

From: Michael AJ. Farrell
To: Steel, Robert;
cc: Scogin, Matthew;
Date: Thursday, March 06, 2008 12:47:11 PM

Bob,

Good to see you this week. I appreciated your time, the frank exchange of perspectives, and the opportunity to provide our trench's eye-view of the credit-markets. Like you, we believe that we are nearing a tipping point. What started as a problem with mortgage borrowers and foreclosures has spread to the broader credit markets—the lack of transparency on pricing for virtually every asset class, the tight credit conditions, the dearth of buyers, the extended balance sheets of banks and dealers, the very real prospect for massive, margin-call-induced asset sales as haircuts get ratcheted up and market values get ratcheted down.

Can Fannie Mae and Freddie Mac be part of the solution? I think the answer is yes, so long as Treasury and OFHEO are comfortable with the prospective change in their risk profile. Generally speaking, any incremental liquidity in the market would be welcome, and the potential size of that increment could be meaningful to the conforming and the jumbo market, as well as helping to relieve some of the pressure on stuffed balance sheets. Removing the 30% capital surcharge and expanding the conforming loan limit—within the context of GSE reform and possible additional capital raises—would certainly make it possible for the Agencies to serve the markets in this purpose. We believe that the Agencies themselves would highly value the reduction/removal of the 30% capital surcharge, but putting that capital (and any additional capital) to work may not be viewed with the same common purpose: From where we sit, Treasury's objective in this operation would be to help stabilize the financial markets; while the Agencies' objective should be to fulfill their Charters, they may be more focused on the prospective return on invested capital. They may believe that the return on invested capital is insufficient for their shareholders, particularly because the mere announcement of lifting the surcharge could result in market front-running.

Clearly, they will have to get past that, and focus on fulfilling their Charters. But they could have a point as far as the use of capital goes. Perhaps the reduction in the capital surcharge could come with conditions on the use of that capital and conditions for requiring additional capital, **but also** give the Agencies the ability to extinguish capital (through buybacks, dividends, etc.) once the crisis has passed. From where I sit, the big picture is that right now whatever is best for the economy and the financial security of America trumps the ROI for Fannie and Freddie shareholders. In FedSpeak this

could be expressed that the "balance of risks" between returns to shareholders and serving the nation are currently tilted towards serving the nation.

In any event, you had asked us to come up with ideas on how to measure the success of this operation. We would suggest three (we can provide backup and Bloomberg tickers if you'd like):

- First, there should be a meaningful reduction in the spread between jumbo mortgage rates and conforming mortgage rates: From June 1998 to June 2007, this spread averaged 44.6 bp. From July 2, 2007 to March 5, 2008, this spread averaged 96.7 bp and currently stands at 109 basis points.
- Second, we would look at mortgage spreads to Treasuries. The current coupon mortgage is currently about 207 bp wide to the 10-year Treasury. These spreads are as wide as I've seen them since the post-LTCM blow-out.
- Third, watch the health of the MBS Dollar Roll market. Like the repurchase market, the Dollar Roll market is an important mechanism by which the financing of Agency MBS occurs and thus plays a critical part in the liquidity of Agency MBS. A Dollar Roll is somewhat comparable to a repurchase transaction, but a major difference is that the party borrowing securities and lending cash does not have to return the same securities, but instead return "substantially similar" securities. Nevertheless, the Dollar Roll market provides investors an avenue to finance their Agency MBS holdings at attractive rates, and also gives the dealer community an important source of liquidity. In fact, one of the main reasons Agency MBS have become one of the world's most liquid instruments is because of the Dollar Roll. This is why we consider it to be a critical measure of the "health" of the Agency mortgage market. Currently this "health" measure shows the Agency MBS market running a high fever. Not only is it more expensive to finance Fannie and Freddie paper versus Fed Funds, but also versus Ginnie Mae. First, the spread between the implied financing rate in the GSE Agency MBS Dollar Roll market and the expected overnight Fed Funds rate is around 75 bps. The average over the last two years for this spread has been closer to 30 bps. Second, the spread between the implied financing rate for GNMA MBS vs GSE Agency MBS is also elevated, currently standing at 106 bps vs an average of about 30 bps over the last 2 years. (This puts the implied financing rate of GNMA MBS about 30 bp below expected Fed Funds.)

Fannie and Freddie could be part of the solution, but there are other tactics that could help. Principal reduction, interest rate-freezes and foreclosure moratoriums certainly help the borrower a little bit but, we believe, larger and more permanent liquidity injections or capital preservation techniques would be more important to fixing the market's broadly-based problems. Suspending certain mark-to-market provisions, utilizing pools such as the Exchange Stabilization Fund to hold assets, conducting coupon passes against Agency debentures or MBS or even non-Agency or corporate securities.

Bob, I hope I'm not being too presumptuous by passing along these thoughts, as you've undoubtedly already considered them. My only interest is in sharing with you the sense of urgency that we and other market participants are feeling right now. I hope that we can continue to serve as source of market color and ideas as you direct the financial markets through the current situation.

Best,

Mike