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The Dismal Science: Freddie Hides in the Hedges

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Abstract (Document Summary)

Right now, nobody knows what, exactly, went wrong or what the ultimate dollar figure will be. But those reading between-the-lines of Fred's public statements think that Fred misaccounted for a lot of the derivatives used to hedge its portfolio. If true, that would be the good news. The bad news would be that Fred was actually speculating not hedging and, although its bet paid off (bigtime), the next time Fred might not be so lucky.

Fred makes tons of money from the favorable spread between its assets (retained mortgage-backed securities) and the debt it issues to buy those assets. Since investors take Fred's relationship with the federal government as a guaranteed bailout should the need arise, they don't much care about the risks that Fred takes on. This leaves Fred with the happy ability to borrow cheaply -- at rates slightly above U.S. government debt.

To belabor the obvious, Fred's finances give new meaning to the phrase black box. It is entirely possible that Fred itself lost track of what it was doing and any speculation was unintentional. (After all, the misplacement of billions of dollars went unnoticed by the Office of Federal Housing Enterprise Oversight whose only responsibility is to oversee Fred and Fannie.) But an unintentional speculation isn't any more reassuring than an intentional one. If Fred doesn't have a reasonable grasp on its finances, the plump payoff could just as easily have been a mighty wash-out.

Full Text (1018 words)

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It's obvious that Freddie Mac, the mortgage-financing behemoth, has a big problem. It seems to have misplaced somewhere between $1.5 billion and $4 billion of earnings.

Right now, nobody knows what, exactly, went wrong or what the ultimate dollar figure will be. But those reading between-the-lines of Fred's public statements think that Fred misaccounted for a lot of the derivatives used to hedge its portfolio. If true, that would be the good news. The bad news would be that Fred was actually speculating not hedging and, although its bet paid off (bigtime), the next time Fred might not be so lucky.

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However, in taking back its securities, Fred opens itself up to interest-rate risk. And, as Dwight Jaffee, finance professor at the University of California-Berkeley, points out, this risk comes in two flavors: the mismatch in the maturities of its assets and liabilities, and prepayment of the mortgages.

Fred's assets are long-term mortgages and a lot of its liabilities are short-term debt. If interest rates suddenly leap up, mortgage- holders will stick around, paying below market rates, while the short- term debt will have to be reissued at higher rates. On the other hand, if interest rates suddenly plunge, holders will prepay their mortgages, which then will be replaced with lower yielding ones while Fred is left paying above-market rates on its longer-term debt. In either case, the spread narrows and earnings suffer.

Simply put, mortgage-backed securities, with their embedded call options, are tricky instruments – especially when the debt that finances the securities is also exposed to interest-rate risk.

Any prudent institution, and Fred says it is among the most prudent, would want to hedge like mad against such a wicked exposure to interest-rate risk. So Fred makes a very big and public deal about how it uses derivative strategies to hedge against risk. Its annual report shows that Fred runs a huge book in derivatives, using both fixed and floating interest-rate swaps, interest-rate caps and floors, futures, options, swaptions, forward sales, Treasury futures and foreign- currency swaps.

But derivatives, which are little miracles of financial engineering, also make it easy to speculate. And the line between hedging and speculating is a snap to cross.

In theory, the difference between hedging and speculating is quite clear. In a textbook world, hedging means reducing a portfolio's net exposure to risk and speculating means allowing a portfolio's exposure to risk. With the former, expected investment returns are muted and, with the latter, expected returns are larger.

In practice, however, the difference between hedging and speculating is way murky. In fact, it's possible to speculate when hedging. Consider: A mortgage bond is vulnerable to a jump in interest rates. The bondholder can hedge against this risk by buying an option to sell Treasurys. If interest rates go up, the bondholder will lose money on the bond but will make money on the option that has, of course, become more valuable.

Here's how the hedge can become a speculation, however. The bondholder can buy options to hedge any amount of risk -- all the way from a smidge, say 1%, up to 150% and beyond. At 1%, the bondholder is underhedged and speculating that rates will go down, at 100% the bondholder is matched and not speculating at all, and at 150% the bondholder is now bearing the opposite risk and speculating that interest rates will go up. Perhaps, then, Fred's misplaced earnings bonanza was the result of speculation that interest-rates would fall -- a bet hidden in its hedges.

When interest rates declined, the value of Fred's portfolio of mortgage securities increased, sure. But any increase would have been dampened by an acceleration in mortgage prepayments. Since Fred would have been hedged for that prepayment acceleration, the negative effect of prepayments would have been offset by its hedges. "It seems likely that Freddie Mac engaged in overhedging or speculation so that its portfolio did even better than one would expect," says Janet Tavakoli, head of Tavakoli Structured Finance. "If the hedges were biased to do well when rates fell, then it's probable the portfolio was underhedged for a potential rise in interest rates."

If Ms. Tavakoli is right, then Fred's gains would be a delicious counterpoint to what happened at Fannie Mae last year. Fannie, which was underhedged for a fall in interest rates and thus possibly speculating that interest rates would go up, lost billions of dollars when rates moved down. Another possibility of course is that Fred was neither speculating nor hedging. The misplaced gain might have been hidden in a derivative designed to defer income or create the appearance that income occurred in later years -- a ploy that Fred disguised as a hedge.

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It's scary that nobody quite knows what Fred, one of the biggest financial institutions in the world, is up to. But more scary is the fact that as a government-sponsored entity, Fred is rock-and-rolling with taxpayer money.