

# METWEST

To: MetWest Clients and Constituents  
From: MetWest Investment Team  
Date: September 8, 2008  
Re: GSE Update

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On July 10, MetWest shared its thinking on the state of the two Government Sponsored Enterprises (GSEs), i.e. FNMA and FHLMC. We suggested at that time that the contemplation of a potential restructuring or default of FNMA/FHLMC debt was a non-negotiable proposition. However, we also suggested that should losses continue to rise in the portfolios of assets held by the mortgage behemoths, that the GSEs might be required to raise capital in a manner dilutive to shareholders.

The US Treasury's actions taken over the weekend would appear to be consistent with both of these observations. The GSEs have been placed under the conservatorship of the Federal Housing Finance Agency (FHFA), the successor regulator to OFHEO, FNMA and FHLMC's former overseers. The CEOs of both organizations are to be replaced, though a transition period is envisioned before Herb Allison (former President of Merrill Lynch) and David Moffett (former CFO of US Bancorp) assume full authority over their respective new charges, Fannie Mae and Freddie Mac. The clear goal is to ensure that the GSEs continue with their normal operations of channeling mortgage credit to the housing markets.

The Treasury has also entered into agreements with the GSEs, the effect of which is to vastly dilute the common shareholders and to infuse new capital in the form of preferred stock. Initially, each GSE will issue to the Treasury \$1 Billion in a senior preferred stock (ranking above the existing preferred stock) with a 10% coupon. These agreements would allow the Treasury, if it so chose, to infuse as much as \$100 Billion into each GSE. These are staggering sums, the size of which are presumably designed to set aside the concerns of even the most dyed-in-the-wool pessimists that FNMA and FHLMC will remain solvent entities. Additionally, the Treasury is to receive equity warrants in each GSE equating to a nearly 80% ownership stake in the firms. The combined impact of these actions is to severely impair the value of the claims of the existing common equity holders.

While the aforementioned issues solve the capital problems of the GSEs, provision has also been made to address any continuing liquidity concerns at the GSEs. This has been accomplished via the creation of the Government Sponsored Credit Facility, essentially a new secured lending facility being provided directly to the GSEs from the US Treasury. Additionally, the US Treasury is authorized to purchase agency guaranteed MBS.

The Treasury's actions are, as far as we can judge, unprecedented and result in the near nationalization of these two (still technically) private entities which, combined, have balance sheets totalling \$1.3 Trillion and mortgage guarantees outstanding that are several times this size. The clouds under which the GSEs have been operating have placed in jeopardy the entirety of the mortgage credit creation process and have elevated the risk premium to all manner of lending within the global financial system. A failure to stabilize Fannie and Freddie was simply not an option.

Still, the question remains, why was this action taken now? While the reasons for the move may not be completely apparent for some time, one of the proximate contributing factors for the move were concerns that the accounting value of certain assets at the GSEs are being carried at valuations substantially above that of their market price. Such a condition is not unique to the GSEs nor is it all that unusual that during a period of deleveraging that a marking to market framework will paint a more negative portrait of a financial institution's prospects. Be that as it may, were, for example, the book of Alt-A mortgage holdings marked to market, the GSEs may

be shown to have been operating below their regulatorily defined minimum levels of capital. Additionally, the two GSEs were reportedly carrying nearly \$40 Billion in capitalized deferred tax assets. Naturally, should the assumption of profitability be removed from the GSEs, this capital would need to be written down (or off), again potentially placing the GSEs in a situation of capital deficit (or negative net worth).

What are the intended net results of these actions?

Treasury Secretary Paulson's stated objectives are to (1) stabilize the financial markets, (2) support the creation of mortgage finance, and (3) minimize cost to the taxpayer. In MetWest's estimation, the Treasury is very likely to have succeeded with the first two objectives. The Treasury has effectively eliminated any doubt that both the means and the will exist to effectively guarantee the senior and subordinated debt obligations of the GSEs. Additionally, concerns that the GSEs will not have sufficient capital or liquidity have been addressed. Whether the cost to the taxpayer is "minimized" or not, the Treasury hardly has a choice as to whether the GSEs need to be kept operating. Still, even should the "cost" to the taxpayer end up being substantial, it will be substantial only to the extent that the GSEs need the help.

Ultimately, we as a society will need to address the internal contradictions of our housing finance system: the desire to foster home ownership while not incurring "cost" to the taxpayer and the attendant illogic of having the GSEs remain privately owned corporations operating under the aegis of the Federal government. We are confident that solutions will be found, but perhaps we are all re-learning a basic lesson of capitalism. Namely, that a system that privatizes the gains from housing finance but socializes the losses tends not to optimize economic efficiency.

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