



## Note on Policy Efforts to Stabilize the Financial Markets

Since August 2007, institutions and investors that participate in the financial markets have contended with significant volatility and dislocation as the debt and housing bubble has begun to deflate. As this systemic destabilizing process has continued virtually unabated, it has become increasingly clear that new and unusual policy efforts would have to be developed to address weakening market conditions. There has been a movement towards a coordinated approach to dealing with the challenges of market liquidity, and that movement has gained significant momentum in the last week. We believe that policymakers are on the right track.

**OFHEO:** We noted two weeks ago that the regulator of Fannie Mae (FNM) and Freddie Mac (FRE), the Office of Federal Housing Enterprise Oversight (OFHEO), had removed the portfolio growth caps of the Agencies and would consider reducing or removing the 30% surplus capital charge (see “Note on Regulatory Changes for Fannie Mae and Freddie Mac”, February 27, 2008, at <http://www.annaly.com/fanniefreddie22708.pdf>). Today OFHEO announced that it was reducing the capital surplus requirements on FRE and FNM to 20% from 30%, and is considering further reductions. The regulator estimates this will free up \$200 billion in immediate liquidity for the market. As part of the initiative, Freddie Mac and Fannie Mae also announced that they will begin the process of raising new capital, which would give them even more buying power. Treasury Secretary Henry Paulson applauded the effort and voiced his support for Fannie Mae and Freddie Mac. “Fannie Mae and Freddie Mac are significant participants in the mortgage market and I am encouraged that today’s announcement will make more financing available in this area. Additional capital will enable the companies to help more homeowners and will strengthen the underlying fundamentals of the mortgage market.” OFHEO Director James Lockhart added that both companies have “prudent cushions above the OFHEO-directed capital requirements and have increased their reserves.”

This new initiative, on top of the recently announced temporary increase in the conforming loan limit to \$729,750 from \$417,000, is intended to help support and restore market liquidity in mortgage securities.

**The Fed:** The response from the Federal Reserve has evolved as this crisis has played out, with Chairman Bernanke and his team adopting increasingly more aggressive actions as the market problems have worsened and threatened the economic health of the United States. Yesterday the Fed slashed the Fed Funds rate by 75 basis points, bringing the total reduction in the overnight rate to 300 basis points, from 5.25% to 2.25%, in less than six months. The reduction is intended to help improve profitability of financial institutions by steepening the yield curve and lowering funding costs.

Apart from using this blunt monetary policy tool, the Fed has also developed a number of new liquidity facilities to help solve the unique problems facing the market. In August 2007, the Fed attempted to inject liquidity into the market by lowering the gap between the Discount Rate and the Fed Funds rate to 50 basis points from 100 basis points (now down to 25 basis points) to encourage financial institutions to access funds at the discount window. This effort bore little fruit largely due to the stigma of discount window borrowing, so in December the Fed instituted a separate facility, the Term Auction Facility (TAF), for depository institutions. The facility has



been increased in size over time, but had not had much effect on the availability of financing for investors. To try and address this, on March 13, the Fed announced a second facility, Term Securities Lending Facility (TSLF), to expand the available liquidity to primary dealers and to expand the availability of acceptable collateral to include non-Agency AAA-rated RMBS.

While the TSLF was a bold move, it is not scheduled to begin until March 27, 2008. This was not soon enough for Bear Stearns, which found itself without liquidity to operate. Moreover, the news regarding Carlyle Capital and other portfolio liquidations weighed on the markets. Facing potential market collapse, over the weekend the Fed rushed in to prevent a collapse in market confidence by arranging the emergency acquisition of Bear Stearns by JP Morgan and instituting yet another liquidity facility designed to help market liquidity. Slated to begin on March 17, the Primary Dealer Credit Facility (PDCF) is essentially an accelerated and expanded version of the TSLF. It provides essentially unlimited funding to primary dealers and expands the collateral accepted to include any investment grade security (i.e., triple-B rated and above), including corporates, municipals, MBS, and ABS. By expanding the program, the Fed is trying to restore confidence among lenders—spooked by prospects of credit losses, defaults and increasing counterparty risk—that there will be a dependable backstop to their financing operations.

We are witnessing a deleveraging process at work in the financial markets that is painful but necessary. We believe that policymakers agree that the financial system has to go through this process and, wisely, are not trying to stop it. Rather, the combination of these programs—the expansion of the conforming loan limits, the reduction in Agencies’ capital charges, the slashing of the Fed Funds rate, the introduction of innovative (and virtually unlimited) liquidity operations—is designed to prevent this process from spinning into a crash. In other words, the risk of taking these steps—and there are some risks—is far, far outweighed by the risk of not taking them. And there may still need to be further steps taken. However, the early indication in the market is that the most recently announced initiatives are working, as prices for certain assets have stabilized and liquidity has improved. We, along with every other financial institution and investor, will continue to monitor the markets for signs of progress.

*March 19, 2008*  
*Jeremy Diamond*  
*Managing Director*

*Robert Calhoun*  
*Analyst*

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