able to control them, because any real control would have an adverse effect on the housing market and that would have major political effects," says Peter Wallison, a scholar at the American Enterprise Institute, a conservative think tank. Mr. Wallison, a longtime critic, advocates completely privatizing and breaking up the two companies into smaller pieces.

Freddie and Fannie in recent years have made big investments in political contributions and lobbying firepower, winning lots of friends on congressional oversight committees. Eleven Republicans on Mr. Baker's subcommittee, including Mr. Ney, have benefited from fund-raisers hosted by Freddie Mac lobbyist Mitchell Delk at Galileo's, an elegant downtown Washington restaurant. Freddie says it hasn't sponsored those events.

Before Congress outlawed unregulated donations to political parties (known as soft money) Freddie Mac gave \$4 million in the 2002 election cycle -- a big increase over previous cycles and more than any other public U.S. company. Republicans got a bit more than half. Fannie Mae also was a major soft money donor, though not as big. Freddie Mac spent about \$9.8 million lobbying the government in 2002 and Fannie Mae spent about \$7.6 million -- more than almost any other U.S. company.

Freddie Mac and Fannie Mae officials long have contended that opponents in the banking world outgun them in such expenditures. "We remain active in part because Freddie Mac and Fannie Mae are the only two companies I know who have an entrenched, dedicated, national opposition group, one that is extremely well-funded," said David Palombi, a Freddie Mac spokesman.

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Dow Jones & Reuters

**Shock Turns To Grief In Bond Markets; 2003 Gains Erased**By **Agnes T. Crane**

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Dow Jones International News

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Of DOW JONES NEWSWIRES

NEW YORK -(Dow Jones)- So long easy money, hello pain.

Primary **dealers**, hedge funds and anybody else lulled into a trade based on the assumption that low interest rates were here to stay broke out the baseball bats this week to beat their way out of this highly leveraged bet.

In the process, they hammered Treasury yields to highs not seen since last summer and blew out swap spreads, agency spreads and most other interest rates products that benchmark to Treasuries, deepening their pain further.

Those who boasted huge returns and subsequent fat earnings in the first half of the 2003 are now crying uncle as they see what had been a phenomenal year turn into an ugly eyesore that few have the stomach to face. The selling reached a fever pitch late this week, after mortgage investors, who were also responsible for accelerating the pace of the bull run, stampeded toward a narrow exit.

"I can't remember a day like (Thursday)," said J.P. Marra, head of government bond trading at Lehman Brothers and a 13-year veteran in the fixed income markets. "The leverage is trying to come out of the market" and the mortgage community "have been the drivers" since the 10-year note breached 4.0%.

"It's highlighted to the market that these are not one-way, risk-free trades," said Marra, who believes the decline in the market will be far reaching, hurting **dealers**, hedge funds and institutional investors alike who had moved heavily into fixed income products.

At its worst point on Friday, the yield on the 10-year note nearly hit 4.60%, its highest watermark for the year and up 40 basis points in just one week. On top of that, 10-year swap spreads widened to nearly 30 basis points from last Friday and mortgage spreads, when also factoring in the rise in the current coupon, shot out around 75 basis points in one week.

Then, there is the agency debt market. The most actively traded Fannie Mae five-year note widened to 60 basis points over Treasuries Friday from 36 basis points a week earlier. The 10-year benchmark shot out to 65.8 basis points from 44.8 basis points in one week.

"The speed is the problem" rather than the actual levels, said Michael Krauss, chief technical strategist at J.P. Morgan in New York. He said he remembered seeing similar price swings in 1987 after the stock market crash and in 1994 when the Fed surprised the market by raising short term interest rates.

Large Investors Hit Hard

Since bond yields touched their all-time lows in mid-June, the 10-year note has piled on about 140 basis points, the five-year note, about 120 basis points and the two-year note, 70 basis points.

The anguish caused by the speed and breadth of the selloff cannot be overstated. Large investors had bet big that interest rates would remain near their historic lows for some time to come, a view supported by comments from Federal Reserve officials who warned that the possibility of deflation, although remote, could derail the economic recovery. Investors reckoned possible deflation on the horizon could mean only one thing: the Fed would buy long term Treasuries to combat falling prices.

So they leveraged up, euphoric that the so-called carry trades - borrowing cheaply and then going long in interest rate sensitive securities from Treasuries to mortgages to agencies - meant clean, easy and healthy returns. But then the Federal Reserve disappointed investors with what they felt was a halfhearted 25 basis point cut in the federal funds rate and a more upbeat assessment on the economy.

Then the great unwind of 2003 began. Leveraged accounts began to bail on what had been a very compelling trade. When the 10-year note reached 4.0%, however, the selling became vicious as the higher yields suddenly forced mortgage investors to sell across the fixed-income universe to rebalance their portfolios and counter an unwanted extension of duration, or average life expectancy, on their funds.

The numbers already paint a grim picture. According to Lipper Inc., a fund tracker based in New York, returns on U.S. Treasury funds have swung from 4.15% for the year as of June to down -1.80% at the close of July. U.S. mortgage funds yielded -1.88% for the year to date through July 31 versus 1.56% just one month ago.

"Everyone who's long interest rates has been hurt," said Alan Kral, portfolio manager at Trevor Stewart Burton & Jacobsen in New York, which manages \$600 million in fixed income funds. "You're going to see negative performance unless you were in cash."

The Lehman Aggregate Index was up 0.43% at close of business Thursday, having wiped out nearly all of its gains for the year. The index was up 3.36% at the end of June and 4.14% at the end of May.

While the bloodletting finally abated Friday, the magnitude and the unprecedented reversal from bull to bear market will be felt for some time to come. "We're correcting a three-and-a-half year bull market," noted Krauss, who reckons Treasuries are establishing a loose range, where the 10-year yield is bracketed between 4.20% and 4.70%.

Some market participants think the upper reaches of the range could heighten concerns about how much more large investors in bonds - such as banks and hedge funds - can withstand. On Friday, once the 10-year note approached 4.60%, a flight to quality bid emerged in the market as investors feared the carnage would put too much pressure on the financial system. "Someone is getting hurt and that will eventually get out," said Krauss. Ironically, this could act to further support Treasuries as investors cast about for a safe haven for their funds.

Ratings agency Standard & Poor's has already thrown down a warning card. In a report released Friday, the agency said U.S. banks could be at risk given their "substantial holdings" of mortgage-backed securities amid the sharp rise in bond yields.

"The last time rates were this low, (mortgage-backed securities) did not exist and as a result, banks and thrifts may not know the degree of extension risk embedded in their (mortgage) portfolios and residential loan books," said Charles Rauch, credit analyst at S&P.

It's not just the banks that may have underestimated the need to hedge their holdings aggressively. "Everyone had on some slightly open-ended trades," said Lehman's Marra. With confidence running high that the Fed would keep a lid on bond yields, there was "a little bit of complacency around hedging," he said.

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(Christine Richard and David Feldheim contributed to this report)

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Dow Jones & Reuters

Business

Interest rate swings often costly for Fannie Mae

ALEX BERENSON

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Interest rate swings often costly for **Fannie Mae**By ALEX BERENSON **New York Times**

Thursday, August 7, 2003

Fannie Mae, the giant mortgage finance company, faces much bigger losses from interest rate swings than it has publicly disclosed, according to computer models used by the company to estimate the value of its assets and debts.

At the end of last year, the models showed that **Fannie Mae's** giant portfolio would have lost almost \$8 billion in value if interest rates rose overnight by 1.5 percentage points, according to internal company documents provided to The **New York Times**. At that time, the market value of all the assets on **Fannie Mae's** books, minus all of the company's debts, was about \$15 billion, according to the company. So **Fannie Mae** would have lost half its market value from a rapid 1.5 percentage point increase in interest rates, according to the models.

With \$923 billion in assets, **Fannie Mae** is the second-largest financial company in the United States, trailing only Citigroup. **Fannie Mae**, which is sponsored by the federal government, helps keep mortgage rates down by buying mortgages from banks and selling them or its own bonds to investors around the world. But some investors and outside experts say the company has become dangerously large and highly leveraged, with too much debt and not enough equity.

The models were provided to the Times by a former **Fannie Mae** employee on the condition that he not be identified. Franklin Raines, the chairman of **Fannie Mae**, responded to a question at a news conference last week that **Fannie Mae** does not depend on the market value of its portfolio to judge the success of its business. Asked whether **Fannie Mae** constructed such estimates weekly, he did not respond.

In interviews Wednesday, **Fannie Mae** executives acknowledged that the company estimates the value of its portfolio weekly, though it discloses such information to investors only once a year. The models provided to the Times are several months old, the officials said, and present an incomplete and misleading view of **Fannie Mae's** finances. They added that **Fannie Mae** hedges its risks properly and discloses them fully to investors.

"There is no reason for anybody to be worried about the company," said Peter Niculescu, **Fannie Mae's** executive vice president for its mortgage portfolio. "We are very happy, comfortable, and proud of our performance this year in what has turned out to be a very volatile interest rate environment." Niculescu declined to say whether **Fannie Mae's** portfolio had gained or lost value this year.

The former employee, who now works for a company that does not directly compete with **Fannie Mae**, said he had decided to publicize the documents because he is worried that **Fannie Mae** is becoming a risk to taxpayers and the financial system.

Because **Fannie Mae** is so large, and because many investors believe that the federal government will repay its bonds if the company cannot, the government could become engaged in a very expensive bailout, the

company's critics warn.

For years, critics have also said that the company does not give them enough information to judge its risks.

"I have no clue" about the company's sensitivity to interest rate moves, said Stan Jonas of Fimat USA, a bond and **derivatives** broker. "But no one else does, either."

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Dow Jones & Reuters

Interview: Stan Jonas of FIMAT USA on the duration gap plaguing some mortgage companies

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English

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RON INSANA, co-anchor:

Well, mortgage demand dropped last week to its lowest level since July of 2002 because rates have risen so dramatically since June. And although the Fed left short-term **interest rates** at 45-year lows, the direction of mortgage rates will be determined more by the bond market than the Fed. Companies that issue and buy mortgages have clearly been adversely affected by the run-up in rates. So is that a serious problem for the markets and the economy? Stan Jonas is managing director of FIMAT USA, and he's been following the so-called duration gap plaguing some of these mortgage companies. And he joins us now to talk more about it.

Stan, good to see you. Thanks for being with us tonight.

Mr. STAN JONAS (FIMAT USA Managing Director): Hi ya, Ron.

INSANA: Well, you know, rates got hammered again today. They went up at the 10-year, and that means that mortgage rates next week will probably go up. What's going on right now?

Mr. JONAS: Well, it's not even clear that we can talk about interest rate movement anymore. What we're really--begin seeing is a risk premium that's entering into, unfortunately, both the government securities market and the swap market. This is the nightmare scenario that may be occurring; that the mortgage-backed players are just too big for the fixed-income marketplace. And their movements, very much like portfolio insurance back in 1987, is moving the market to areas where it will have potentially an impact on the real economy.

INSANA: So to--to use the expression from 1987, the use of dynamic hedging strategies, where you sell more bonds as bond go down, can create a problem not only in the Treasury market but the mortgage market as well. How so?

Mr. JONAS: Well, the mortgage market--let's put it this way. Mortgages themselves are not very risky. The problem is that the big players--and here we're really talking about the government-sponsored entities of Freddie Mac--Freddie Mac and Fannie Mae--are basically best described as, quote-unquote, in my opinion, "leveraged **hedge funds**." They buy these mortgages, and then they attempt to hedging them. And one of the lessons, as you and I know f--from our good friend Nassim Taleb is that a--very often when people start to hedge things, that's when they get risky. Just buying and holding and going ...(unintelligible) isn't a risky thing. Here you've got people that sort of have a recipe, and the recipe is very similar to 1987, and the recipe is buy high and sell low. And what's happening now is **interest rates** are going higher. They're mandated by their algorithms to keep on selling more and more securities.

INSANA: Now let me ask you about that, Stan, because I got an e-mail from Jason Lobo of Fannie Mae, who says they have been watching intently our coverage today of their monthly financial disclosures, saying that they do not use Treasury securities to rebalance their portfolios; that they can, as they deal with their duration gap issues, do a lot of things. They can purca--purchase new mortgages demonstrated by the 41 percent record July increase, issue more funding of shorter or longer term or cancel or add options and swaps. They may do that. Is the net effect still to put downward pressure on Treasury prices?

Mr. JONAS: Ah, it's even worse. What's happened is that they--by utilizing the swap market, which had previously been considered to be the most liquid area, they're basically turning the Treasury market into the tail of the big dog. And the big dog is basically what's happening to swap yields, and that's basically where Fannie Mae and Freddie Mac operate. The Treasury market's just merely a hedging vehicle. And what we see in Treasuries is the tail end of their hedging. But there's a much larger, more liquid market that's going on at the moment, and that's the swap market, which is precisely--which is--is being roiled by these hedging

opportunities, which is where the sign of that is the huge variance in the spread between Treasuries and swaps.

INSANA: All right. So net this out in English for us if you would. I know you've got a mathematical bias here. What happens if things get worse?

Mr. JONAS: Well, the--the problem is by getting worse, they get even worse because--it's just like when you're short an option. The lower prices go, the more their models tell them that they have to sell more, which in turn tells us that prices get lower. And as the old saying goes, when they go into the marketplace and they say to sell, the question is: To whom? And that's the problem they're finding out--is that since everybody knows what their algorithm is, it's basically like being caught. And that's why it's very much like Long-Term Capital. Everybody now either knows or assumes, which is even worse because we don't really know the details, what these people are going to be doing, and the marketplace tries to position itself in advance.

INSANA: All right. Stan, we'll leave it there. Good to see you. Thanks for being with us tonight.

Mr. JONAS: OK.

INSANA: Stan Jonas, managing director at FIMAT USA.

Coming up, an impressive performance for a firm devastated on September 11th, and rising US deficits are partly responsible. ESpeed's Howard Lutnick is our guest in the CEO Spotlight.

HERERA: And Going Places--it's not too early to think about next summer's vacation, especially if you want to go to the Olympics in Athens, Greece.

INSANA: Plus, Penthouse goes broke. We'll tell you how. All this and more when BUSINESS CENTER returns.

(Announcements)

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Dow Jones & Reuters

**Battered by bonds.**

By PHILIP COGGAN AND ELIZABETH RIGBY.

2,736 words

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Financial Times (FT.Com)

English

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Government bonds are supposed to be a safe and steady investment. But not in recent weeks. The US bond market has been on a switchback ride that first took yields down to their lowest levels in 45 years in June and then, in July, saw bond investors endure one of the worst months ever recorded.

The market's performance this year resembles the equity market's gyrations in 1987, the year of Black Monday. In retrospect, what was remarkable about 1987 was not just the speed of the crash - the US market lost 22 per cent in one day - but the phenomenal rise in the stock market in the first half of the year. Even with the crash, share prices were still ahead on the year.

Price slide shocks

Asian central banks

July's decline in Treasury bond prices must have come as an unpleasant shock for the market's most enthusiastic buyers - Asian central banks. Read

Similarly, when investors look back at this year, what may seem remarkable is not the speed at which bond yields rose in July, but the levels they reached in mid-June, when the yield on the 10 year note fell to 3.1 per cent.

Yields fell so sharply because of an extraordinary set of circumstances in the markets. Fundamental factors were boosted by the activities of speculators and demand from "captive" investors, who were then forced into buying Treasury bonds. When those factors dissipated, yields rose sharply.

This "bungee jump" move in the market has undoubtedly dented the performance of some **hedge funds**. It may also have tarnished the reputation of Alan Greenspan, the venerable chairman of the Federal Reserve. The Fed tried to repair some of the damage in Tuesday's statement, aiming to stabilise bond yields by indicating that short rates would be kept low for the foreseeable future. But the damage had already been done.

The early part of 2003 was a nervous time. Three years of falling equity prices and an imminent war with Iraq made investors risk-averse. At the same time, the global economy looked weak and there was little sign of inflationary pressures. Buying government bonds seemed a safe bet.

Retail investors certainly appeared to think so. Net cash inflows into US bond mutual funds had already climbed from \$88bn (GBP55bn) in 2001 to \$140bn in 2002, according to the Investment Company Institute. Another \$68bn was invested in the first six months of this year.

Furthermore, the Fed seemed to be encouraging investors to buy Treasury bonds. A speech by governor Ben Bernanke in November last year suggested measures that might head off deflationary pressures, including buying Treasury bonds to force down yields. When, in May, the Fed said that "the probability of an unwelcome substantial fall in inflation, though minor, exceeds that of a pick-up in inflation from a low level", there seemed a real risk that the Fed would be forced into deflation-fighting mode.

For speculative investors, such as **hedge funds** and the proprietary trading desks of banks, this seemed an attractive opportunity. The Fed seemed to be saying that it could not cut short-term **interest rates** much further because lower rates become less and less effective as they approach zero. But it could use its buying power to force down long-term yields. That prompted many people to bet that the gap between short and long rates would narrow - a flattening in the yield curve.

Added to that was demand from two other sources. First was the willingness of Asian central banks to buy Treasury bonds as part of their attempt to control the exchange rates of their currencies against the dollar.

The second group of buyers came from the holders of US fixed-rate mortgages and mortgage-backed securities. In the US, most borrowers take out fixed-rate loans but with the right to refinance at any time. Naturally, they tend to exercise that right when fixed rates (linked to government bond yields) are falling.

As homeowners refinance, mortgage lenders and the holders of mortgage-backed securities suddenly find that their long-term stream of income has been replaced with an infusion of cash. In other words, the duration of their portfolio has shortened. To counter this, they will tend to buy longer-dated fixed-income securities, such as Treasury bonds. This creates a self-reinforcing cycle, as bond yields are forced lower, prompting further refinancing.

Suddenly, in June, the market turned. One reason may have been the feeling that the economic data were improving and the risks of deflation were declining.

The data, however, hardly point to a dramatic shift in views. "Economists' inflation forecasts have barely moved, and the break-even inflation rate implied by the yield spread between conventional and inflation-indexed Treasuries has risen by a modest 30 basis points," says Mark Cliffe of ING Financial Markets. "Economists' forecasts for US economic growth have moved even less."

More decisive in turning the market was the Fed. In July, Mr Greenspan appeared to rule out the possibility of the Fed making bond purchases to depress yields, while hinting that short-term rates could fall even further.

In effect, Mr Greenspan was signalling a steepening of the yield curve, rather than the flattening of the curve that investors had been expecting. That caused a lot of investors to change their bets very quickly.

European markets were also seeing speculative bets in the first half of the year. "A lot of leveraged money had been speculating in the two-to three-year part of the euro market, betting on the view that the European Central Bank would be forced to slash rates to combat deflation," says Jan Loeys, managing director at JP Morgan Securities. "Many have now been forced to cover their positions."

The speculative investors were quickest to react. "Fixed-income assets are the province of Wall Street and **hedge funds** and they are very quick to bale out," says Nassim Nicholas Taleb, founder of Empirica Capital and author of *Fooled by Randomness*.

The mortgage-backed market in the US was also forced to move quickly. As bond yields rose, so did fixed mortgage rates. In mid-June, rates on 30-year fixed mortgages had reached 5.21 per cent, the lowest for more than 40 years. By early August, the rate had leapt to 6.34 per cent.

Rising rates meant there was no incentive for homeowners to refinance their loans. According to the Mortgage Bankers Association of America, mortgage refinancings dropped nearly 68 per cent from a record high in late May while overall mortgage applications fell 36 per cent in just three weeks.

As a result, the duration of the portfolios of mortgage agencies and holders of mortgage-backed securities lengthened considerably. To offset this, they tended to sell longer-dated assets, such as Treasury bonds. This selling drove up yields further, exacerbating the trend.

Suddenly, investors seemed to regard 3.1 per cent as an inadequate return for the risks involved in buying Treasury bonds. After all, the supply of government bonds is set to expand rapidly; the White House is forecasting a fiscal deficit of \$455bn this year; economists predict the UK will have to borrow GBP34bn next year; while in the euro-zone, France and Germany are struggling to meet the 3 per cent of gross domestic product limit on deficits, agreed at Maastricht.

This increase in supply would not have mattered when everyone was clamouring for bonds; but it will be harder to digest now that investors' appetite has diminished. Merrill Lynch's survey of global investors found that two thirds of fund managers expect 10-year bond yields to be higher a year from now. Most asset allocators are now underweight bonds.

As a result of this turmoil, many investors are now sitting on heavy bond losses. According to Lipper, the fund statistics specialists, general US Treasury bond mutual funds lost a record 5.7 per cent in July.

The biggest losses will have been incurred by the more speculative institutions. The sectors most exposed to the moves have been macro **hedge funds**, fixed-income players, arbitrage and managed futures funds. "All had the same position in place - they were long in the bond market - so we have seen a significant unwinding by macro **hedge funds**. They are going to be feeling the pain," said one London-based hedge fund manager.

Hennessee's hedge fund indices, which comprise 680 funds, showed a 1.68 per cent fall for fixed-income funds in July, while macro funds - up 8.25 per cent this year - were off 1.24 per cent for the month.

Some funds have been harder hit than others. Mail Capital, a \$280m macro fund set up by the former IIU trader, Stephen Mail, has lost 15 per cent in the past two months. And Camomille Associates, a \$64m macro outfit, said its \$32.5m macro fund was down 6.82 per cent last month.

The bigger funds have not escaped either. Clinton Group, the US-based \$5.3bn manager which runs a number of different **hedge funds**, lost 2.8 per cent in July on its \$640m fixed-income fund, while its \$1.6bn multi-strategy fund was down 1.85 per cent.

Meanwhile, Rubicon, one of London's most successful **hedge funds**, is thought to have lost about 7 per cent in July. Last year the \$2.9bn macro manager finished the year up 30.5 per cent. Managed futures funds, which use statistical models to track market trends, have also had a difficult couple of months, caught out by the bond market reversal. Dunn Capital, a US-based \$1.1bn hedge fund, lost 12.8 per cent in two months in its \$625m WMA programme, which made 54 per cent in 2002.

Brokers and investors now think some funds that have been hit particularly hard by the sell-off may be forced to close as investors redeem money.

Michel Nassif, managing director of Swiss-based Calabria, a hedge fund advisory group, concedes that some smaller funds may be forced to close in the coming months. "It is possible that you may have a few smaller funds that have not properly managed risk getting hard hit and losing 10 or 15 per cent. As a result, they may suffer some redemptions and some may have to close.

"Overall, the move in bonds was much stronger than the 1998 crisis but the fall-out for **hedge funds** has not been nearly as bad this time round; managers have been more intelligent about how they manage risk and how much leverage they use."

He also said that the volatility was a "good test" for the hedge fund industry because it exposed managers that had not managed risk well and reminded investors of the importance of diversifying their portfolios across different types of **hedge funds**.

Bank profits may also have been hit. Falling bond yields in the first half of 2003 were very good news for the proprietary trading arms of banks. Stuart Graham, banking analyst at Merrill Lynch, says that bond trading contributed 10-33 per cent of group revenues at the large wholesale and investment banks in the first half of the year.

While it is not impossible for traders to make money when bond yields are rising, it is a lot harder. Peter Wuffli, UBS president, said on Wednesday that second-half profits would not match the first-half numbers, partly because of the downturn in fixed-income markets.

The rise in bond yields will also affect the broader economy. One reason why US consumer spending has been so robust over the past three years is that homeowners have been able to refinance their mortgages at lower rates, increasing their spending power. In addition, they have used the process to release some of the equity from their homes, giving them further cash to spend.

Goldman Sachs estimates that mortgage equity withdrawal was running at an annualised pace of \$550bn in early 2003. About half of this money was likely to filter into consumer spending and home improvement.

The upward jump in bond yields has changed the picture. Goldman says that higher **interest rates** and slower house price gains are likely to cut the numbers in half over the next 18 months, knocking the equivalent of four-fifths of a percentage point off GDP growth. If that estimate is right, the US economic recovery may be weaker than many hope.

Perhaps the biggest impact in the long term, however, will be the decline in Mr Greenspan's reputation. Many investors feel misled by the Fed's actions this year. "The Fed's comments about the risk of deflation contributed to falling yields and the credibility of the Fed has now been damaged," says Michael Metcalfe of State Street.

In effect, investors feel they were manipulated into buying bonds in May, as part of a Fed strategy to keep yields low and boost the economy. But when the Fed did not follow its talk with action, investors lost out.

This will not stop investors from buying Treasury bonds, which still offer the most liquid market in the world. But bond investors have long memories. As the old Who song goes: "They won't get fooled again."

.....
Price slide shocks Asian central banks

July's decline in Treasury bond prices must have come as an unpleasant shock for the market's most enthusiastic buyers - Asian central banks.

China and Hong Kong have both pegged their currencies against the dollar, while Japan has been intervening in the foreign exchange markets to prevent the strengthening of the yen against the greenback.

In both cases, this has required the central banks to sell their own currencies and buy dollars. Rather than hold the money in cash deposits, central banks often convert a good part of the proceeds into Treasury bonds.

The sums involved have been huge. Combined purchases of Treasury securities by China and Hong Kong have reached \$290bn (GBP180bn), according to Chen Zao, chief emerging markets strategist at Bank Credit Analyst Research Group.

UBS estimates that Chinese and Japanese central banks funded about 45 per cent of the US's account deficit in the second quarter of this year.

The trade has mostly worked well for both sides. China and Japan, by holding down their exchange rates, have kept their exports competitive, while the US has found willing financiers for its soaring current account deficit.

In effect, the Asian countries have exchanged their goods for American IOUs.

The pace of support picked up in early 2003. According to Ashraf Laidi, chief currency analyst at MG Group, foreign inflows into US assets reached \$109.5bn in May, the highest monthly figure on record.

This burst of buying appears to have been related to the Federal Reserve's talk of unconventional policy measures. The Fed was suggesting that it might perform the equivalent of printing money to head off deflationary pressures.

In the long run, that would mean the debasement of the US currency. Such concerns probably contributed to the decline of the US dollar against the euro in the first half of the year.

But the general weakness of the dollar put even more pressure on the Asian central banks to keep buying, in order to prevent the appreciation of their currencies giving a further boost to demand for Treasury bonds.

If the Asian central banks had been acting as fund managers, trying to maximise performance, they would have

been better off investing in euro assets.

"There was a lot of buying of Treasury bonds in the second quarter and that money has gone in at the top of the market," says Michael Metcalfe, senior strategist at State Street. But buying euro-denominated bonds would have been pointless, given the aim of controlling the dollar exchange rate.

Nevertheless, the strength of the dollar in recent weeks must have reduced the need for the Chinese central bank to intervene, and thus cut its demand for Treasury bonds. At some point, the attitude of the Chinese authorities may change.

"The Chinese have accumulated so many Treasuries, they might be getting nervous. They don't have to sell," says Stephen Stanley, senior market economist at RBS Greenwich Capital. "If they just stop buying, it is a big negative for the market."

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Financial

Fannie Mae's Board Briefed on Troubles [CORRECTED 28 SEPT 2004]

David S. Hilzenrath

Washington Post Staff Writer

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PUBLISHED CORRECTIONS: A Sept. 21 Business article about a regulatory review of **Fannie Mae** incorrectly said the mortgage funding company had hired Stanley Sporkin, a former enforcement chief at the Securities and Exchange Commission. Sporkin was hired by **Fannie Mae's** regulator, the Office of Federal Housing Enterprise Oversight. (Published 9/22/04)

Fannie Mae's board of directors met yesterday to hear details about accounting problems its regulators have uncovered during a long-running review, according to a source familiar with the matter.

It was not clear if the problems were extensive enough to lead to a restatement of Fannie's past earnings, said a government official who had been briefed on the findings but spoke on condition of anonymity because the report had not been released to the public.

One area of concern involved possible "earnings management," the government source said. The term refers to making corporate financial results look stronger or steadier than they would otherwise appear, which can boost or protect a company's stock price. Some types of earnings management may comply with accounting rules, which are sometimes fuzzy or debatable; other types can cross the line into violations of securities laws.

Office of Federal Housing Enterprise Oversight regulators described "a number of circumstances that sounded troubling, and we need to know more," said an Securities and Exchange Commission official who was briefed on the findings last week.

"It does appear that smoothing has been a problem at **Fannie Mae**, . . . that there has been smoothing of earnings" in the company's financial reports, said Michael DiResto, spokesman for Rep. Richard H. Baker (R-La.).

Baker, a frequent critic of the company, chairs a House subcommittee that oversees **Fannie Mae**. Baker was briefed on OFHEO's finding over the weekend.

Spokesmen for **Fannie Mae** and OFHEO declined to comment on the review, which was reported yesterday in the **Wall Street Journal**. Several outside board members did not return calls, and one referred questions to the company.

The regulators hired the accounting firm Deloitte & Touche LLP in February to help scrutinize Fannie's accounting after revelations last year of elaborate manipulations at Freddie Mac, another private, government-chartered mortgage company. Freddie agreed to pay \$125 million and replaced its top executive team.

In May, OFHEO disclosed partial results of its review, saying **Fannie Mae** had not fully accounted for losses on certain assets that had declined in value.

Matters that regulators are now questioning include Fannie's accounting for complex financial contracts known as **derivatives** (which the company uses to hedge against interest-rate movements), the costs of loan originations and possible use of "cookie jar" reserves several years ago, a government official said. Cookie jar reserves are funds that companies place in reserve in times of bounty to draw upon and bolster reported financial performance when earnings are weak.

In a congressional briefing, the agency said it found shortcomings in **Fannie Mae's** internal controls and "discrepancies" with generally accepted accounting principles, said a congressional source, who would not be quoted by name because it was not the source's place to speak for the regulators.

Fannie and Freddie were chartered by the government to create a steady flow of funds for home mortgages. The companies borrow money from investors to buy mortgages from lenders, thus replenishing lenders' funds. They also package mortgages as securities for sale to investors. Fannie guarantees the payments on about \$1.9 trillion of mortgage-backed securities.

The scandal at Freddie Mac spurred efforts by the Bush administration and some members of Congress to create a new regulatory agency for Fannie and Freddie, but those efforts have stalled.

Fannie Mae recently hired Stanley Sporkin, former head of enforcement at the SEC, who declined to comment yesterday on the review.

Last year, as the problems at Freddie came to light, **Fannie Mae** Chairman Franklin D. Raines said Fannie had "not undertaken any transactions to distort our true financial condition."

Fannie Mae's stock closed yesterday at \$75.98, down \$1.23.

Staff writer Kathleen Day contributed to this report.

<http://www.washingtonpost.com>

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Dow Jones & Reuters

**UPDATE: Fannie Acctg Problems More Serious Than Freddie's**

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Dow Jones Capital Markets Report

English

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(Updates with quotes from a letter OFHEO Director Armando Falcon sent Fannie's board Monday.)

By Dawn Kopecki

OF DOW JONES NEWSWIRES

WASHINGTON (Dow Jones)--Fannie Mae's (FNM) federal regulator asked the company's board of directors to take immediate action correcting severe accounting deficiencies there, saying Thursday that Fannie's accounting problems are more serious than those found last year at smaller rival Freddie Mac (FRE).

The Office of Federal Housing Enterprise Oversight, in a scathing review of the company's accounting practices released late Wednesday, accused Fannie Mae executives of a wide-range of accounting abuses, including intentionally deferring expenses in at least one quarter to meet analysts' earnings expectations.

The regulator released Thursday a letter to Fannie's board from OFHEO Director Armando Falcon calling for immediate remedial action. OFHEO officials, who held a background briefing for reporters Thursday, wouldn't release a proposal Falcon gave the board. And they declined to say whether OFHEO asked the board to reaudit Fannie's books, replace top officers or hold additional capital. However, in the letter, Falcon warned the board, "you must realize I am prepared to act if the board does not."

OFHEO officials said Fannie's accounting problems are more serious, complex and larger in scope than the problems they found after Freddie Mac's auditor forced it to restate several years of earnings and to disclose evidence of accounting manipulation last year.

Officials said they couldn't estimate the magnitude of the problem at Fannie or whether a possible restatement would result in a net increase or decrease to previously reported earnings.

"These findings cannot be explained as mere differences in interpretation of accounting principles, but clear instances in which management sought to misapply and ignore accounting principles for the purposes of meeting investment analyst expectations," Falcon wrote. Falcon and other senior OFHEO officials weren't present at the briefing, which was conducted by the agency's technical staff.

However, they said they believe Fannie Mae executives intentionally manipulated the company's earnings to hit Wall Street analysts' expectations. OFHEO's report reflects instances where Fannie Mae executives appear to obstruct OFHEO's investigation. OFHEO officials wouldn't say whether they've referred those matters to the Department of Justice.

"The board and OFHEO are working to resolve any issues raised in the examination," said Fannie Mae spokeswoman Janice Daue, who declined further comment. [09-23-04 1558ET]

A spokesman from the U.S. Attorney's Office in the District of Columbia, which would investigate any criminal charges against Fannie or its executives, would not confirm nor deny whether OFHEO has referred any matters to them.

OFHEO officials said their report focused on just two main issues: problems with Fannie's implementation of financial accounting standard 133, or FAS 133, and problems with the way it estimated purchase premiums and discounts on certain securities and loans, governed by FAS 91. They emphasized that their investigation is ongoing and that more problems could surface. The report released Wednesday pointedly states that it reflects "findings to date."

OFHEO officials said they found problems with Fannie Mae's implementation of FAS 133 since the Financial Accounting Standards Board, or FASB, enacted it in 2000. FAS 133 requires companies to reflect changes in fair value on their derivatives contracts, which are used to hedge interest-rate and other risks, in the balance sheet. Under generally accepted accounting principles, or GAAP, gains and losses that were previously reported on a company's balance sheet have to be booked under income if the hedges are later found to be improper. In those cases, the accounting treatment for an entire pool of securities has to be unwound - even if a small fraction of the hedges used to offset the security were bad.

OFHEO officials said Fannie's pervasive use of improper hedges has tainted a vast majority of the company's \$1 trillion derivatives portfolio. That means those hedge relationships would likely get unwound if the company had to restate its financial reports, and gains and losses for those derivatives would impact past earnings.

Correcting FAS 133 errors had the biggest impact on Freddie Mac's restatement, which resulted in a cumulative increase of \$5.1 billion in net income from 2000 through 2002. Freddie discovered another \$200 million in mistakes it missed in its restatement that were added to its income for 2003.

While OFHEO officials said Fannie's FAS 133 mistakes would substantially impact its earnings, it committed more serious GAAP violations in the way it estimated purchase premiums and discounts on certain securities and loans, governed by FAS 91. While both companies appeared to have problems in that area, OFHEO officials said Fannie adjusted its estimates in a way that essentially maintained a reserve account without disclosing those reserves to investors. [09-23-04 1643ET]

Wall Street did not react favorably to another day of bad news.

Fannie Mae's stock tumbled by 5%, or \$3.54 a share, to a close of \$67.15 in heavy trading after a 6.5% drop on Wednesday. The stock has fallen by 13% since Friday's close of \$77.21 a share.

Spreads on Fannie Mae's triple-A-rated benchmark debt also took a beating, widening by 3 to 4 basis points compared to Treasuries on Thursday, making it more expensive for the company to raise money from Wall Street.

Standard & Poor's prepped investors for a possible downgrade on some of Fannie's debt, placing Fannie Mae's double-A-minus risk to government rating, subordinated debt ratings and preferred stock credit ratings on negative credit watch. It affirmed Fannie Mae's key senior, unsecured triple-A rating, which assumes the government will bail out bondholders in a crisis.

And shareholders filed on Thursday what could be the first of many class action lawsuits to come, charging Fannie Mae Chief Executive Franklin Raines, Chief Financial Officer Timothy Howard and Controller Leanne Spencer with securities fraud.

-By Dawn Kopecki, Dow Jones Newswires; 202-862-6637; Dawn.Kopecki@dowjones.com

(Christine Richard and Madeleine Lim in New York contributed to this story.) [09-23-04 1730ET]

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