



Note on the Housing and Economic Recovery Act of 2008

On Thursday July 30, 2008, at 7 AM and with little fanfare, President Bush signed into law The Housing and Economic Recovery Act of 2008. The passage of the Act is the capstone to a series of dramatic events that had roiled the fixed income and equity markets (see “Note on Policy Announcements Regarding Fannie Mae and Freddie Mac”, http://www.annaly.com/Note_July_2008.pdf, July 14, 2008). The sweeping new legislation is designed to bolster the economically vital housing market from both ends of the mortgage finance cycle—the borrower and the lender.

The Act addresses the challenges facing homeowners in several ways, including a) authorizing the Federal Housing Administration to insure up to \$300 billion in new residential loans refinanced by distressed borrowers if their lenders are willing to take losses and underwrite the mortgage on 90% of the current value of the property, b) providing tax credits of up to \$7,500 for first-time homebuyers, c) setting aside approximately \$4 billion in emergency assistance to communities hard hit by foreclosures and d) raising the conforming loan limit up to a maximum of \$625,000, thereby making a larger universe of loans eligible for Fannie Mae and Freddie Mac.

The Act addresses the mortgage lending process primarily through the safety, soundness and regulatory structure of Fannie Mae and Freddie Mac. Important provisions include the creation of a new independent regulator called the Federal Housing Finance Agency, which will replace OFHEO. The FHFA will oversee Fannie Mae, Freddie Mac and the Federal Home Loan Banks and be endowed with authorities similar to other federal financial regulators, such as the power to establish capital risk management and portfolio standards, restrict asset growth and dividends for undercapitalized institutions, and put a regulated institution into receivership. The Act also expands the governmental backstop of the GSEs by granting the Treasury Department the authority to purchase unspecified amounts of their debt or equity through the end of 2009.

As challenging as it may be to predict exactly how these provisions (and the many others contained in the 631-page Act that we do not mention in this very brief summary) will help the current situation, suffice it to say it will likely be less than hoped-for. By that we mean that there is no magic bullet that will turn the housing market around, no legislation that will reverse the inevitability that busts follow booms. For example, we believe that despite this government largesse, too few homeowners will be bailed out of distressed situations by the FHA program, the handful of first-time homebuyers taking advantage of the tax credit will not be enough to forestall falling house prices, and some communities will simply be over-run by foreclosures. As for the GSEs themselves, nothing in the Act will reverse the worsening credit trends in all sectors of the mortgage market or seems to have had a significant effect on the equity valuations of the two companies.

That said, the Act does two very important things as it relates to the housing and mortgage market. First, it validates the market’s belief that the US government would, in the worst case scenario, provide absolute financial support for the guarantee side of the GSEs’ business. To us, this is the business line of Fannie and Freddie that embodies their execution of the government charter. If the degree of government support for Fannie Mae and Freddie Mac were a train from



Boston to Washington DC, with Boston being no backing, New York being implicit backing and Washington, DC, being explicit backing (a la Ginnie Mae), then the train didn't travel all the way from New York to DC with the passage of the Act, but it did make it as far as Baltimore. This was critical. While the fixed income markets never really doubted the primacy of the Agency mortgage market and thus the US Government's backstop, the incessant headline risk through much of the first half of July had injected much general anxiety into the market. This all began with the debate over consolidation of qualified special purpose entities according to FAS 140, and was exacerbated by the collapse in the GSEs' stock prices. (On the same day President Bush signed the Act into law, the Financial Accounting Standards Board decided to delay the implementation of FAS 140. Coincidence? We think not.)

The Act's second important accomplishment is it focuses the market on the financial condition of the GSEs. The expansion of the Treasury's relationship with them begs the following question: Do Fannie and Freddie need the expanded line of credit and capital backstop, or did the market just need to see that it was there? We believe that Fannie and Freddie likely don't need the backstop, but they did need a stronger insurance policy. (To that end, the Federal Reserve also announced that Fannie and Freddie could access the discount window if they ever needed the liquidity.) To wax metaphorical one more time, the GSEs are like a house in need of fire insurance. Twenty years ago, it was a two-bedroom house with a one-car garage, but today, after remodeling and expansion, it is a five bedroom house with a two-car garage and a screened-in porch. The risk of fire is the same today as it was twenty years ago, but the insurance coverage has to be expanded because the severity of loss is now greater. Clearly, the two companies have grown. Together they own or guarantee over \$5 trillion of U.S. home mortgages, or nearly half of those outstanding, more than double in just a decade, while their regulatory core capital has about tripled.

As it relates to their ability to meet their obligations without resorting to accessing the Treasury or the Fed, let's take a top-down look at Freddie Mac, which reported earnings today. (We provide this analysis for illustrative purposes only as they are based on assumptions which may or may not come true. Actual results may differ substantially from these scenarios.) Freddie Mac is currently earning average guarantee fees of roughly 19 basis points, while the fees on new volume are expected to rise to 20 to 25 basis points by the end of 2008. At the end of the second quarter of 2008, the total guarantee portfolio was \$1.84 trillion. Even if we assume no growth in the portfolio, with an average guarantee fee of only 20 basis points, the company will generate approximately \$3.7 billion annually in guarantee fees. Freddie Mac also generates revenue from net interest income on its retained portfolio of loans and securities. Through the second quarter of 2008, the company is earning roughly \$4.7 billion on an annualized basis from this portfolio. The company has operating expenses (salaries, occupancy, etc.) of roughly \$1.7 billion annually.

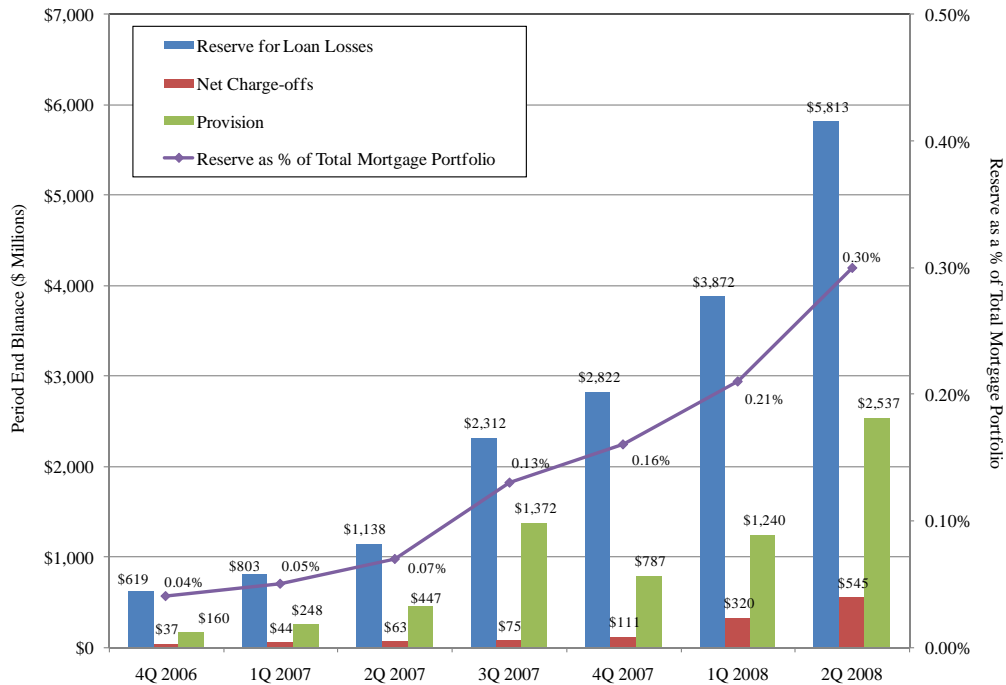
	(in billions)
Guarantee Fee Income	\$3.7
Net Interest Income	\$4.7
Operating Expenses	<u>(\$1.7)</u>
Operating Income	\$6.7

The back-of-the-envelope table above shows the company is currently generating approximately \$6.7 billion annually in cash flow (before dividends, which are being cut) that can be used to cover guarantee liabilities, and assumes no increase or run-off in their book of business.



Additional coverage for guarantee liabilities comes from their regulatory capital, which the company must maintain at certain minimum levels. Regulatory capital stood at \$37.1 billion at the end of the second quarter. In addition, the company has stated its intention to raise an additional \$5.5 billion. At current levels, Freddie Mac is \$8.4 billion over the required minimum capital level and \$2.7 billion over OFHEO’s required 20% surplus (these capital cushion amounts would rise with the new capital). If the company is unable to cover losses out of current income, they can dip into this capital.

The challenges to both companies will come about from mark-to-market, increasing provisions for losses and the incidence of actual losses. We have calculated an aggressive potential loss scenario: The current 90+ day delinquency ratio for Freddie Mac is 104 basis points in the single family guarantee portfolio, which is \$1.84 trillion. If we assume that lifetime defaults would be approximately quadrupled, or 4%, which is a fairly aggressive assumption, then that would be \$73.5 billion in lifetime defaults. Loss severities on prime mortgages are currently running at around 25% (meaning that the ultimate loss is twenty five cents on the dollar after all recovery efforts). If we move that up to 40% loss severities on these defaults, ultimate credit losses would total \$29 billion. (For what it’s worth, this is close to Freddie Mac’s “medium” default and severity case.) Consider that Freddie Mac has been increasing its loan loss reserves like mad—currently it stands at close to \$6 billion (see graph below). Consider that this loss would occur over time, and not likely over the course of only one year. Consider that the company would hopefully be taking steps to shore up capital outside of the Federal backstop if this drastic scenario were to occur. Also consider that the GSEs actually have the option to leave a defaulted loan in the guarantee portfolio for up to two years, which means that they only have to keep forwarding principal and interest during that time. This will allow them to smooth out losses. We can’t predict mark-to-market or provision strategies, but it is fair to assume that they will be volatile.



Source: Freddie Mac

The real issue, however, is funding. One could certainly model a credit loss or a capital impairment scenario that required Fannie Mae or Freddie Mac to tap their governmental backstop but, like any insurance company, the GSEs can survive through any market challenge as long as



they are able to fund themselves. Thus far, they seem to be able to do so. Most recently, on July 17, Freddie Mac priced a new \$3 billion two-year reference note to yield 3.358%, or 88 basis points more than the two-year Treasury and on July 9 Fannie Mae priced a similar security to yield 3.272% or 74 basis points more than the two-year Treasury. Indeed, these spreads are historically wide (back in 2005 and 2006, the spreads were in the 20-30 basis point range, only to start widening after August 2007), but we understand they nevertheless were well-bid. Shorter-term funding has also seen no diminution in demand. For example, Freddie Mac's latest issue of one-month discount notes were priced to yield 22 basis points less than one-month LIBOR. Since 2004, Freddie Mac one-month discount notes have been priced to yield an average of 18 basis points less than one-month LIBOR. Moreover, the latest auction of the notes had a bid-to-cover ratio of 3.6x, compared to the average bid-to-cover since 2004 of 3.0x.

The wisdom, rationale and efficacy of The Housing and Economic Recovery Act of 2008 will likely be debated for some time. No one seems to doubt the idea that housing and the economy need help in order to recover, but having Fannie Mae and Freddie Mac set up by the US Department of Treasury to be the primary policy vehicles for recovery is a challenging concept; like Social Security, now that it's here it is a little late in the game to try and take it away. We believe that the future status of Fannie Mae and Freddie Mac has yet to be decided, but for now the passage of the Act means the GSEs can continue to play the role for which they were chartered, to provide liquidity, stability and affordability to the housing market. As long as they are playing that role and providing that guarantee of timely payment of principal and interest, Agency MBS will continue to be the premier asset-backed security in the world.

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*Jeremy Diamond
Managing Director*

*Robert Calhoun
Vice President*

*Michelle Trilli
Vice President*

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