

GSE Activity Report

June 29, 2007

Make-Up, Six-Inch Hooker Heals, the Tramp Stamp and a GSE or Two

Summary

Leaving aside the GSEs, the items above characterize the increasing travails in the subprime market according to PIMCO's big spender and why the ratings agencies were so ready to give high rating to what now looks to be dodgy paper. In light of market developments, we today take another look at the GSEs' exposure. We examine again Fannie and Freddie's AAA books in light of the announcements earlier this week providing current data on the GSEs' portfolios, and we put this in context with S&P's announcement that it's looking at downgrades not only for subprime and second-lien paper, but now also for jumbo prime and Alt-A. We conclude yet again that the GSEs' implicit guarantee -- not to mention the lack of timely filings -- may well be shielding them from the market discipline now wracking other big mortgage players. Indeed, Fannie and Freddie may temporarily benefit from the ongoing flight to quality. However, we continue to believe that the GSEs' big private-label bets will lead to significant AOCI adjustments and eventually to earnings hits, considerably worsened if these lead one or both to come below the OFHEO regulatory-capital standards.

Analysis

Last Friday, we provided a detailed analysis of the GSEs' private-label holdings based on the best available data. Since then, the May monthly numbers have come out and we see that, unfazed by recent developments, both GSEs have in fact increased their private-label MBS positions. At the end of May, Fannie held \$121.5 billion in these assets and Freddie held \$246 billion, up \$3 billion and \$2 billion

respectively from March. The monthly reports provide no additional information on what comprises these holdings, so we can work only with the prior data on the degree to which private-label paper may be subprime and/or AAA-rated. Last Friday's analysis provides considerable detail on these points, noting in particular the critical question of whether the AAA paper is super-senior or mezzanine. Based on the percentages of non-AAA paper cited earlier, we calculate based on the May updates that Fannie now holds \$12 billion and Freddie \$10 billion in paper rated below AAA.

The reported results of the Bear Stearns auction and Queen's Walk Investment sales – not to mention Caliber's collapse yesterday -- now allow us to put more facts into the mix than available late last week. Reports indicate that, before the whistle sounded, AAA paper was being discounted ten or fifteen percent at Bear Stearns. Queen's Walk Investment reports a 50% write-down in its subprime paper and Caliber was discounting its 2005 subprime book 53% before it folded. We have little, if any, way of knowing how the GSEs' internal models priced their paper before the debacle. The bulk of the valuation is doubtless marked-to-model because of the very illiquid subprime market. Without data on what's in the AAA-rated book, we cannot determine if the GSEs are principally holders of super-senior tranches – in which case they may argue that they are doing better than the market – or big in the AAA-mezzanine tranches – in which case, they are of course not doing so well. Thus, for purposes of analysis, we will assume that the GSEs valued their private-label paper much as everyone else has done and they are thus being hit in the same fashion

Taking this on to an earnings analysis, both GSEs book their private-label MBS as available-for-sale with the unrealized gains or losses in their accumulated other comprehensive income (AOCI) accounts along with the fair value of their cash flow hedge derivatives. As long as the losses remain in this account they impact shareholder's equity but are not taken into the income statement – something that readers will remember was a factor in the accounting problems found at both GSEs.

For Freddie, a decision to move impairment losses into the income statement occurs when the security's fair value drops below its amortized cost, taking into account factors such as "severity of the decline in value, credit ratings, the length of time the investment has been in an unrealized loss position, and the likelihood of sale in the near term." However, Freddie is clear that its "intent and ability to hold the investment until a point in time at which recovery can be reasonably expected to occur" is a way out of taking an earnings hit. As Freddie notes, they "apply

significant judgment in determining whether impairment loss recognition is appropriate.”

But, judgment aside, what would happen if current pricing were reflected in the GSEs’ income statements? To be sure, they need not necessarily do so and pricing could improve or other gains and income could offset these hits. On the other hand, the way things are going, subprime and Alt-A prices could of course go the other direction and we therefore think an assessment of the current market is at least interesting and, perhaps, quite important. Looking only at their non-AAA positions, a writedown of 15% to 30% would mean a \$1.8 billion to \$3.6 billion hit for Fannie and a \$1.5 billion to \$3 billion hit for Freddie. As we’ve noted earlier, neither GSE has much in the way of reserves to cushion these losses. Losses of this magnitude for either GSE could thus easily eliminate net income for one or more quarters and, in Freddie’s case, it would prolong the string of recent quarterly losses.

As we noted yesterday, retained earnings for either Fannie or Freddie could potentially be reduced to a level where the 30% capital cushion would be breached, with Freddie more at risk in this case because of its thinner capital cushion. Were a writedown also required for AAA-rated subprime holdings, the earnings impact would be profound. A mere 10% writedown on all subprime holdings would mean a \$4.4 billion hit for Fannie and a \$12 billion hit for Freddie, with the latter GSE seeing its capital drop below the statutory minimum capital level.