A Second Bite?
Be wary of another helping of GSE preferreds
By Jim Reber

Even the most irascible, anti-big-government-minded, inflation-fearing bond investor must concede: You’re probably going to get your principal back.

The bond market’s performance confirm these expectations. Here in the United States, 10-year investment-grade corporates have averaged about 2.75 percent in yield this year. Virtually no credit risk premium is built into these levels. Bond investors are quite confident that a default, at least in their portfolios, will not occur.

Stocks are a different matter. Fannie Mae and Freddie Mac have now been in an administrative and legal purgatory for eight years that was intended to be short-lived. This purge wiped out the market value of the stock of both companies. Preferred stock shareholders, which included community banks, in particular felt gypped, because they purchased their shares when they carried solid investment-grade ratings from all national rating agencies.

Recent legal dialogue
Since August 2012, the quarterly earnings of the two housing government-sponsored enterprises (GSEs) have been funneled directly to the Treasury under the Net Worth Sweep (NWS). The argument made by the government was to protect the taxpayer, who at that point had invested $188 billion in senior preferred stock as a bailout. By 2014, all of the investment had been recouped, assuming the NWS was to be used for that purpose. In fact, Treasury still owns senior preferred stock in both organizations.

Since the advent of NWS, more than 20 lawsuits have been filed that argue private investors, which now are primarily hedge funds, are entitled to a restoration and retroactive payment of dividends. Speculative buying from 2012 through Sept. 30, 2014, caused prices of many preferred issues to increase 20 times (not 20 percent). Then came a ruling by a U.S. District Court for the District of Columbia that declared the NWS to be proper and legal. Preferred stock prices, again, came tumbling down.

Place your bets
Most of the outstanding preferreds, which number 42 different issues and $33 billion par, have market values that are about 12 percent of the original issue price. Sales volume varies by issue, but most trade in very small blocks of several hundred shares. The market values have essentially run in place for the last two years.

Occasionally community bankers will inquire with my colleagues and me about the upside in owning some of these issues at the deeply discounted prices. The proper metric for a banker to consider is this: Ca/D. These are the Moody’s and Standard & Poor’s bond ratings for each of these issues, respectively.

Caveat emptor
The S&P’s “D” ratings definition simply states, “A nonpaying issue with the issuer in default on debt instruments.” I have yet to see a community bank that has adopted an investment policy allowing such positions. So just from a regulatory standpoint, these are a no-go.

Still more to come! Fannie and Freddie remain vital to the housing finance industry, purchasing or guaranteeing about half of all mortgages originated in 2016. ICBA has been consistent in its criticism of the NWS and has called for a permanent capital plan to protect the taxpayer. The 2014 court ruling is being challenged on appeal. And the only advice your broker should give you about investing in the current GSE model is to run, not walk.
New ICBA Securities Board Members

ICBA Securities recently elected three leadership community bankers to its board of directors. They are Scott Heitkamp of ValueBank Texas in Corpus Christi, Texas; Mark Holmes of Cornerstone Bank in Wilson, N.C.; and John Witkowski of the Independent Bankers Association of New York State in Albany, N.Y.

Successful Webinar Series Concludes

Thanks to the hundreds of community bankers who participated in ICBA Securities’ Community Banking Matters webinars in 2016. Nearly 1,000 bankers earned Continuing Professional Education credit for the series. ICBA Securities’ exclusive broker Vining Sparks will announce next year’s agenda early in 2017.