

PMC Weekly Perspective – August 3, 2008

By: Bob Andres, Chief Investment Strategist

Bill Gaine, Research Strategist

This edition, of the PMC Weekly Perspective, utilizes a question and answer format to provide clarity on the issues and controversies surrounding Fannie Mae and Freddie Mac.

How would you define the role that Fannie Mae and Freddie Mac play within the U.S. housing market?

Both the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) are government-sponsored enterprises (GSEs) that provide funding for home mortgages in the U.S. Each is a public company authorized to make loans and loan guarantees. Currently they own or back \$5.2 trillion of the \$12 trillion of mortgages outstanding in the U.S.

What are the origins of FNMA and FHLMC?

FNMA was founded as a government agency in 1938 as part of Franklin Roosevelt's New Deal to provide liquidity to the mortgage market. In 1968, Fannie Mae was re-chartered by Congress as a shareholder-owned company, funded solely with private capital raised from investors on Wall Street and around the world, explicitly for the purpose of removing its debt from the balance sheet of the federal budget. FHLMC was created in 1970 to provide competition for FNMA.



How do both companies provide value to their shareholders?

They provide liquidity to the mortgage industry by purchasing mortgage loans from financial institutions. They then charge fees for loan guarantees on securitized mortgage-backed securities they structure. In essence, both organizations receive fees for guaranteeing the principal and interest payments of the underlying mortgage loans.

What agency oversees these two mortgage giants?

The Office of Federal Housing Oversight (OFHEO) is responsible for both companies. This agency is charged with monitoring the capital adequacy and financial safety of both GSEs.

How did FNMA and FHLMC get so large?

An implicit guarantee of the U.S. Government allowed both companies to borrow at favorable rates. This advantage provided an arbitrage opportunity through earning incremental returns relative to their cost of borrowing. They prospered as the housing market expanded, as did all other mortgage entities. The companies became politicized while experiencing unrestrained growth. This process was encouraged by management and tolerated by public officials. Management lost sight of their principal mission: to expand affordable housing while making capital available for the broader U.S. housing market.

What is the genesis for FNMA and FHLMC current problems?

Systemic issues involving too much liquidity, too much leverage and significant excesses in the financial engineering phenomenon have created the problem. Self-inflicted wounds also played a critical role and the negative situation was enhanced by greed, a broad under pricing of risk in the lending process and a questionable rating system. FNMA and FHLMC bought only "conforming" loans that were then repackaged and sold as mortgage-backed securities. Conforming loans are limited in size (although recently the size has been increased) and represent good quality borrowers. In the search for higher returns, both entities purchased private label mortgage-backed securities (subprime and ALT-A quality) in the secondary market. These securities were either held in their "retained" portfolio or resold for a profit or loss. In this process, FNMA and FHLMC took on attributes and risks normally associated with leveraged hedge funds and investment banks. Central to the current problem is the fact that both agencies were allowed to function and grow substantially while being under-funded. In December of 2007, the capitalization of both companies totaled approximately \$83 billion. This capital base supported over \$5 trillion in debt and guarantees. The implicit guarantee of the U.S. government and the fact that most of their business was in the form of conforming loans gave comfort that these high levels of leverage could be managed effectively. The approximate 15% decline in housing prices to date has led to a major increase in defaults, lower valuations on mortgage portfolios and substantial losses for both FNMA and FHLMC.

Are FNMA and FHLMC too big to fail?

The simple answer is yes. These two agencies play an integral role in the structural integrity of the U.S. housing market. The broad decline in the housing market has led to enormous write-offs by financial institutions, thus exacerbating the issues associated with a slowing economy while placing the entire financial system at risk. Allowing FNMA and FHLMC to fail, a process supported by some free-market system proponents, would lead to chaos in the housing market and a systemic banking crisis.

What are the main components of the Treasury's rescue plan?

Three main components provide the Treasury Department with substantial authority through 2009:

- Liquidity will be enhanced through a temporary increase in the line of credit extended to the agencies from the Treasury.
- The Treasury will have temporary authority to purchase equity in either agency in a plan designed to insure adequate access to capital.
- The plan calls for stringent regulatory reforms. The Federal Reserve has been given a consultative role in setting a broad range of standards including capital requirements.

The bill raises the U. S. debt ceiling to \$800 billion. This action leaves \$1.1 trillion (the difference between the debt limit and the current deficit) available to support the rescue plan. The result of this legislation is an explicit government guarantee of FNMA and FHLMC.

What are the expected capital needs of FNMA and FHLMC?

Their future capital needs will parallel the course of housing prices. The analysts at BCA Research have constructed three housing market scenarios designed to estimate the capital required to maintain minimum OFHEO standards. The first scenario suggests that an additional \$12 billion in new capital would be required if housing prices and transactions stabilize quickly. The second scenario suggests that an additional \$30 billion would be required if current trends continue through 2009 and into 2010. The third and most pessimistic scenario calls for an additional \$50 billion, with defaults tripling from current levels. The need for a capital infusion seems apparent. The only question is how much, and can it be raised privately through the capital markets.

Is nationalization a viable option?

Yes, nationalization is an option, though not the course of action preferred by the Treasury or the Fed. Any form of nationalization would reverse the original rationale for operating both FNMA and FHLMC as private companies i.e., keeping agency debt off the federal government's balance sheet. An option would be the bifurcation of assets. The high-risk retained portfolio could be nationalized and the conforming portfolio could form the base of both agencies' assets.

Would any form of nationalization adversely affect the credit rating of the U.S.?

This is highly unlikely. The U.S. has a more favorable debt/GDP ratio than most other AAA nations. In addition, any actual debt transferred to the government's balance sheet would have to be discounted by the value of the collateral. Dollar transfers, on the other hand, would increase the Federal deficit on a one to one basis.

What are the implications for taxpayers?

The taxpayer may have consequences despite the claims of Secretary Paulson. The amount of taxpayer liability is in direct relationship to home price declines in the future and the ability of both FNMA and FHLMC to raise capital in the financial markets. Taxpayer liabilities will need to be viewed in the broader context of the entire housing crisis. Three recent bank failures, including IndyMac and the likelihood of more as the crisis unfolds, will require taxpayer support for recapitalizing the FDIC.



What are the implications for bondholders and shareholders?

At first glance, bondholders appear to be in a better position than shareholders. These agencies have spent millions on lobbyists in the last ten years helping them develop and sustain a business enterprise that ran counter to their original charter. Their growth, earnings and inflated stock price were a consequence of the accelerated growth in housing and the simultaneous growth in higher yielding mortgage structures. The current rescue package gives the Fed "a consultative role" in "setting capital requirements and other prudent standards." Political support for both GSEs will be undermined by the potential negative impact on taxpayers. It seems likely that Chairman Bernanke, armed with new consultative powers, will be in a position to set in motion his views expressed in a speech last March before the Independent Community Bankers of America's Annual Convention. He stated: "Legislation to strengthen the regulation and supervision of GSEs is highly desirable, both to ensure that these companies pose fewer risks to the financial system and to direct them toward activities that provide important social benefits." He continued, "financial safety and soundness can be enhanced by giving the GSE regulator capital powers comparable to those of bank supervisors, and by creating a clear and credible receivership process that leads debt holders to recognize that they would suffer financial losses should a GSE fail." Finally, the Federal Reserve Board believes that the GSEs investment portfolios should be firmly anchored to a measurable public purpose, such as the promotion of affordable housing. I believe this approach provides a reasonable balance of social costs and benefits for the GSE portfolios. In particular, this approach would re-focus the GSEs on the affordable housing objectives given to them by the Congress.

Fannie and Freddie have made political and economic comebacks in the past but currently the re-focusing winds are blowing. A re-structuring of both GSEs, if it occurs, will have its impact on future growth prospects and valuations. However, in whatever form the agencies re-appear, they will have a competitive advantage as a result of other mortgage entities fleeing the business.

Are both FNMA and FHLMC continuing to operate during this period?

Yes. In essence, they are the only option available. Today, they have a virtual monopoly, financing approximately 80% of current mortgage originations.

This exercise was designed to provide a basis for further analysis and discussion regarding the past, present and future viability of both Fannie Mae and Freddie Mac. The current situation is fluid and it should be understood that neither the questions nor the answers are seen as all encompassing or the final word on the topic.

Additional Assessments

Different Week, Same Music...

- **Investing** – We maintain our view expressed last November that in uncertain environments, investment strategies that allow one to win by not losing are the most rewarding.
- **The Fed** – We expect the Fed to leave rates unchanged on August 5th despite the views of President Plosser and his associates.
- **The Economy** – Expect further weakness into the fall (despite this week’s expected strong GDP numbers) as consumers, minus rebate checks, retrench and the housing mess deepens.
- **Equities** – Expect volatility to continue with limited upside until housing prices stabilize, energy prices decline further and investors come to understand that inflationary pressures are unwinding – financial stocks will remain vulnerable to further declines in housing prices.
- **Bonds** – We continue to think that the bond market is the beneficiary of the problems facing the economy and the equity market. The concept of a “flight to quality” is back in vogue. Bond valuations are supported by demand and the strong likelihood that the Fed is on hold through the end of the year.
- **Commodities** – We believe commodity prices will moderate as the global economy continues to slow – the global slowdown has trailed the decline in the U.S. and is now picking-up momentum.

The economic calendar this week includes the FOMC meeting on Tuesday, Initial Jobless Claims, Pending Home Sales and Consumer Credit on Thursday, and Productivity and Wholesale Inventories on Friday.

Sources consulted include: The Fannie Mae and Freddie Mac website, BCA Research, Forbes, Bloomberg News, Reuters, Western Asset, The Economist, and the Federal Reserve website.

This commentary is provided for informational and educational purposes only. It is not intended as and should not be used to provide investment advice and does not address or account for individual investor circumstances. Investment decisions should always be made based on the client’s specific financial needs and objectives, goals, time horizon and risk tolerance. The statements contained herein are based solely upon the opinions of PMC. All opinions and views constitute our judgments as of the date of writing and are subject to change at any time without notice. Information was obtained from third party sources, which we believe to be reliable but not guaranteed. Past performance is not indicative of future results.