CAPITOL ANALYSTS NETWORK, INC.
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GAMBLING WITH FANNIE MAE: A BET AGAINST THE HOUSE?

After a dreary run of seemingly never-ending bad news, Fannie Mae and Freddie Mac shareholders had reason to cheer the outcome of the much awaited showdown inside the House Financial Services Committee late last month. By an overwhelming 65-5 vote, the Committee approved legislation to create a new regulator for the housing enterprises with limited powers, while expanding the markets the housing enterprises can serve. Despite the best efforts of the Bush Administration and Alan Greenspan, the Committee ignored their demands that the new regulator have sweeping discretionary power to compel the GSEs to liquidate most of their mortgage portfolios. Instead of facing a powerful regulator, Fannie Mae and Freddie Mac would face a bright future of growing market share if the Committee's bill were to become law.

Despite the change from bad news to good, investors holding these stocks must have gamblers' hearts. The divergence of opinion between the House Financial Services Committee and the White House will be revisited, first on the House floor, then as this legislation faces Senate consideration, where the Bush Administration Treasury expects to win more support, and finally when the House and Senate conferees meet to resolve their differences. Stock prices may jump and fall in reaction to shifting probabilities of which side will win the fight.

The Key Factor – Portfolio Lending

In housing enterprise parlance, "portfolio lending" means issuing debt which sells at very low interest rates because it has an "implied" federal guarantee, then using these funds to purchase mortgages or the mortgage-backed securities that Fannie Mae and Freddie Mac have packaged for sale to investors – thereby locking in a healthy spread between bottom-market costs of funds and conventional mortgage investments. Since portfolio lending creates up to 85 percent of Fannie and Freddie's collective earnings, depending on how people keep score, the Committee decision to limit the new regulator's power to order retrenchment only if portfolio lending poses risks to the safety and soundness of the government-sponsored enterprises (GSEs) offers shareholders hope that an important corner is being turned. This, however, remains to be seen.

Alan Greenspan has publicly stated that he wants Fannie and Freddie to reduce their mortgage asset balances to at most $400 billion – down from the current $1.5 trillion. Treasury Secretary Snow has made similar comments, saying the GSEs should own little more than a working inventory of mortgages awaiting resale. These two powerful men want this retrenchment to be the byproduct of new rules that would forbid the GSEs from holding onto mortgages for very long after they buy them and letting their old books of mortgages run off when home owners sell or refinance, or make monthly payments. Fannie's net mortgage asset

balance on old books of business is declining by 24 percent annually, as described at www.sec.gov/Archives/edgar/data/310522/000095013305002459/w09450exv99w2.htm. In five years, Fannie's mortgage assets would fall by 66 percent if the company could not replenish its holdings at the current runoff rate.

This would be a big deal for investors, as a "back of the envelope" calculation demonstrates. Seven weeks ago, Professor Dwight Jaffe presented his paper, "On Limiting the Retained Mortgage Portfolios of Fannie Mae and Freddie Mac," at an American Enterprise Institute conference; it is available at www.aei.org/event1041. Jaffe found that Fannie and Freddie together earned net interest income of $23 billion, while its other income source, guarantee fees, provided only $4 billion. This suggests 85 percent of GSE profits now come from buying and holding mortgages, funded with cheap debt . If net interest were only $8 billion in five years, due to portfolio retrenchment, then GSE earnings probably would fall by more than half – and continue falling!

Forks in the Long Road Ahead

The 65-5 House Financial Services Committee vote was an impressive achievement. Also impressive was the lobbying campaign thrown up by the GSEs' friends, the National Association of Realtors and the National Association of Homebuilders, to fend off the Administration's efforts to curtail portfolio lending. Their campaign was so effective that Oxley felt he could not pass the amendment Treasury Secretary Snow hand delivered to him to skinny down the GSEs balance sheets. Instead, Congressman Scott Garrett (R-NJ) offered Snow's amendment, talked about it, and then withdrew it before Committee voting began in the face of certain defeat in a Committee with 37 Republicans and 33 Democrats. Since Committee amendments die on a tie vote, and all Democrats were believed to oppose the provision, only two GOP defectors out of 37 would have doomed Garrett's bid.

However, bipartisan backing is not as strong as it appears. The robust Democratic support shown in the final committee vote rests squarely on a controversial provision requiring Fannie Mae and Freddie Mac to direct 5 percent of their net incomes to low income housing programs. Conservative Republicans are promising to fight for amendments that remove this language when the bill it brought before the House. Without this provision, Democratic support plummets, and final passage in the House turns on a unified Republican offensive.

The Administration has vowed to regroup, and its first chance will be the House floor. Full House consideration of H.R. 1461, the Federal Housing Finance Reform Act of 2005, is expected in late June or July. White House strategists and the House GOP leadership must determine if they can limit House GOP defectors to 13 out of 231 on any package they send up to restrain portfolio lending, assuming they cannot attract any Democrat support. Right now, this appears unlikely. Therefore, CAN doubts the Administration will press the GOP House leadership for a floor vote to materially reduce portfolio lending.

Next Stop: The Senate Banking Committee

Once the House acts, the Senate Banking Committee will formulate the Senate's position. Lobbyists we talk to believe that Committee's Chairman, Richard Shelby (R-AL), will support giving the new GSE regulator more authority than the House Committee has done to shrink portfolio lending. Apparently, the lobbyists' opinion is shared by Senator Sununu (R-NH) who is a Committee member. According to a Dow Jones story from May 24, "The Senate Banking Committee will approve a bill that will go along the lines of the Fed and Treasury's proposals on portfolio limits." Shelby's position may prove pivotal because he is likely to get his way inside the Senate Banking Committee. This Committee presents a dangerous shoal to GSE investors.

The Senate Floor: A GSE Rest Stop

The Senate floor probably is a safe place for the GSEs. Most of the time deals cut in Senate Committees stick on the floor, and there is little likelihood that a tougher portfolio lending amendment would succeed if it the Banking Committee hasn't already approved one.

Showdown in the House-Senate Conference

It is not supposed to happen under congressional rules. However, sometimes provisions not found in either the House-passed bill or the Senate-passed bill are included in the final compromise product sent to the House and Senate floors for final passage before a bill is presented to the President for his signature or veto. There is a chance that tough portfolio lending language could emerge for the first time at the eleventh legislative hour. This is where the Bush Administration may have its greatest chance for success. It can tell the conferees that the White House will not support the bill unless its principal concerns are met. **With both the House and Senate in GOP hands, GOP congressional leaders will avoid sending Bush a bill he does not want.** Therefore, the conferees could accept tough portfolio lending language in exchange for White House support. There are two other alternatives: the bill dies in conference or the Administration gives in.

Overall, there is a thirty percent chance of a law passing that gives the new regulator the authority to force the GSEs to liquidate much of their mortgage portfolios, power we believe he would use. There is a forty percent chance of a deadlock that produces no bill, and a thirty percent chance the White House blinks and agrees to a bill like the House Financial Services bill.

What if there is a Legislative Deadlock or the White House Blinks?

GSE investors should still worry. Current law gives Secretary Snow the legal authority to compel the housing GSEs to reduce their portfolio lending. He simply has to say "no" when they ask permission to issue new bonds. He has the power to forbid them from raising new cash – as Title12, Chapter 13, Subchapter III. Section 1719(b) of this Subchapter seems to make explicit:

"... the corporation is authorized to issue, **upon the approval of the Secretary of the Treasury,** and have outstanding at any one time obligations having such maturities and bearing such rate or rates of interest as may be determined by the corporation **with the approval of the Secretary of the Treasury, ...**" This section of Fannie Mae's charter is available at http://assembler.law.cornell.edu/uscode/html/uscode12/usc_sec_12_00001719----000-.html. Similar authority over Freddie Mac is contained in 12 U.S.C.11A, subsection 1455(k), at http://assembler.law.cornell.edu/uscode/html/uscode12/usc_sec_12_00001455----000-.html.

The press reported last Congress that the Administration quietly had sought a legal opinion from the Justice Department about its powers to block new GSE bond issuances. According to these press reports, the Department reported back its opinion that the Treasury had such authority. Still, the Administration never articulated its position on portfolio lending before the 2004 election and rumors circulate that Karl Rove opposed any action before then that might threaten home prices. However, the elections are over, and Bush will never again face the voters. What is to stop Treasury Secretary Snow from using his authority to restrict new bond issuances to compel Fannie and Freddie to skinny down? He has already asked Congress to give the new regulator the power to do just that. Equity investors, are you feeling lucky?

As investors track the possible actions of Congress and the Treasury Department, it is worth recalling that headline risk can reappear at any time from three sources which will strengthen those who want to reduce the GSEs portfolios: the Justice Department which appears to be conducting a criminal investigation of Fannie's old leadership for cooking the books to pocket bonuses, the SEC which is studying Fannie's accounting practices for violations, and former Senator Warren Rudman who has been hired by Fannie Mae to determine if former Fannie executives gamed accounting rules to boost their pay. There is a reason why Fannie is trading a 7 times earnings. It is a risky stock to own.

Higher Loan Limits Help the GSEs

In addition to rebuffing the Administration on placing limits on portfolio lending, which is by far the most important issue for GSE investors, the House Financial Services Committee passed Gary Miller's (R-CA) amendment which expands Fannie's and Freddie's market opportunities. Currently, the GSEs cannot purchase loans from mortgage originators greater than $359,650, except in the "high cost areas" of Alaska, Guam, and Hawaii. Under the Miller amendment, any area with a median home price greater than $359,650 is a "high cost area," and loan limits in such areas would rise to the local medians, unless the median exceeded $539,475, which would be the new nationwide loan limit ceiling in high cost areas.

It would be up to regulators to determine the size of an "area." If they define an area to be a census tract which averages 4,000 people, then the GSEs could buy conventional loans made against houses selling in tony neighborhoods almost anywhere in the U.S. for between $540,000 and $675,000. The upper limit would be even higher when purchasers use second mortgages to finance the gap between $675,000 and a higher purchase price. Some will.

Using new home sales as a proxy for all home sales, 32 percent of American homes sell for more than $300,000, suggesting that approximately 25 percent sell for more than $360,000. Http://www.census.gov/const/www.charindex.html . Using the census tract as the definition of "high cost area," the GSEs might buy 18 percent more home mortgages, given that houses around San Francisco, LA, San Diego, Boston, New York, and Washington often sell for much more than $675,000. Such purchasers would still rely on jumbo first mortgages. Alternatively, if the new rule would apply to overall metropolitan areas which will have lower "median prices" than census tracts in expensive areas, then it would open up less business, perhaps 10 percent. Importantly, the GSEs would have to securitize these loans; they could not hold them "in portfolio," which is much more profitable.

A Long, Hot Summer Smolders Ahead

Fannie and Freddie won last month inside the House Financial Services Committee, breaking a two-year losing streak. Press reports, however, are overstating the prospects that the federal government won't force the GSE's to shrink their large mortgage portfolios, and their profits. Either the Treasury Department or the Congress could force action. It may be only one or two more bad headlines away from happening.

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