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FANNIE, FREDDIE FRACAS

Fannie Mae and Freddie Mac equity investors rightly assess a political risk premium in evaluating their buy, sell, and hold decisions. The long run political climate continues to deteriorate. These two mortgage giants face both minor and major political risks. As Congressionally chartered and federally regulated enterprises, Fannie and Freddie must operate in a strategic environment defined by politics. So must their investors.

Congress, the Lesser Player

Long time Fannie and Freddie watchers know that Capitol Hill can generate headline risk whenever Congressman Richard Baker (R-LA), Chairman of the House Subcommittee on Government Sponsored Enterprises and Capital Markets, elects to hold hearings. Baker is the closest thing Fannie and Freddie have to a Congressional nemesis. At a Baker hearing on March 22, 2000, Clinton's Treasury Undersecretary Gensler first stated that Administration's skepticism that business as usual should continue. By the end of Baker's hearings, and debate over his reform legislation which never came close to passing, Fannie and Freddie share prices fell by 40 percent before recovering. On one bad day, when a letter from Alan Greenspan to Baker became public that was viewed by investors as unhelpful to Fannie and Freddie, Fannie Mae stock fell by 7 percent. Baker plans to resume his hearings before the end of June.

Baker thinks he is making headway. Eleven days ago he told the *New York Times* that he is gathering increasing support, publicly and privately, from his House colleagues. "More people are willing," he said, "to stand up and say at least something should be done." While the Chairman has not announced a final topic list, the Baker hearings are expected to cover these issues:

- the ability of Fannie Mae and Freddie Mac to withstand a ten-year "stress test" developed by the Office of Federal Housing Enterprise Oversight (OFHEO), their regulator inside HUD;
- the advisability of transferring regulatory oversight of Fannie Mae and Freddie Mac to a more powerful body – the Treasury Department or possibly the Federal Reserve;
- the desirability of eliminating Fannie and Freddie exemptions from SEC registration requirements as proposed under the Shays-Markey bill, HR 4071, the Uniform Securities Disclosure Act;
- the utility of creating a third federally chartered entity – or even more – to compete with Fannie and Freddie, most likely by privatizing Ginnie Mae or expanding Ginnie's secondary market presence.

Public debate has long centered on whether these two housing government sponsored enterprises (GSEs) are adequately capitalized. After laboring for ten years, OFHEO, finally produced a computer model driven “stress test” that measures whether the companies could withstand harsh economic conditions without going under. Equity investors in particular care because a negative answer means dilution is not far behind as the companies would be forced to issue more shares to strengthen their capital bases. Critics claim that OFHEO went soft and made the test too easy. Time may one day tell, but the practical consequence is that dilution is not a serious risk for the foreseeable future. The GSEs are expected to pass OFHEO’s first stress test, with room to spare. If this is Baker’s main topic in June, the hearing will be a non-event, or maybe even a boon, for shareholders. If Baker moves on to other issues, political risk rises.

The Most Immediate Legislative Risk Comes From Shays-Markey

Baker could bring up two other long-debated issues – stiffer regulation and enhanced competition. During this Congress and the prior one, he introduced bills that would shift Fannie and Freddie oversight from OFHEO to an independent regulator within Treasury or the Federal Reserve. Recently, during an interview on CNBC, he commended Rep. Marge Roukema’s (R-NJ) proposal for “Ginnie Mae Choice,” which would allow Ginnie Mae to compete with Fannie Mae and Freddie Mac in the secondary market for conforming mortgages. However, the political risk generated by these issues is negligible for now. No one is saluting. The new topic addressed in HR 4071, SEC registration, is the only legislative idea with any momentum. It’s unlikely to pass before Congress adjourns this year, but will pose a serious threat next year, provided the GOP controls Congress after the November elections. Therefore, it warrants discussion.

Fannie Mae and Freddie Mac, which together earned nearly \$10 billion in 2001, are exempt from SEC registration requirements. These two mortgage finance powerhouses are the only members of the Fortune 500 with this special exemption. It is a remarkable federal favor, given that they issued \$918 billion in mortgage backed securities (MBS) last year as well as \$485 billion in unsecured debt. CAN estimates that HR 4071 would cost Fannie and Freddie \$130 million in annual registration fees.

In addition, HR 4071 is likely to lower Fannie’s and Freddie’s operating results by putting their secondary market MBS customers on a more equal footing with them. Currently, some MBS customers complain that they overbid for new MBS issues because Fannie and Freddie lace the pools with up to 10 percent of subprime mortgages. These loans have faster prepayments and higher default rates than plain vanilla mortgages that used to make up 100 percent of the mortgage pool backing an MBS. SEC disclosures would identify the mix of loans in pools, lowering the bids that investors would make for Fannie Mae and Freddie Mac blended MBSs. Peter Wallison, a scholar at the American Enterprise Institute, also asserts that some purchasers of MBS who later resell them back to Fannie Mae and Freddie Mac, complain that Fannie and Freddie understand their seasoned merchandise better than the investors who had owned the MBS – because they never reveal all the original underwriting data! Like antique dealers rummaging through garage sales, Fannie and Freddie cart off bargains, outwitting less knowledgeable sellers. HR 4071 may cut down this action.

Between SEC fees and lower MBS profits, our hunch is that HR 4071 would cost Fannie and Freddie about \$500 million a year, slicing about 5 percent off their earnings and presumably their stock prices.

Watch the Administration – It’s the Real Threat

When the Bush Administration sends a representative to testify before Richard Baker, issues more serious than those listed above may surface. Investors might find themselves faced with a pivotal event. If the Bush Administration takes a hostile position and expresses a desire to rein in the fast growing companies, investors should promptly sell on the news because later news will only get worse. If the Bush Administration gives the all clear sign, then Fannie and Freddie investors can breathe easier; they are probably safe for two years, and equity prices likely will rally. There also is the considerable possibility of a mixed message – criticism and praise in rough balance – combined with statements that the matter remains under review.

Equity investors are kidding themselves if they think the Bush Administration can’t hurt them. The financial press may have been chasing the wrong rabbit. It’s the Treasury Department that can unilaterally demolish per share earnings *any time it wants to, not Congressman Baker*. The benefits of the GSEs federal charters to shareholders are well known, especially the opportunity to float debt less expensively than any other for profit companies due their “implied federal guarantees.” What would happen if the Treasury curtails this subsidy?

Last year, the Congressional Budget Office found that Fannie Mae earned a 90 basis point arbitrage by issuing inexpensive debt, then using the proceeds to buy mortgages from mortgage originators or to buy back pools of conforming mortgages it had issued earlier. Freddie Mac, CBO said, made 80 basis points in arbitrage. Assuming CBO’s experts are correct, the GSEs liberal use of Uncle Sam’s credit card has helped to balloon Fannie and Freddie operating margins smartly over time. Arbitrage alone now generates GSE gross margins over \$10 billion annually, six times what it did ten years ago!

The Impact of Arbitrage on Fannie Mae and Freddie Mac Earnings

(\$ in millions)	Fannie Mae			Freddie Mac		
	Outstanding Debt	Mortgages & MBS Held	Arbitrage @ 90 bps spread	Outstanding Debt	Mortgages & MBS Held	Arbitrage @ 80 bps spread
1992	\$166,300	\$156,000	\$1,404	\$29,600	\$34,000	\$272
1993	\$201,100	\$190,000	\$1,710	\$50,000	\$56,000	\$448
1994	\$257,200	\$221,000	\$1,989	\$93,300	\$73,000	\$584
1995	\$299,200	\$253,000	\$2,277	\$120,000	\$108,000	\$864
1996	\$331,300	\$286,000	\$2,574	\$157,000	\$138,000	\$1,104
1997	\$369,800	\$317,000	\$2,853	\$169,200	\$165,000	\$1,320
1998	\$460,300	\$415,000	\$3,735	\$287,400	\$256,000	\$2,048
1999	\$547,600	\$523,000	\$4,707	\$360,700	\$323,000	\$2,584
2000	\$642,700	\$607,000	\$5,463	\$426,900	\$385,000	\$3,080
2001	\$763,500	\$705,000	\$6,345	\$561,900	\$492,000	\$3,936

Source: OFHEO, Bond Market Association, Fannie Mae and Freddie Mac Annual Reports

Fannie and Freddie now make most of their money as arbitragers. It's not the old fashioned way originally intended by Congress, credit enhancing and reselling bundled mortgages into the secondary market. By some estimates, Fannie and Freddie now are buying and holding for their *own accounts* over 70 percent of newly originated conforming fixed rate mortgages, basically funded through issuing new debt. **Unknown to 9,999 of 10,000 investors, the Treasury Department can end this game any time it wants to. It has sweeping power to do so under 12 USC 1719(b). Legal beagles can look it up at <http://www4.law.cornell.edu/uscode/12/1719.html> .**

The Clinton Administration did just the opposite. On March 8, 1996, it sent out a press release announcing that GSEs, including Fannie Mae and Freddie Mac, no longer had to check with the Treasury Department before issuing new debt. As the table above shows, the mortgage giants responded to this green light as drag racers would. When the start flag fell, Fannie and Freddie boosted their debt outstanding by \$780 billion by 2001. If there ever is a GSE-driven financial crisis, this will not be viewed as one of former Treasury Secretary Robert Rubin's better decisions. His reported Enron lobbying involvement will look better to historians.

The Administration has other ways to slow down Fannie and Freddie other than the power to block their access to the credit markets or condition it on whatever criteria it selects. For example, they are supposed to get prior approval from HUD before launching new programs. Despite the law, <http://www4.law.cornell.edu/uscode/12/4542> , Fannie and Freddie rarely wait for an "OK" from HUD before launching new programs.

Too Big to Fail or Too Big to Challenge?

The upcoming Baker hearings present the Bush Administration with the opportunity to publicly reverse favoritism granted to Fannie Mae and Freddie Mac by the Clinton Administration. All the White House has to say is that it wishes to exercise its right to deny, or slow down, further issuances of MBS or Fannie Mae and Freddie Mac unsecured debt. On that day, equity investors won't want to read their quotrons. The Fannie and Freddie growth story will be over. Despite the pleadings of many conservative economists, industry competitors including many of the largest banks in the U.S., and even Ralph Nader, to force reforms on the companies, the Administration probably won't do so this year.

Actions that rein in Fannie and Freddie could be perceived as gratuitously causing a financial crisis just months before pivotal Congressional elections. These two companies have become the primary source of mortgage funds in the U.S., and are financing a popular runup in home values nationwide. Their debt obligations also are major investment holdings for numerous financial institutions. According to the *New York Times* of May 21, 2002, "two-fifths of all United States financial institutions hold one to five times as much debt from these agencies as they do capital." Excessively aggressive Administration action that calls into question the creditworthiness of these obligations could produce a shock wave throughout the housing market and the financial system.

The Administration will weigh the impact of its words on the markets this summer against the benefit of slowing down the already dangerously large – \$1.3 trillion and growing – mountain of unsecured Fannie Mae and Freddie Mac debts that investors here and abroad believe the U.S. Treasury will guarantee if necessary. Allowing Fannie and Freddie to continue to grow exponentially also has risks. If either mismanages its business, it could precipitate an S & L style crisis many times larger than the last one.

Before this November's elections, the West Wing cost/benefit analysis is unlikely to generate a decision to confront the housing GSEs. Eventually however, Fannie and Freddie will prove Too Big to Ignore. The message to investors: don't overstay the party. The federal police will come at a time of their choosing, and they will bring this unruly profit festival under control.

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