

# METWEST

To: MetWest Clients and Constituents  
From: MetWest Investment Team  
Date: July 10, 2008  
Re: FNMA / FHLMC

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We wanted to briefly share our thinking on the agencies given the sharp declines in these companies' equity market valuations and attendant speculation that Federal National Mortgage Association (FNMA) or Federal Home Loan Mortgage Corp (FHLMC) might be "insolvent".

Conceptually, FNMA/FHLMC are government chartered but privately held mortgage finance companies overseen by a Federal regulator, Office Of Federal Housing Enterprise Oversight (OFHEO). Their debt is not full faith and credit, but their size and centrality to housing markets make them, in our view, absolutely indispensable to the functioning of the national economy and global financial markets.

Each entity has a balance sheet the asset side of which represents some \$600+ Billions in mortgage loans plus roughly an additional \$150-\$200 Billion in agency guaranteed mortgage backed securities. (For comparison, JPM and BAC have balance sheets that are roughly twice as large). Combined, these two entities hold or guarantee approximately 50% of the mortgage loans of the US housing stock. Additionally, loans above 80 loan to value that are held by these entities are insured for the first 20% of losses by private mortgage insurers, limiting the agencies exposures to the first dollar of losses.

Indeed, the bulk of the assets held by the agencies are fixed rate in nature and are therefore largely insulated from the travails of the adjustable-rate mortgage market. And, though they hold material amounts of subprime loans, these loans are largely super senior or pass-through in terms of structure.

Nonetheless, concerns have been expressed relating to the leverage of these entities and potentiality that these companies are, or may become, capital constrained. Detractors of FNMA/FHLMC point out that these businesses are 30x levered if measured by balance sheet and perhaps 70x (or more) when the agency guarantees are taken into account. Ought market participants to be worried?

Interestingly, the answer may depend upon whether you are an owner or lender. While the equity market has decimated the stock prices of these entities, the bond market has been fairly sanguine. By way of example, one of the agencies floated two-year senior debt this week at a premium of 75 basis points over Treasuries, i.e. LIBOR - 25bp. This is cheaper capital than money center banks can fund themselves. Though subordinated debt spreads have widened somewhat, three year sub debt is only a modest 40-50 basis points more expensive. Hence, the capital markets are expressing a dichotomy of views: the equity market is discounting what appears to be highly negative outcomes for the agencies while the fixed income markets have only modestly increased the cost of capital on the agencies.

How ought this seeming dichotomy be understood? It strikes us that the proper context is that the bond market understands that FNMA/FHLMC are of such a size that contemplating such apocalyptic outcomes as liquidating the businesses or placing them into "run-off" are unthinkable. A potential shut-down of FNMA/FHLMC would, for all intents and purposes, likely foster an environment in which the supply of mortgage loans is cut-off. Such an event would be catastrophic. Homes might only be purchased by cash buyers, causing the market prices of homes to collapse and, equally likely, to catalyze a depression. Further, an inability to sell (or obtain agency guarantees) for mortgages would mean that many thousands of regional and local banks would be out of the business of originating mortgages. The bottom line as we see it

is that FNMA and FHLMC will be afforded every opportunity and given all latitude to continue their operations in an uninterrupted basis.

This statement seems to be at odds with the conduct of the equity market and with former bank president's Poole's remarks earlier today that FNMA/FHLMC are "insolvent." We believe the explanation to be straightforward: while the preservation of the FNMA/FHLMC businesses is a non-negotiable proposition, the regulators may nonetheless demand that FNMA/FHLMC dilute existing equity holders via a secondary offering of stock.

The agencies are subject to regulatory capital tests, one of which relates to OFHEO as well as a congressionally mandated statutory capital limit. Hence, should losses rise substantially in the portfolios of FNMA/FHLMC, the regulators and Congress could either decide to provide a measure of forbearance to the agencies and/or require that the agencies raise equity capital via a process that would be dilutive to the equity holder.

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