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Note on Regulatory Changes for Fannie Mae and Freddie Mac

Today was an eventful day for the Government Sponsored Enterprises Fannie Mae and Freddie Mac. This morning, Fannie Mae became a timely filer of its audited financial statements. (Freddie Mac will release its earnings tomorrow.) Later in the day, the Office of Federal Housing Enterprise Oversight, the regulator of the two companies, made a significant announcement related to their business activities. "In recognition of the progress made by both companies…OFHEO will remove the portfolio growth caps for both companies on March 1, 2008." Prior to this announcement, their portfolio growth was capped at 2% annually.

In addition, OFHEO addressed the capital position of the two companies, specifically the mandate to maintain a capital level that is at least 30% in excess of the statutory minimum capital requirement. OFHEO had instituted this capital charge because of their operational and financial difficulties of the past several years. "In retrospect, this OFHEO-directed capital requirement, coupled with their large preferred stock offerings means that they are in a much better capital position to deal with today's difficult and volatile market conditions and their significant losses….OFHEO will discuss with [management of Fannie Mae and Freddie Mac] the gradual decreasing of the current 30 percent OFHEO-directed capital requirement."

In the past few weeks, there was another major development related to the operations of Fannie Mae and Freddie Mac. On February 13, President Bush signed into law H.R. 5140, the Economic Stimulus Act of 2008. The $168 billion package—whose centerpiece is giving tax rebate checks of up to $1,200 per couple (with $300 more for each child) and $600 for individuals—increased the conforming loan limit for Fannie Mae and Freddie Mac from the current limit of $417,000 up to a max of $729,750. In essence, this means that Fannie and Freddie will now be able to acquire certain loans previously considered "jumbo." The increase applies only to mortgages originated between July 1, 2007 and December 31, 2008.

There are many ways to look at these announcements. First, the regulators and the Administration understand the depth and breadth of the mortgage debt and housing problem in the US and the extent to which Fannie Mae and Freddie Mac can be part of the solution. One of the biggest problems in the market today is the price and availability of credit for mortgage borrowers. Lowering the Fed Funds rate, injecting liquidity into banks via the TAF auction facility or introducing new rate modification or foreclosure avoidance programs have not helped bring down mortgage rates, made it easier to get a loan or eased the housing oversupply problem. If Fannie and Freddie have more buying power—by expanding their growth potential as well as the size of loans they can acquire—more liquidity flows into the mortgage finance space. This will help. Bear Stearns estimates that each GSE could buy $40 in pass-through mortgages for every $1 in capital it has available to deploy. Thus if the 30% excess capital charge were reduced to zero, they calculate that they would have an additional $700 billion in buying power. Estimates vary for how much more mortgage assets will be available for purchase by the GSEs after expanding the loan limit, but Credit Suisse analysts estimate that borrowers of $243 billion in outstanding prime jumbo and Alt-A mortgages will be able to improve their mortgage rates by 60 to 75 basis points through refinancing.

This development, we hope, does not reward borrowers and lenders who made bad decisions, although this could certainly be an unintended consequence. Rather, this will Fannie and Freddie to continue to play a fundamentally critical role in the mortgage finance cycle, not only in enabling a smoothly functioning secondary market but also generally enforcing more stringent underwriting discipline.

Second, there are potential market implications from these regulatory changes. Agency mortgage-backed securities have generally underperformed Treasuries during the recent rally in rates (although they have vastly outperformed anything with credit risk), due to liquidity issues as well as mortgage-related convexity issues (refinancing activity typically increases as rates fall, changing the expected average lives of securities). A greater appetite for securities could result in tighter spreads versus Treasuries as liquidity improves. In addition, prepayment speeds on non-Agency jumbo mortgage securities could increase as the refinancing options for those borrowers increase.

Third, investors have to consider the potential effects of these changes on the risk profiles of Fannie and Freddie themselves. All other things being equal, removing growth caps and reducing capital requirements means that the GSEs could be in a position to increase leverage. For example, at December 31, 2007 Fannie Mae's balance sheet debt-to-equity ratio stood at 18.1—granted, this is down from 43:1 at December 31, 2003—and with both companies raising high-priced capital to shore up their balance sheets, facing rising defaults and delinquencies even for their prime borrowers, and managing exposure to troubled mortgage insurers, we have to wonder about the wisdom of allowing the Agencies to carry less capital. Offsetting this concern, however is the fact that Fannie and Freddie have tremendous pricing power in their guarantee-fee business as well as a demonstrated ability to raise capital when necessary. It was also nice to hear on today's earnings call that Fannie Mae Chairman Daniel Mudd said that the "number one priority is capital."

The next point we would make is the one that underlies Fannie Mae's and Freddie Mac's standing in the financial markets: The market perceives that the US government implicitly backs the activities of Fannie Mae and Freddie Mac, a perception of which the US government is clearly aware. For the US government regulator to loosen the reins on Fannie Mae and Freddie Mac in this way only strengthens that perception in the mind of the market. (Can anyone imagine the US government not stepping up in the absolute worst-case scenario, particularly after they have instituted these changes?)

The final perspective is the only one that is measurable—the vote of the markets. And the markets like it. Agency MBS outperformed Treasuries today. Fannie Mae 5-1/2s were up 17/32nds and 6s were up 13/32nds, while the 10-year Treasury was only up about 6/32nds.

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