



Note on Policy Announcements Regarding Fannie Mae and Freddie Mac

In coordinated announcements on Sunday July 13, 2008, the Federal Government set forth a series of actions designed to bolster market confidence in Fannie Mae and Freddie Mac (“the Agencies”, or “the GSEs”).

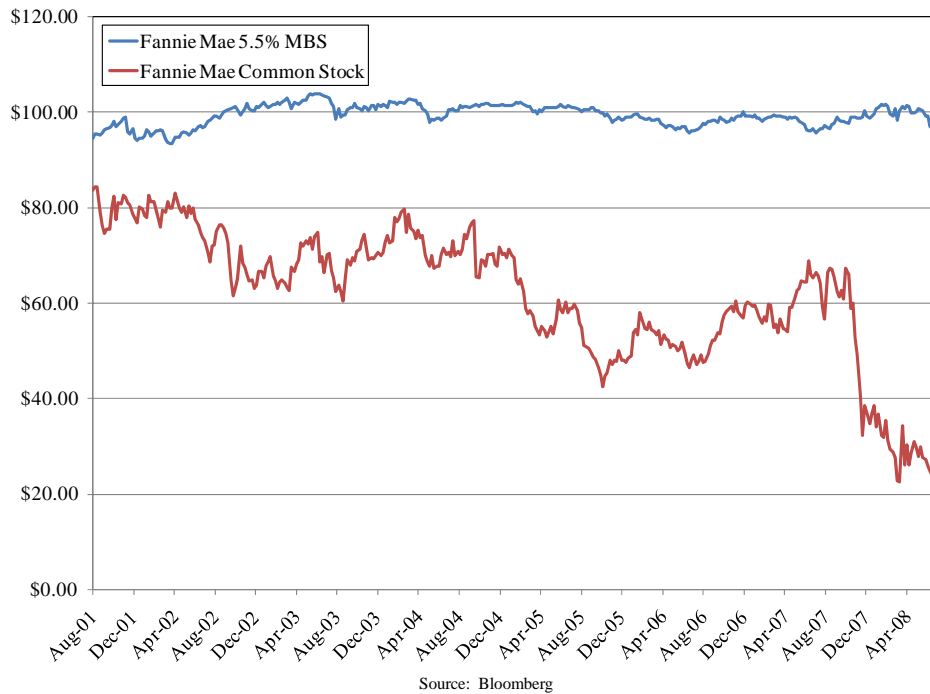
- Secretary Paulson announced that he would seek Congressional approval to temporarily increase the line of credit the Agencies have with the Department of Treasury beyond the current \$2.25 billion “as a liquidity backstop.”
- He also announced that to ensure the Agencies “have access to sufficient capital to continue to serve their mission” he would seek approval to give the Treasury Department temporary authority to purchase equity in either of the two Agencies if needed.
- The Federal Reserve announced that it had given the Federal Reserve Bank of New York the authority to lend directly to the Agencies “should such lending prove necessary”. (The New York Fed executes the Fed’s open market operations, the discount window and the new liquidity facilities.)

The GSEs themselves and the Office of Federal Housing Enterprise Oversight (OFHEO), their regulator, followed up the announcements with suitably approbative releases of their own.

The market is wrestling with the implications of these announcements, and we are still sorting through our own thoughts, but there are a few conclusions that ring out clear as a bell: First (and these are in no particular order), the Federal Government is indeed standing behind Fannie Mae and Freddie Mac. We have long maintained that in our core strategy “we take virtually no credit risk” (<http://www.annaly.com/mc/ammc/gsemls.htm> June 22, 2005) by virtue of the fact that we own Agency mortgage-backed securities (“MBS”). We’ve always been comfortable making that statement for many reasons, beginning with the Agencies’ underwriting standards, which include loan qualification requirements, loan-size limits, loan-to-value limits and full loan documentation. The result of these standards is a loan loss experience that is superior to the rest of the national bank community. We take comfort in the risk analysis established by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 to calculate risk-based capital requirements, including stringent stress tests of home price depreciation. We also know that a mortgage itself offers several levels of protection to the lender—the MBS holder is protected and secured by the collateral of the mortgage-borrower, the equity in the home, property/casualty and life insurance, the rights of foreclosure and the settlement process, and the reduction in the principal amount from monthly amortization. These levels of protection are *before* the explicit guarantee of Fannie Mae and Freddie Mac and the implicit backing of the US Government to make timely payments of principal and interest in the event of a default or delinquency. The interesting part of this relationship is that from a pure asset performance perspective, on a standalone basis the Agencies’ credit experience has been very strong and they’ve never needed the implied government backstop to help them make good on their guarantee. Nonetheless, it is this implied backstop that gives Agency MBS (and their other unsecured senior obligations) their triple-A status.



Second, the events of the past week or so have only confirmed that Fannie Mae and Freddie Mac serve two masters. The GSEs fulfill their government charter to foster and support a liquid and functioning residential mortgage market while also looking out for the best interests of its owners, the common stock holders. In most markets, those two masters co-exist in a comfortable, nebulous status quo. The government essentially gets an off-balance sheet special purpose entity whose operations are not consolidated into the Federal debt, and the stock market gets a privileged, leveraged growth company. We first wrote about this truism in 2002, before the accounting problems surfaced at the GSEs, while Leland Brendsel and Franklin Raines were still running the companies (http://www.annaly.com/mc/fnm/fnm_1.html, June 21, 2002). As we said at the time, “The last five years of financial results would lead any observer to conclude that management of these two entities has been listening more to the second master, possibly to the detriment of the first. The bigger, more leveraged and more complex Fannie and Freddie become, the more the first master will take notice.” This has now come to pass. Beginning on July 7, when the Lehman research report on the GSEs capital requirements under new FAS 140 proposed rules was issued, the equity market began to force this issue on which master would prevail. The conclusion of the market is now clear. The part of the GSEs’ capital structure that would be made whole in a worst-case scenario would be the top part, that which has the implied government backing. The bottom part of the capital structure would not fare as well, as it risked severe dilution or even complete wipeout in the event of a full-on nationalization. The graph below illustrates this bifurcation of perspective as the fixed income and the equity market evaluated their respective hands. The Fannie 5-1/2s have traded fairly closely around par for several years, while the common has only fallen, especially in the last week or so.

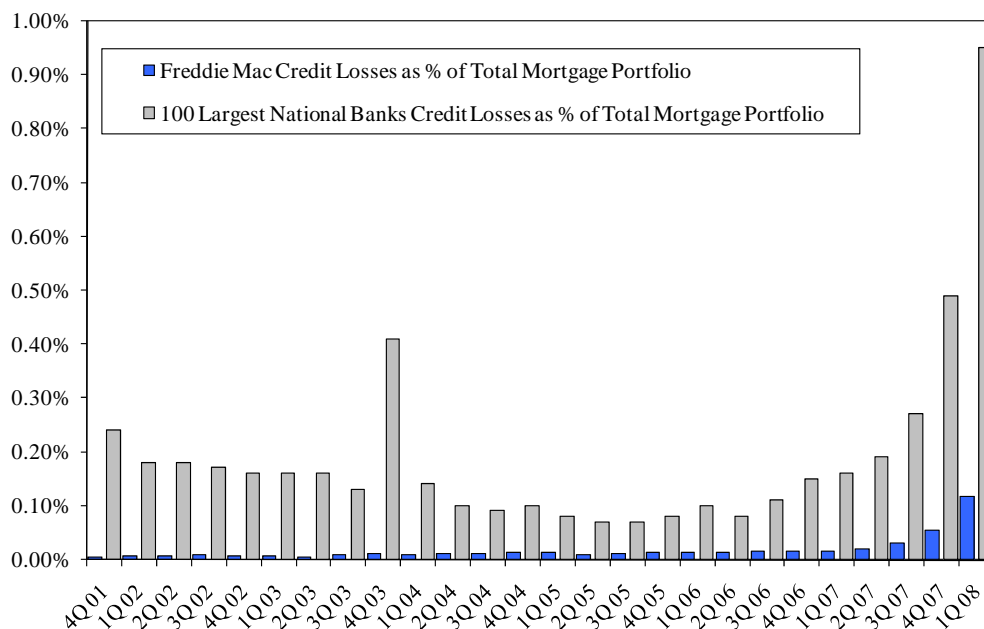


Granted, this is a fairly rough way to look at these two markets. For example, for the bond it does not capture the fluctuation of spreads between Agency MBS and Treasuries, and the share price does not factor in the market backdrop for financial institutions, but the point survives: Even before the Fed and Treasury came out with its announcements on July 13, the bond market was certain that the implied backstop by the Federal government would be honored, and the equity market was equally certain that they would not be treated the same way.



Third, if there is any remaining uncertainty on the GSEs, it is whether these announcements are enough—enough to bolster market confidence, enough to plug any capital holes at the companies, enough to make a dent in the more macro problems in the economy. Market confidence is a tricky thing, and we’ve all learned some hard lessons over the past year about how quickly market confidence can turn and the risks of that happening. In this case, it’s clearly too early to tell, and it may be years before we know the answer to that question. Today the short-term note offering by Freddie Mac went extremely well, and the weekend announcements may have helped. But on the face of it, policymakers are still trying to preserve the status quo, by not explicitly stating that the senior unsecured debt obligations of the GSEs are backed by the government but by simply letting the market know that there are provisions to backstop in the event they are needed. As Secretary Paulson said on Friday, July 11, “Today our primary focus is supporting Fannie Mae and Freddie Mac *in their current form* as they carry out their important mission” (italics ours). Thus policymakers stopped short of injecting capital, instead only seeking the ability to do so. They stopped short of lending outright to the GSEs, instead just looking to make more credit available from the Treasury’s line of credit and from the Fed.

As it relates to whether the plan is enough for any potential capital shortfalls at the Agencies, we note that policymakers also stopped short of putting any numbers in their proposals. We have no crystal ball on the capital needs of Fannie Mae and Freddie Mac. They are exposed to the same market and credit environment faced by every other financial institution. But as for whether the GSEs ever avail themselves of this recent regulatory largesse, we have a few observations. As the graph below demonstrates, the Agencies’ underwriting standards have helped to deliver a superior track record in credit experience.

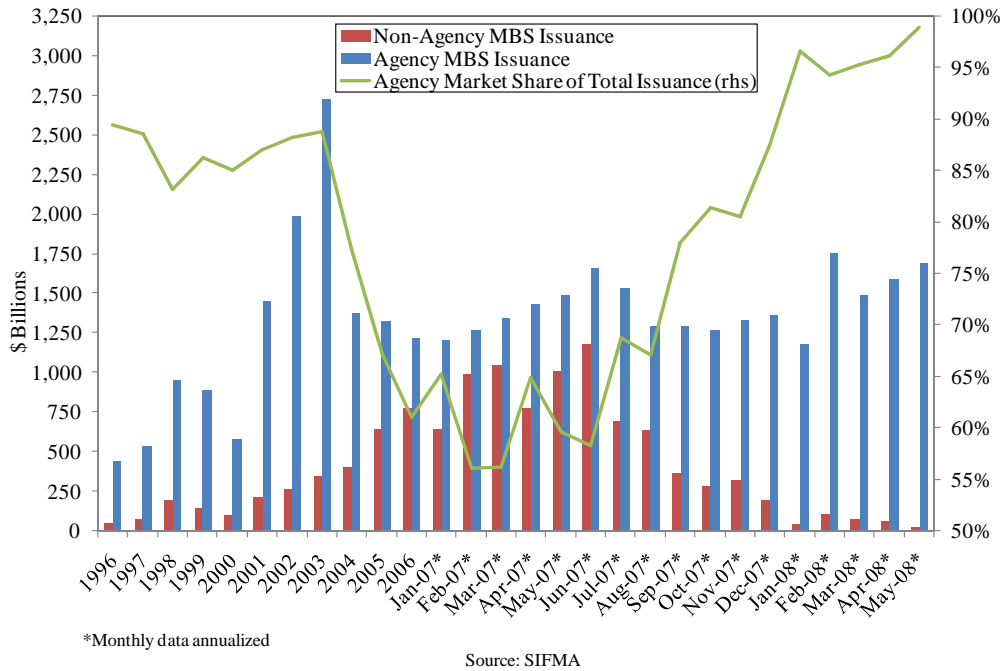


Source: Freddie Mac, Federal Reserve

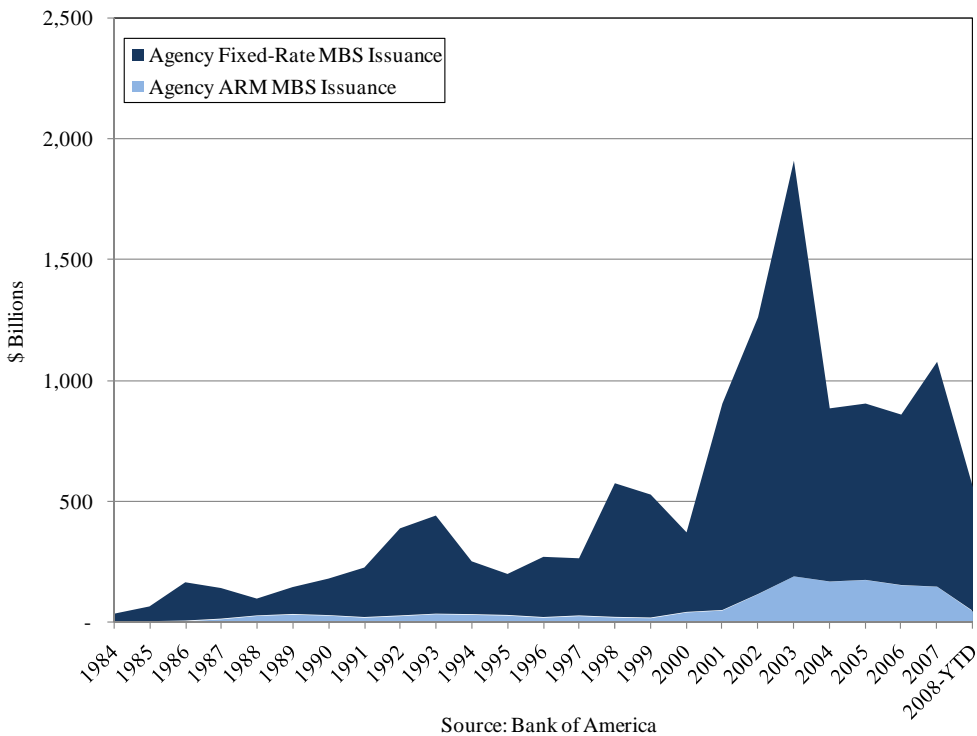
Rather than being a “reckless” lender over the past several years (as some in the press have called them), Fannie and Freddie have stayed largely under the radar of the most egregious practices of the mortgage debt bubble. In fact, from 2003 to date, Fannie Mae’s retained portfolio has actually shrunk in size while Freddie Mac’s is only marginally larger. At the same time, both companies have increased their regulatory core capital. As the graph below illustrates, the Agencies lost



significant market share to the non-conforming loan market, and have since recaptured it as non-Agency issuance has evaporated.



Just as important in the Agency risk profile is the type of loans that are packaged in their MBS. The best performing loans in the current environment have been the traditional fixed-rate loans, which still account for the lion's share of the Agency universe.





The events of the last week and the announcements of policymakers over the weekend didn't change much of what we know or don't know about the GSEs, but these items were clarified. Remaining unclear, for example, are Fannie and Freddie's future capital needs, or how they will raise that capital if needed (not so different from the lack of clarity over any bank). But as it relates to our exposure as an owner and financier of MBS issued and guaranteed by Fannie Mae and Freddie Mac, a few things remain clear: By holding a portfolio of only Agency MBS, we take virtually no credit risk. The implied backing of the US government has been reinforced by this weekend's policy statements, which only serves to strengthen a market that is already functioning well. Moreover, this weekend's announcements have shown us that policymakers understand the fundamental importance of Fannie Mae and Freddie Mac to the US housing market, the US economy and global financial markets. We'll give Secretary Paulson the last word on this issue, as he said in his statement: "Fannie Mae and Freddie Mac play a central role in our housing finance system and must continue to do so in their current form as shareholder-owned companies. Their support for the housing market is particularly important as we work through the current housing correction. GSE debt is held by financial institutions around the world. Its continued strength is important to maintaining confidence and stability in our financial system and our financial markets."

Last, the policy initiatives announced this weekend won't fix what's broken in the housing market. But they will put Fannie Mae and Freddie Mac in a better position to be part of the solution.

July 14, 2008
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Managing Director

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