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LITTLE SHORT-TERM POLITICAL RISK FOR FANNIE, FREDDIE

We seem to zig when others zag. For the last four years, CAN has warned that the Kings of the Hill, Fannie Mae and Freddie Mac, sat uneasily on their thrones. They were growing their balance sheets too fast, making too many enemies among lenders and lawmakers in the process, and making Alan Greenspan nervous about rising systemic risk. During the past 13 months, reformers have gained credibility as Washington learned that:

- In September 2002, Fannie hoodwinked its regulator, the Office of Federal Housing Enterprise Oversight (OFHEO). Fannie had made an unusually large bet on the direction of interest rates by allowing a sizable mismatch to open up between the overall maturity dates of Fannie's assets and liabilities, and it did not tell its regulator.

- In June 2003, Freddie disclosed that it had bamboozled OFHEO and shareholders by cooking its books, hiding $4 billion in profits. This deception also probably means filing false tax returns with the IRS.

- In September 2003, the New York Federal Home Loan Bank, one of twelve Federal Home Loan Banks or "FLUBs," announced that it had miscalculated the risks of mobile home lending, blowing $183 million of shareholders' money. Yet their regulator, the Federal Housing Finance Board, didn't know they were taking big bets on subprime loans. FLUBs lend funds to financial institutions who are members of the Federal Home Loan Bank system. Like Fannie and Freddie, the FLUBs have been expanding their balance sheets rapidly, with Uncle Sam their contingent guarantor.

This is enough to incite some congressional nobles to rebellion. After this triple whammy hit, Washington momentum is building toward challenging the unwritten law that the housing kings can't be overruled. Next year, Congress may present to the Kings of the Hill a housing Magna Carta.

Rebellion Leaders Have Slowly Recruited Their Troops

Since the late 1990's, when both Ralph Nader and the American Enterprise Institute held conferences warning about the unregulated growth of Fannie Mae and Freddie Mac, an increasing number of D.C. policymakers have become convinced that the regulatory procedures established in 1992 for the housing enterprises are not working. In 1999, the Federal Reserve Chairman added his voice in support of stronger GSE oversight. Unrest is growing with the perception that these government sponsored enterprises (GSEs) – Fannie, Freddie, and the FLUBs – may no longer offer a favorable cost-benefit ratio to the government. The key arguments made by reform advocates were laid out by Budget Director Holtz-Eakin in testimony

before the Senate Banking Committee on October 23. The CBO calculates that the GSEs receive subsidies of up to $15 billion annually, mostly by relying on the "implied federal guarantee" to shave their borrowing costs by about 41 basis points. Those direct borrowings now total more than $2 trillion.! To paraphrase the late Senator Dirksen, "41 basis points here and 41 basis points there and pretty soon you're talking about real money."

In return for providing a taxpayer-backed "implied guarantee" of trillions in GSE debt, mortgage borrowers get a small interest-rate benefit. Director Holtz-Eakin told the Senate Banking Committee mortgages qualifying for placement in a GSE-guaranteed mortgage-backed security typically carry an interest rate that is about one-quarter of a percent lower than other mortgages. For example, a homeowner with a $100,000 mortgage saves $250 a year, pre-tax – or about enough, after-tax, to buy two cups of Starbucks' "Coffee of the Day" every week.

The First Battlefield: The House Financial Services Commitee

The impetus for reform comes from Rep. Richard Baker (R-LA), Chairman of the Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises. Since 2000, Rep. Baker has been introducing bills to rein in Fannie Mae and Freddie Mac. HR 2575, The Secondary Mortgage Market Enterprises Regulatory Improvement Act, creates an independent safety and soundness regulator, moving this function out from a toothless OFHEO housed in HUD and into the Office of Thrift Supervision, an office within the Treasury Department that supervises savings and loan institutions.

In addition, the bill enhances the regulator's ability to enforce its oversight of capital adequacy by adjusting the risk factors used to calculate "risk-based capital" and "minimum capital." Assessments paid by the GSEs would be set to cover the cost of operating this independent regulator. HR 2575 contains no change to regulation of the twelve regional Federal Home Loan Banks, or FLUBs. Since introducing his bill, however, Baker has come out in favor of placing the FLUBs under the new regulator's control.

Baker cannot legislate in a vacuum. He has clashed with Fannie Mae and Freddie Mac before, so he knows how much influence they can exert on members of Congress. He has to worry, not only about Fannie Mae's lobbying power, but also whether the full Committee's leader, Bill Oxley (R-OH), will back him. Oxley in the past has been supportive of Fannie and Freddie, and did not show encouragement to Baker until the scandals broke. Now he says he favors a bill overhauling their regulator, but he wants a "consensus bill." These are code words for saying that Committee Democrats, lead by Barry Frank (D-MA) should be active players in shaping a compromise. Frank thinks things are fine as is and sees no reason to restrain Fannie and Freddie by saddling them with an effective regulator. If Oxley and Frank write the final bill with these perceptions foremost, then the event will resemble a Fannie/ Freddie dinner party.

The Second Initiative: The Senate Banking Committee

The pattern in the House is repeated in the Senate. Banking Committee Senators Chuck Hagel (R-NE), Elizabeth Dole (R-NC), and John Sununu, Jr. (R-NH) think it is time that Treasury pros take over the regulation of Fannie and Freddie, so they have introduced S. 1508, the Federal Enterprise Regulatory Reform Act of 2003. This bill puts Fannie Mae, Freddie Mac and the FLUBs under the authority of a single regulator that is part of the Treasury Department. S 1508 gives the new regulator broad authority to reset capital requirements and take supervisory action if a GSE is found to be undercapitalized. As in HR 2575, assessments paid by the GSEs would be set to cover the cost of operating this independent regulator. The Senate Banking Committee Chairman, Richard Shelby (R-AL), historically has enjoyed warm relations with Fannie and Freddie in the past. Still, he has said that he won't "write a bill without taking into account the views"of the three GOP energetic reformers on the Committee.

During the October 23 hearing, Chairman Shelby committed to making reform a priority for next year, at the same time emphasizing that a new regulator would have authority over the Federal Home Loan Banks as well as Fannie Mae and Freddie Mac.

The Bush Administration Takes a Stand with the Rebels

The Bush White House has never named reforming GSE oversight as a first term priority. However, after the cumulative impact of the scandals energized Congressional nobles, Administration officials have donned Robin Hood's robes and picked up a bow and arrow. Treasury Secretary John Snow has stated that any legislation that gains White House support must include provisions for a new, strong regulator for Fannie and Freddie housed inside Treasury which has the power to adjust risk-based and minimum capital standards and also approve new programs. In addition, FLUBs oversight eventually should be come under the authority of this new regulator. Assistant Treasury Secretary Wayne Abernathy has listed his own criteria for a new GSE regulator:

- Authority to review all safety and soundness areas, including financial, legal, and reputational;
- Ability to adjust both risk-based and minimum capital standards;
- Authority to order and oversee receivership;
- Right of prior approval for new activities;
- Accountability to the Treasury Department; and
- Independence from Congressional appropriations

Abernathy has been quoted saying that GSE reform legislation must be implemented in 2004.

What's Important to Investors in This Fight

The minimum capital standards are the key to investor impact. If the new regulator has the power to compel Fannie or Freddie to secure additional equity capital, it has the power to

dilute existing shareholders and simultaneously improve the security of their bondholders. Under current law, Fannie and Freddie must hold minimum capital which is set by statute to equal 2.5 percent of the mortgages retained in portfolio plus 0.45 percent of the mortgage-backed securities they guarantee. On September 30, 2003, OFHEO announced that at the end of June Fannie's minimal capital requirement was $29.1 billion and the firm exceeded this requirement by a mere $1.5 billion. By comparison, Freddie's minimal capital standard was $22.7 billion, which it exceeded by $6.3 billion. If OFHEO had the power today to compel Fannie to conduct a secondary equity offering to buttress its core capital to protect taxpayers, its stock price likely would be below what it is now, reflecting potential dilution risk. By comparison, Freddie's equity price probably would not be affected substantially.

Rep. Jim Leach (R-IA), who headed the House Banking Committee for six years, has pointed out that if Fannie, Freddie, and the FLUBs all are regulated by the same party, the regulator might move to a common minimum capital standard. For the FLUBs, the standard right now is 4 percent of mortgages held in portfolio. If Fannie had to operate with a 4 percent capital requirement on mortgages held in portfolio, instead of 2.5 percent, and the higher rate applied to $800 billion in mortgages it owns, it would have to raise $12 billion from the stock market to play on a "level playing field," just to retain the mortgages it already owns. This could lower earnings per share by 18 percent.

An empowered regulator also could raise the minimum capital requirement on GSE mortgage-backed securities from the present 0.45 percent. An industry source declares that fully private issuers face a 1.33 percent requirement. If a Treasury regulator raised this requirement enough, it would cause dilution *and* embolden competitors to enter the market, hurting earnings.

Chances For Passage and Recommendations for Investors

The GSE reformers have their best opportunity to press for stronger GSE oversight. Everyone says they favor changing the way the housing enterprises are regulated – including Fannie Mae and Freddie Mac. However, even with White House support and existing bicameral initiatives, reform is hardly a done deal. First, bills must pass the House and Senate, then be melded into consensus in conference. A new regulator may be in the making, but the GSEs will not sit on the sidelines. They will work actively to dilute the enforcement provisions of the bills. Fannie Mae and Freddie Mac can count on numerous congressional allies, whose sympathies have been nurtured by years of political contributions and astute lobbying, to slow momentum for tough standards.

There is just over a fifty percent chance that Robin Hood and the nobles will force the Kings of the Hill to sign a GSE Magna Carta that gives a Treasury regulator the power to set minimum capital standards. Legislation will not pass until next year, since members of Congress already are counting the days until they recess for the year. Assuming the Administration does convince skeptical majorities of the House and Senate Banking Committees to give a new Treasury regulator the power to compel higher minimum capital standards is no reason to believe that this new regulator *will* require them – or that it will insist on the FLUB rate. However, a

cautious analyst would assume a fifty percent chance that a new Treasury regulator would require the FLUB rate or compel a like minded hike in the MBS minimum capital requirement. As of now, therefore, there is about a 25 percent chance of an 18 percent dilution for Fannie shareholders. As far as federal political risk goes, this is not serious.

Investors, rest easy. Odds are,Washington will not seriously hurt the GSEs, this year or next. Stated differently, there is a 100 percent chance of no significant change in minimum capital standards until after the 2004 elections – and a75 percent chance of no significant change in minimum capital standards, even after the elections either. Furthermore, the passage of a bill will resolve for some time just how "bad" a Republican President and a Republican Congress will treat the GSEs. Others argue that being regulated by the Treasury would be a *plus* for GSE shareholders. They claim that the credibility of the implied federal guarantee of the GSEs debt would go up due to the bill. In the event of trouble, they hold, it was always more likely that a HUD regulated entity would be allowed to twist in the wind than one overseen by Treasury.

If "safety first" guides your equity philosophy, this is a good time to wait out the 25 percent chance of a Fannie shareholder dilution. For others, this might be a good time to zig while many are zagging.

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