

Research

September 08, 2008

Peter Passing Andersen, Senior Analyst, +45 4513 7019, pa@danskebank.dk

Signe Roed-Frederikson, Senior Analyst, +45 45 12 82 29, sroe@danskebank.dk

Allan von Mehren, Chief Analyst, +45 45 12 80 55, alvo@danskebank.dk

US: Fannie and Freddie rescue, version 2.0

- On Sunday, 7 September, the US Treasury announced further steps to overcome the problems with the two large mortgage lenders, Fannie Mae and Freddie Mac. The Government is effectively taking over control of the two agencies under so-called conservatorship of the Federal Housing and Finance Administration.
- The Treasury's plan also includes *securing the solvency of the agencies* through injecting capital by issued senior preferred equity shares, *securing the liquidity* of the agencies and the Federal Home Loan bank by introducing a new credit facility, and finally securing the liquidity of the market by issuing a temporary programme to buy GSE MBS.
- The plan is expected to trigger relief in the market in the next few days; the pattern set by the 13 July statement suggests we should see some return of risk appetite. We have already seen strong equity performance in Asian markets and a sharp rise in US bond yields. Also expect a tighter US agency spread, and tighter swap spreads.
- Whether the Treasury's move is sufficient to more lastingly break the negative dynamics in the financial markets remains to be seen. This is the boldest move so far in the crisis and makes it clear that the US Government is willing to go to great lengths to prevent systemic risks from evolving too far. However, plenty of troubles are still out there and with US house prices still falling, it is too early to make any firm conclusions on the lasting impact of this intervention. The growth outlook for the rest of the year is still very shaky and we expect bond yields to revert lower again when the dust settles from the relief in the markets.
- Given the scope of the Treasury's actions, we think the plan will be able to bring mortgage rates lower. This would be a key achievement in ultimately promoting some stabilisation in the housing market.

Treasury to the rescue

A bold move

Following more than a week of cogitation, the US Treasury has now taken additional steps to help the country's two largest mortgage lenders, Fannie Mae and Freddie Mac, out of their bind. The aim of

the move is to stabilise the US housing market and improve financial market conditions.

The details, announced by Treasury Secretary Hank Paulson and the Federal Housing Finance Agency's (FHFA) Director Jim Lockhart in a [statement](#) on Sunday afternoon, reveal that the government now

effectively takes control of the two mortgage lenders.

The plan includes four main points.

1) Taking control: the Federal Housing Finance Agency, Fannie and Freddie's regulator, now has control of the entities, which has put the companies under a conservatorship. This does not mean the common and preferred stock will be eliminated; however, the agencies will now be run with the objective of improving mortgage financing conditions - not to maximize common shareholders' returns.

2) Securing solvency: the Treasury and FHFA have established Preferred Stock Purchase Agreements - contractual agreements between the Treasury and the Government Sponsored Enterprises (GSE). Under these agreements the Treasury will continually inject capital into the GSEs, thereby ensuring that the agencies' net worth is always positive and sufficient to fulfil their financial obligations. In return for the injected capital the Treasury receives senior preferred equity shares and warrants. While the existing common and preferred shares are not wiped out, the shareholders will bear losses ahead of the new government senior preferred shares.

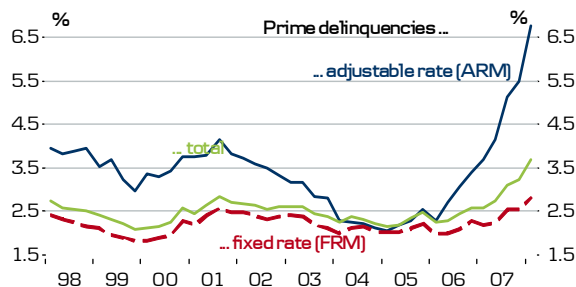
3) Securing liquidity: the Treasury is ensuring liquidity for the large mortgage market operators Fannie Mae, Freddie Mac and Federal Home Loan Banks, by introducing a new secured credit facility. The facility is intended to serve as an ultimate liquidity backstop and will be available until December 2009.

4) Securing market liquidity: the Treasury is securing market liquidity as well by issuing a temporary programme to buy GSE MBS. The programme will be launched later this month and will cover investments in new GSE MBS. It will also expire in December 2009.

Why they did it

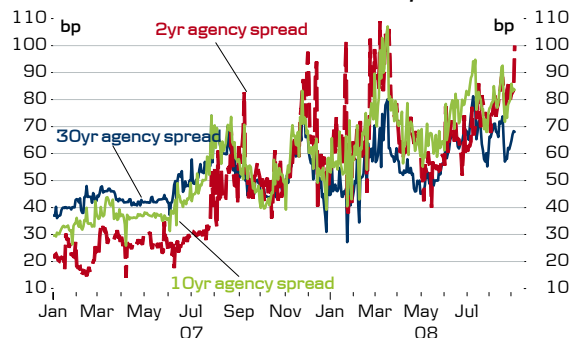
Fannie Mae and Freddie Mac, which own or guarantee more than USD 5 trillion, (nearly half of US home mortgage debt), have been under increasing pressures over the past quarters. As a result of bad loan performance, the agencies have, so far, suffered combined losses of up to USD 14bn - some of them in non-prime loans. With an eroding capital base and more losses in the pipeline, the solvency of the agencies has been put in question.

Fannie and Freddie have suffered losses due to rising foreclosures...

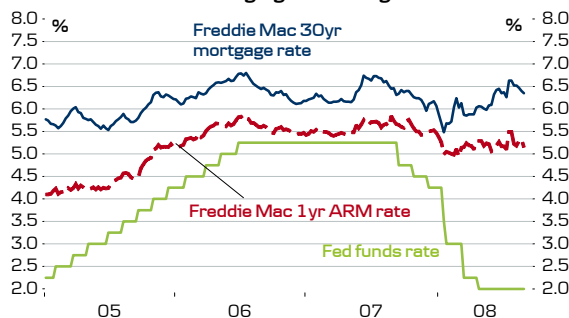


This had made it increasingly difficult for the agencies to raise fresh capital, which in turn has created concerns among the agencies' creditors. While the agencies have in fact remained able to roll over their senior debt, investors have been demanding an increasing risk premium on loans. The higher risk premiums have pushed lending rates for home owners correspondingly higher, threatening to trigger an even steeper leg down in the US housing market.

... which has raised investor risk premiums...



... and mortgage lending rates



In the current situation this could be particularly devastating as the two agencies have had an incremental role in the government initiatives to stabilise the US housing market. Furthermore, non-agency mortgage lending has been very limited, essentially leaving the US homeowner with no alternatives to the agencies.

To prevent a vicious circle, on 13 July the Treasury and the Fed announced explicit support for the two

agencies. Fannie and Freddie were granted access to the Fed's discount window together with a liquidity back-stop at the Treasury. Moreover, the Treasury was granted authority to inject capital (buy equity) into the agencies ([see Flash Comment - US: Fed and Treasury take action on GSEs](#), 14 July). The hope was that these explicit guarantees would be sufficient to re-establish financial market confidence in the agencies. Unfortunately, things went differently and over the past weeks the situation has deteriorated further. For instance, several foreign big-stake holders in the company's debt, including foreign central banks, have been expressing increasing concern about its quality ([see Flash Comment - US: confidence in GSEs is fading rapidly](#), 21 August). To prevent a large sell-off in the agencies' debt, which would amplify the situation considerably, the government was essentially forced into the current initiatives.

Financial implications

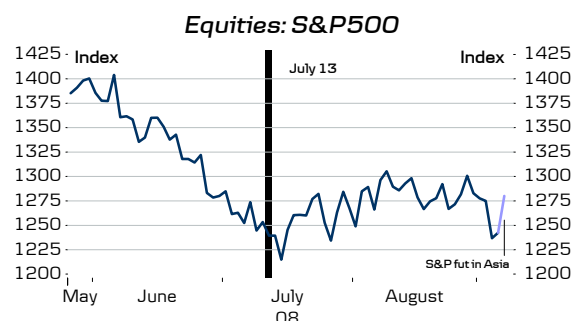
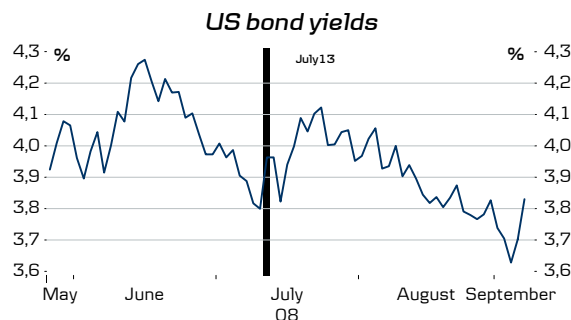
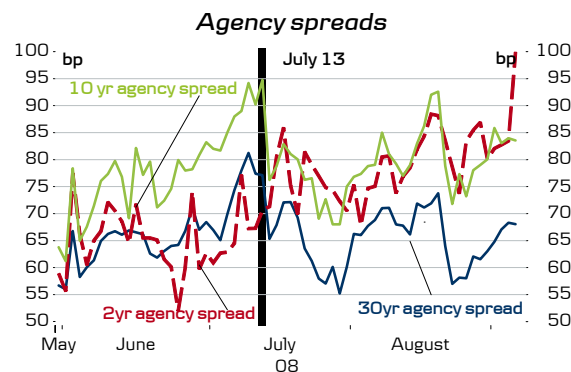
It is important to remember that the current package has been taken out of necessity and should therefore not be seen as a positive event in itself. That said, we expect the plan to trigger some relief in the markets and hence a rise in risk appetite. This was already seen early Friday when rumours of a package led to higher equity prices and a rise in bond yields. This has continued overnight in Asia where we have seen strong equity performance and a further rise in bond yields. US 10y bond yields are up 25bp from the lows seen Friday.

Generally, we think that the reaction following 13 July should provide some guidance of market behaviour. This points to a narrowing in the US agency and US swap spreads, with some beneficial spin-off into European swap spreads. The flipside of this reaction will be higher Treasury yields, partly reflecting some relief from flight-to-quality trades and partly some additional risk premium on Treasury debt, as the government increasing its liability through the agencies implies increasing concerns about the public budget. After the intervention on 13 July US bond yields rose a total of 35bp.

Does it affect the outlook?

Given the situation in the market, government intervention was urgent to prevent a major sell-off of agency MBS and in turn a worsening of the financing conditions in the housing market; hence it is fair to see some short-term relief in the market. But will the steps taken also be sufficient to generate a more sustained stability in the financial markets and in the housing market?

How did markets react after July 13



In the housing market the plan should help to bring the agencies' mortgage rates lower. So far homeowners have received little easing of financing conditions; despite the aggressive Fed cuts ARM rates have increased moderately and long-term agency mortgage rates are up by almost 1 percentage point from their low early this year. However, given that the Treasury is now able to provide liquidity and buy GSE MBS, the spread between Agency and Treasury debt should considerably narrow. In turn, this should bring mortgage rates lower, a key achievement in promoting some stabilisation in the housing market.

Whether the Treasury's move is sufficient to break the negative dynamics in the financial market remains to be seen. This is the boldest move so far in the crisis and makes it clear that the US Government is willing to go to great lengths to prevent systemic risks from evolving too far. However, plenty of

troubles are obviously still out there and with US house prices still falling we doubt that the last losses have been reported yet.

The growth outlook for the rest of the year is still very shaky and we expect bond yields to revert lower again when the dust settles from the relief in the markets.

This report has been prepared by Danske Research, which is part of Danske Markets, a division of Danske Bank. Danske Bank is under supervision by the Danish Financial Supervisory Authority.

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high quality research based on research objectivity and independence. These procedures are documented in the Danske Bank Research Policy. Employees within the Danske Bank Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and to the Compliance Officer. Danske Bank Research departments are organised independently from and do not report to other Danske Bank business areas. Research analysts are remunerated in part based on the over-all profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Danske Bank research reports are prepared in accordance with the Danish Society of Investment Professionals' Ethical rules and the Recommendations of the Danish and Norwegian Securities Dealers Associations.

Calculations and presentations in this report are based on standard econometric tools and methodology. Documentation can be obtained from the above named authors upon request.

Major risks connected with recommendations or opinions in this report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

First date of publication

Please see the front page of this research report.

This publication has been prepared by Danske Bank for information purposes only. It is not an offer or solicitation of any offer to purchase or sell any financial instrument. Whilst reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness and no liability is accepted for any loss arising from reliance on it. Danske Bank, its affiliates or staff, may perform services for, solicit business from, hold long or short positions in, or otherwise be interested in the investments (including derivatives), of any issuer mentioned herein. Danske Bank's research analysts are not permitted to invest in securities under coverage in their research sector.

This publication is not intended for private customers in the UK or any person in the US. Danske Bank A/S is regulated by the FSA for the conduct of designated investment business in the UK and is a member of the London Stock Exchange.

Copyright (©) Danske Bank A/S. All rights reserved. This publication is protected by copyright and may not be reproduced in whole or in part without permission.