THE VALUE ALLIANCE

Corporate Governance Alliance

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Executive Summary

The issues related to Freddie Mac (and more recently Fannie Mae) have created a heightened scrutiny related to financial institutions. The larger issue is not the accounting for derivatives and the definition of a hedge, but more broadly the ways financial institutions can (and do) smooth earnings. On the next page is an example (one of many) from *Economic Value Management* that shows a major bank's earnings over a ten year period and the difference between its accounting and economic returns.

The difference between the ever increasing accounting returns and the more volatile economic returns shows the effects of smoothing and of uneconomic transactions. In the year 3 to year 7 period, it may appear that the company's strategies are working, while the economic results provide a very different picture. It also represents the case of a firm that, immediately after this time period, was purchased in a major M and A deal by another company -- and in fact generated significant problems for the acquirer. (Directors of major financial firms tell me their CEOs would make similar mistakes in their own deliberations.)

So, how can financial intermediaries (insurance, lenders, investors) and companies respond?

In the case of D and O insurance, three major geneses for lawsuits include lack of disclosure, mergers, and compensation. Both companies and their financial intermediaries can benefit by paying careful attention to the answers to three questions.

(1) Is disclosure adequate to provide an understanding of gaps between accounting and economic returns? If not, there could be negative consequences and legal difficulties when the true picture emerges.

(2) Are merger targets analyzed on an economic basis, considering the long term impacts? If not, bad transactions will be made that drag down the results of the firm.

(3) Have executives been paid appropriately based on the economics generated rather than the accounting results presented? If a negative picture emerges, shareholders will be even more determined to "right" what they consider to be an unfair situation.

The "Background and Comment" on the following page discusses the Freddie Mac issues in more detail. The bottom line: there are ways companies and their financial intermediaries can limit risk and improve returns. With the right processes in place to answer these and other questions, the time of discovery of smoothing of results would not occur three years after the fact. When appropriately implemented by both companies and their financial intermediaries, early warning signals are put in place, and companies and their Boards can take corrective action that will benefit them. The question, however, remains: who will take the first step?

I would be pleased to discuss these issues further. (ebloxham@thevaluealliance.com; 614-571-7020)

With best regards,
Eleanor Bloxham
President, The Value Alliance and Corporate Governance Alliance

About us: We have over 25 years of experience working with over 600 companies, their CEOs and Boards – and their financial intermediaries. We have consulted to companies and to the world's largest financial intermediaries on customer relationships as well as peer and company analyses. We provide convenient, straightforward ways to ensure processes are in place to address these issues.

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Background and Comment

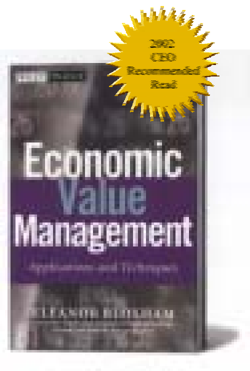
We are in new territory. And yet it has a familiar ring.

Remember the issue at Wells Fargo related to securities accounting? Two years ago Wells Fargo had an $87 mil loss ending June, 2001, the result of a billion dollar write-off associated with marking to market investments. CEO Kovacevich thought the mark to market rules were off-base and fought against marking the securities up in 2000; he had to yield given the FASB rules, only to write the investments back down when the market fell in 2001.

The issues at Freddie Mac have a familiar ring, but the circumstances are quite different. What happened as reported so far? (1) They classified up to $260 billion in mortgage securities as "hold to maturity" investments instead of as "available for sale“ recording them at cost instead of marking them to market. (2) Their nearly $1 trillion derivative portfolio was designated as interest rate risk hedges although much of it was speculative. (3) They failed to disclose their own contingent liabilities associated with the mortgage pools they securitize and sell, distorting their (regulatory) capital ratio. (4) To hold down the derivatives' value, and defer profits, some option-related derivatives were mis-valued because the company "did not incorporate all applicable market pricing data." (Source: USA Today 6/26)

While the primary reason for restatements is revenue recognition, CFOs say reserves are the primary way they manipulate the results. As issues like those at Freddie Mac occur, and investors and the media become even more attuned to the motivations behind smoothing, scrutiny is likely to increase, and financial institutions are particularly vulnerable. As is well recognized, at Enron, it was the trading business that started the recent wave of revelations. The proposals now being made related to fair value accounting will exacerbate not only the scrutiny but also the vulnerability of financial institutions as we move forward.

A recent worldwide conference by the fund industry revealed the belief that it will take years to restore investor trust. This poses opportunities for those willing to make the assertive moves required to restore trust; if not, companies and their financial intermediaries will find themselves buffeted by the scandal du jour.



Available at all online and most major bookstores

From: *Economic Value Management* by Eleanor Bloxham; John Wiley and Sons: Copyright 2003 All rights reserved. Named a "**late addition candidate for one of the Best Books of 2002**" by CEO Refresher and chosen as a **Featured Book Recommendation** by Harvard Business School's HBS Working Knowledge.

More information about the book at http://www.thevaluealliance.com/book.pdf

Exhibit 7.7 Loan Depot's Peer 5 Graph