

# GSE Activity Report

June 18, 2007

## *Follow the Bouncing Ball*

### Summary

We note that some of the subprime second-lien MBS downgraded Friday by Moody's were AAA-rated ones. If this trend continues and exacerbates, it would worsen Fannie and Freddie's risk-based capital adequacy under the OFHEO rules. However, only sharp downgrades in lots of MBS would, we think, create a serious prospect that either GSE would slip below the adequate-capital threshold.

### Impact

Press attention has focused principally on the degree to which the Moody's downgrade is a precursor to others and its impact on Bear Stearns' struggling mortgage hedge fund. These are, to be sure, interesting in and of themselves. However, we also noted the small indication in the Moody's release that, while the bulk of the downgrades took MBS rated A or below to lower ratings, some also took AAA-rated paper to AA. This would, as far as we know, be the first instance in which AAA-rated paper took a hit and we thus view it as a critical blip on our early-warning radar. The market – not to mention bank regulators – have assumed that AAA paper is immune from the ills gripping the mortgage sector, but we've long been less sanguine on that point. To the degree AAA paper gets this accolade because of over-collateralization, the risks are far from insignificant that 2006 MBS – especially second-lien paper – won't have time to establish a reserve if there's any early-payment default and/or house prices aren't where the models said they would be when the cock crows.

OFHEO's risk-based capital rule differentiates capital for MBS based on rating. AAA-rated MBS have a 3.5% haircut; AA paper gets an 8.75% haircut and it goes quickly downhill from there until below BBB-rated paper gets a 100% hair-cut that essentially requires dollar-for-dollar capitalization. For the GSEs, AAA paper is where the action is.

On Thursday, Freddie reported that 96% of its private-label MBS paper is AAA. We don't know the comparable current number for Fannie, although it's been at pains to assure the market that the vast majority of its private-label paper is also AAA.

The principal issue for the GSEs is the degree to which AAA paper gets slammed and, if so, how much of that paper they hold in relation to the rest of their book. Without good numbers, it's simply impossible to make useful projections. Even more importantly, the OFHEO risk-based capital models insulate the GSEs from the impact of any downgrade. For one thing, the rules permit the GSEs to cross-subsidize credit RBC with that allocated to interest rates. Thus, if one or the other GSE has swapped its way to nirvana under the current, volatile interest-rate conditions, it can use a capital "surplus" there to offset the impact of a downgrade that hits its credit RBC. Largely because of this, the GSEs' minimum-capital requirement has long been the only meaningful constraint on their portfolio and any downgrades would have no impact on this simple capital-to-assets ratio calculation.

Interestingly, the GSEs are more subject to capital hits from MBS downgrades than big bank holders of private-label MBS. The bank rules lump AAA paper with AA MBS, meaning that capital increases occur only as paper falls to the A level. The biggest investment banks, however, are under a capital framework that mimics Basel II in some respects, leaving them potentially also vulnerable to MBS downgrades. This would, though, carry far less of an overall whack for the bulge-bracket investment banks because of their asset diversity.

## Outlook

Despite the cautions noted above, the GSEs are not immune from market turmoil. Both are struggling under the OFHEO 30% capital surcharge, with Freddie's cushion sinking a bit during the first quarter. Freddie's CFO Thursday talked about the prospects for release from this requirement now that the GSE was making current quarterly filings, but Lockhart moved quickly to reject any such speculation. Thus, Freddie is under the surcharge unless it contests OFHEO's authority or, more likely, comes both current and timely in an SEC-registered framework some time next year. Fannie is still far behind even on current, let alone timely, so the surcharge is there for the duration.

What would happen if, heaven forefend, one or both GSEs slipped below the surcharge capital threshold? Could OFHEO then deem the GSE to have failed the

“adequate” standard, below which a variety of sanctions is imposed under current law? To say the least, its authority to do so under current law is unclear. We’ve long argued that the capital surcharge itself is questionable under current law, although both GSEs doubtless decided not to contest it because their hands were so weak when this was imposed. Similarly, we’ve questioned the degree to which OFHEO could have deemed Fannie significantly under-capitalized as it did in 2004 when things were not going well between the GSE and its regulator. That, too, stuck, although OFHEO didn’t press its luck by also seeking to impose any sanctions at the time.

Fannie’s subjection to the 30% capital surcharge is under an official enforcement action that specifies penalties that OFHEO could then impose. Thus, it could in fact feel some pain if its capitalization slipped through the 30% surcharge in the AAA downgrades. In contrast, Freddie’s portfolio limit is voluntary, as the GSE was at pains to point out when it was imposed last year. Thus, its hands may be more free to reset any sanctions OFHEO might seek to impose under the risk-based capital rules. For each GSE, though, this is doubtless a circumstance devoutly not to be wished for. As noted, we don’t now think it likely, but we’ll be watching the ratings agencies very, very carefully.