



Industry Update

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Mortgage Finance: Government Sponsored Enterprise

GSEs Under Conservatorship-Implications for the GSEs and Beyond

Summary-- As a result of safety and soundness concerns by their regulator, Fannie Mae and Freddie Mac were placed under conservatorship over the weekend by the Federal Housing Finance Authority (FHFA), essentially the equivalent of a Chapter 11 bankruptcy. The U.S. Treasury will provide a capital backstop for the two companies and stand by to purchase GSE mortgage-backed securities, allowing the companies to continue to operate.

Key Points--

- We believe the moves by Treasury and the FHFA should stabilize the market for SE debt and mortgage-backed securities and narrow the spreads between mortgage rates and Treasury rates, thus providing support to the conventional mortgage market and the slumping housing industry. This is not, however, a long-term solution for the GSEs. It is our view that the position of the GSEs will be re-evaluated by Congress in 2009 and a permanent solution will be found. That solution is unlikely to provide meaningful value for the current preferred and common shareholders, in our view, unless there is a rapid near-term rebound in the U.S. housing market. We believe that the government has created a situation where the emergence of the GSEs from conservatorship into its historic corporate structure with common and preferred shareholders is difficult to imagine
- Our most likely eventual outcome for the GSEs is for Congress to develop a structure for them similar to the Federal Home Loan Banks that are essentially cooperatively owned by financial institution members. Similar to the FHLBs a capital structure could be set up such that future capital needs are generated by a portion of the guarantee fee charged to lenders. Under such a scenario, in our view, Congress would likely provide only very limited reimbursement of principal to common and preferred shareholders.
- We expect the broader equity markets to receive the news of conservatorship for the GSEs well as it removes a major uncertainty from the market. However, the added mortgage risk being absorbed by Treasury could result in Treasury rates rising over time. The net effect on mortgage rates will still be positive, in our view, achieving a modest overall benefit to the economy. Specific financial sectors to benefit should be MBS REITs, Title Insurance and Student Lenders, in our opinion.

GSEs Under Conservatorship-Implications for Fannie, Freddie and Beyond

As a result of safety and soundness concerns by their regulator, Fannie Mae and Freddie Mac were placed under conservatorship over the weekend by the Federal Housing Finance Authority (FHFA), essentially the equivalent of a Chapter 11 bankruptcy. The U.S. Treasury will provide a capital backstop for the two companies and stand by to purchase GSE mortgage-backed securities, allowing the companies to continue to operate. Key elements of the plan include:

- **New Owners/New Management:** Under conservatorship the FHFA now controls the companies and has sole voting authority. It was announced that the CEOs of both organizations would step down and that Herb Allison, chairman of TIAA-CREF, will become CEO of Fannie Mae and that David Moffitt, CFO of USB, would become the CEO of Freddie Mac.
- **Capital Backstop:** The Treasury will invest in senior preferred stock agreements in the GSEs, initially with a \$1 billion investment in each, but with provisions to invest up to \$100 billion in each as needed to ensure that firms have positive net wealth. The coupon on the new preferreds will be cumulative and is 10% per year, unless the GSEs miss a payment, in which case the coupon goes to 12%.
- **Secured Lending Facility for the GSEs and the FHLBs:** The Treasury has agreed to become the "lender of last resort" for the GSEs and the Federal Home Loan Bank system by creating a secured lending facility by which the GSEs and the FHLBs can borrow at LIBOR plus 50 through the Federal Reserve Bank of New York using agency guaranteed MBS and FHLB advances as collateral.
- **Treasury MBS Purchase Facility:** The Treasury committed to begin buying an undisclosed level of GSE guaranteed mortgage securities later this month. The program may continue through the end of next year with monthly reporting.
- **Common Shareholders in Diluted First Loss Position:** The position of the common shareholders to claims on the companies was maintained in first loss position and the Treasury received a warrant for 79.9% of the common shares at a "de minimis" price.
- **Preferred Shareholders Lose Dividend and are in Second Loss Position:** The dividend payments on the current preferreds at Fannie Mae (\$27.9 billion) and Freddie Mac (\$14.1 billion) were suspended by FHFA Director Lockhart. In addition, the preferreds were put in a junior position to the senior Treasury preferreds.
- **Undetermined Fee to be Imposed on the GSEs Beginning 3/31/2010:** The GSEs will be required to pay to the Treasury a "commitment fee" to compensate the Treasury for the explicit guarantee granted in the agreement. The fee is to be determined by the Treasury and FHFA, with consultation from the Federal Reserve.
- **Portfolio Growth Limited:** As part of the covenants on the new preferred, the GSEs have agreed to limit their growth to have retained portfolios of no more than \$850 billion each at the end of 2009 and then to shrink by 10% per year after that until they reach \$250 billion. Fannie Mae had a retained portfolio of \$758 billion at the end of July and Freddie Mac had a retained portfolio of \$798 billion.

We believe the moves by Treasury and the FHFA should stabilize the market for GSE debt and mortgage backed securities and narrow the spreads between mortgage rates and Treasury rates, thus providing support to the conventional mortgage market and the slumping housing industry. This is not, however, a long-term solution for the GSEs. It is our view that the position of the GSEs will be re-evaluated by Congress in 2009 and a permanent solution will be found. That solution is unlikely to provide meaningful value for the current preferred and common shareholders, in our view, unless there is a rapid near-term rebound in the U.S. housing market. We believe that the government has created a situation where the emergence of the GSEs from conservatorship into its historic corporate structure with common and preferred shareholders is difficult to imagine. There are at least three reasons for our conclusion:

- **Treasury Statement GSEs "will no longer be managed with a strategy to maximize common shareholder returns":** Without management to maximize shareholder value, it is difficult to imagine the companies under private control.
- **Future Access to the Equity Capital Markets is in Doubt:** By putting the preferred dividends on unlimited hold and removing control of the company by the common shareholders, the companies will have difficulty accessing private equity to support future operations, in our view.
- **With an Undisclosed Fee to Reimburse Taxpayers, Value is Nearly Impossible to Determine:** At a minimum, it is unlikely that the deferred tax assets at each company (\$20.6 billion at Fannie Mae and \$18.4 billion at Freddie Mac), which represent future tax refunds, would be allowed to be realized by the companies to benefit shareholders.

Our most likely eventual outcome for the GSEs is for Congress to develop a structure for them similar to the Federal Home Loan Banks that are essentially cooperatively owned by financial institution members. Similar to the FHLBs, a capital structure could be set up such that future capital needs are generated by a portion of the guarantee fee charged to lenders. Under such a scenario, in our view, Congress would likely provide only very limited reimbursement of principal to common shareholders.

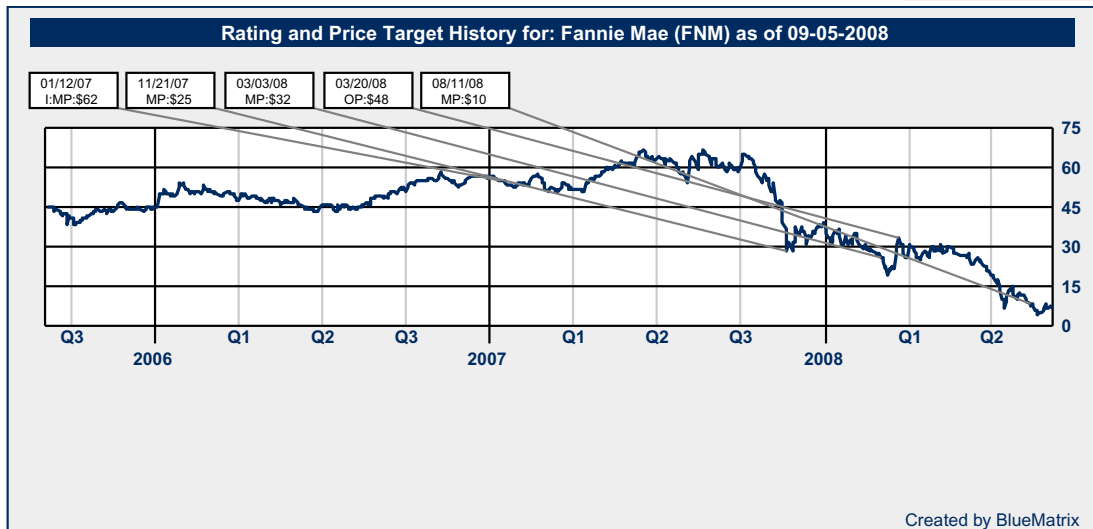
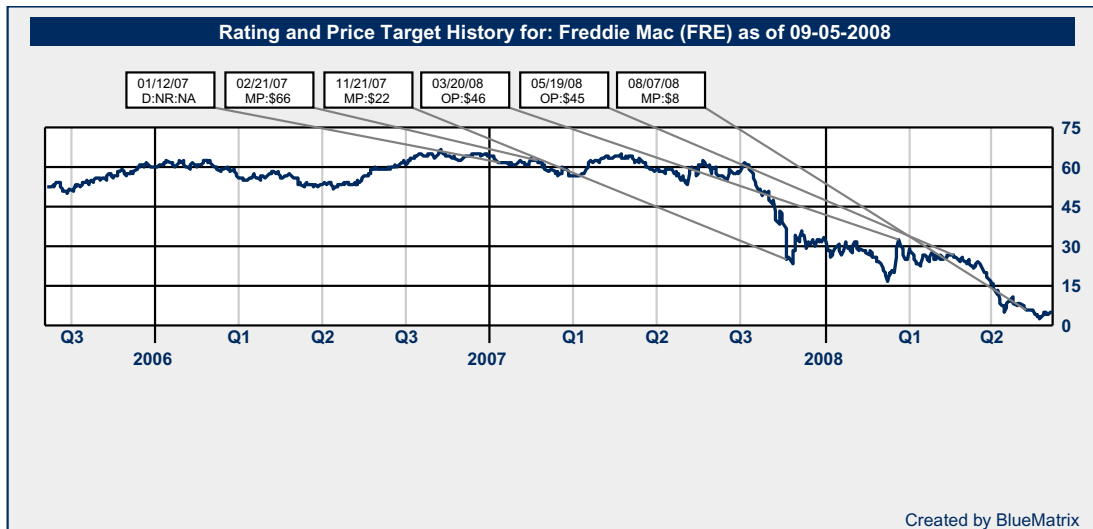
It is interesting to think of what has to happen for the common shareholder to receive any returns:

- First, the GSEs would have to absorb future losses and return to profitability under the constraints of shrinking the balance sheet from 2010, limiting the guarantee fee level so as to support the mortgage market and managing themselves not to maximize shareholder value.
- Second, the GSEs would need to pay Treasury 10% on all of its preferred investments and pay a fee to compensate for the explicit guarantee.
- Third, the GSEs would need to reinstate the preferred dividends.
- Then, common shareholders would then get diluted by 80% as Treasury exercised its warrant.

Implications for the Broader Financial Services Sector

We expect the broader equity markets to receive the news of conservatorship for the GSEs well as it removes a major uncertainty from the market. However, the added mortgage risk being absorbed by Treasury could result in Treasury rates rising over time. The net effect on mortgage rates will still be positive, in our view, achieving a modest overall benefit to the economy. Key affected areas should include:

- **GSE Common and Preferred Shares Under Pressure:** As discussed above, we expect the shares of the Fannie Mae and Freddie Mac common and preferred to be under significant downward pressure in the next few weeks.
- **MBS Mortgage Spreads Should Tighten Providing Strength to MBS REITs:** With the Treasury backstop for GSE mortgage securities, we expect mortgage spread to tighten toward Treasury rates. This should improve the outlook for the MBS REITs.
- **Improve Mortgage Volumes, but Higher Prepayment Speeds Should Help Title, Hurt Servicing:** We would expect the volume of mortgages to pick up with tighter spreads (assuming Treasury rates increases are not enough to offset spread tightening). Higher volumes should help title insurance. However, mortgage lenders are likely to face tighter gain on sale margins and declining servicing revenues, offsetting higher volumes.
- **Banks without GSE Preferred Investments Should Benefit Modestly:** We expect stabilization of the GSE activities will provide liquidity to the mortgage market, providing support to the housing market. However, this will not, in our opinion, create a near-term turnaround to housing as foreclosures are not expected to peak until the first half of next year.
- **Limited Support to the Non-Agency Securitized Market:** The Treasury was very clear in the proposal that GSE guaranteed loans and securities would be supported, but that support would not extend to other asset-backed securities. We believe that there could be a positive spillover into the student loan market, but that there will be limited intermediate impact on other areas of the securitized market.



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			Count	Percent
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Suspended [SP]	18	3.19	5	27.78

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