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Investment Opportunities In Government Sponsored Enterprise ("GSE") Debt Securities

During his testimony before the House Banking Subcommittee on March 22nd, Treasury Under Secretary Gary Gensler voiced the Treasury's support of a House bill, sponsored by Representative Richard Baker (R-LA), that would effectively overhaul the charters of Government Sponsored Entities (GSEs, or "agencies"), so as to reduce or eliminate the federal government's implied guarantee of their debt. If enacted, such legislation would undoubtedly hurt the agency-related fixed income securities market, as most investors believe, if somewhat erroneously, that the government is explicitly obligated to back GSE debt with the full faith and credit of the United States. There are several reasons why we think this legislation will not even make it out of committee and why now could be an excellent time to invest in GSE securities. Let's review the issues at hand.

GSEs, such as Federal Home Loan Banks, the Federal National Mortgage Association ("FNMA," or "Fannie Mae") and the Federal Home Loan Mortgage Corporation ("FHLMC," or "Freddie Mac"), have the following advantages either embedded in their charters, or granted by other laws:

- Their debt and mortgage-backed securities are exempt from registration with the Securities and Exchange Commission
- GSEs are exempt from state and local corporate income taxes
- Banks are permitted to make unlimited investments in GSE debt securities, whereas limits are imposed on their investments in the debt securities of other companies
- GSE securities can serve as collateral for public deposits and for loans form Federal Reserve Banks and Federal Home Loan Banks
- GSE securities are lawful investments for federal fiduciary and public funds
- GSEs are permitted to borrow directly from the US Treasury (the Federal Home Loan Bank, for example, can borrow up to $4 billion and Fannie Mae can borrow up to $2.25 billion. It is this ability to borrow directly from the Treasury that is the source of investors' belief that the government would bail GSEs out of any difficulties.

If passed, the aforementioned House bill, would make several specific changes to the relationship between the federal government and the GSEs. These include:

- The elimination of the agency credit line at the Treasury

- The creation of a new oversight body for all GSEs

- The requirement that each agency obtain an annual credit rating from a nationally known credit rating firm

- The lifting of the unlimited investment exemption that banks currently enjoy with GSE debt.

There is little chance that this bill will ever make it out of committee, let alone be voted into law, owing to the major role that the GSEs play in both the US housing and credit markets. GSEs were created to generate and maintain liquidity in the mortgage market, thereby helping to lower mortgage rates and make affordable housing available to the public. Their loss of sponsorship by the US government could increase their funding costs and significantly hinder their ability to fulfill this central role in the US economy. In our view and that of many others, the elimination of this relationship, which might lead to higher housing costs, would not be politically acceptable to Congress, particularly in an election year.

In addition, the GSEs have never borrowed on their credit lines, and, in any case, the credit lines are not large in relation to their mortgage portfolios, or other debt programs. As the Treasury indicated, “any function the lines perform at this point is purely symbolic”. It should also be noted that the federal government has never incurred a cost in its relationship with the GSEs.

Partly due to their special relationship with the government, Fannie Mae and Freddie Mac have grown to dominate the home mortgage financing industry. Agency debt, at $1.6 trillion, is now larger than the entire municipal bond market and half the size of the total Treasury market. As US Treasury debt shrinks, GSEs are likely to become the largest issuers in the fixed income market.

In the short run, the proposed change in the status of the GSEs’ ultra-safe securities has contributed to “spread” pressure and lower prices. In the medium term, however, the credit markets will increasingly look to agency debt to partially replace Treasury debt. This will, over time, add to the value of the securities issued by these two largest GSEs. In recognition of this shift, the Chicago Mercantile Exchange in March initiated futures contracts of Freddie Mac and Fannie Mae debt securities.

In the middle of June, Moody’s commented on the current controversy and reviewed its outlook for agency debt. Key points included:

- No change in GSEs’ Aaa debt rating, or their fundamental business outlook, is expected

- GSEs ability to borrow from the Treasury is only one of many symbolic links between GSEs and the government

- The assets of Fannie Mae, Freddie Mac and the Federal Home Loan Banks are low risk, as they have strong management who have demonstrated the ability to manage interest rate risk.

Moody’s continues to commend GSEs for their superior cash flow, favorable short-term to long-term debt ratios and consistent earnings. Looking back over one, three, and five years, GSEs are in the 90th percentile on an option-adjusted spread level. Given its strong underlying credit

quality and historically attractive spread levels created by Mr. Gensler's comments, we believe that the Agency market now provides a unique investment opportunity, one that should be acted upon before the present market disarray inevitably dissipates.

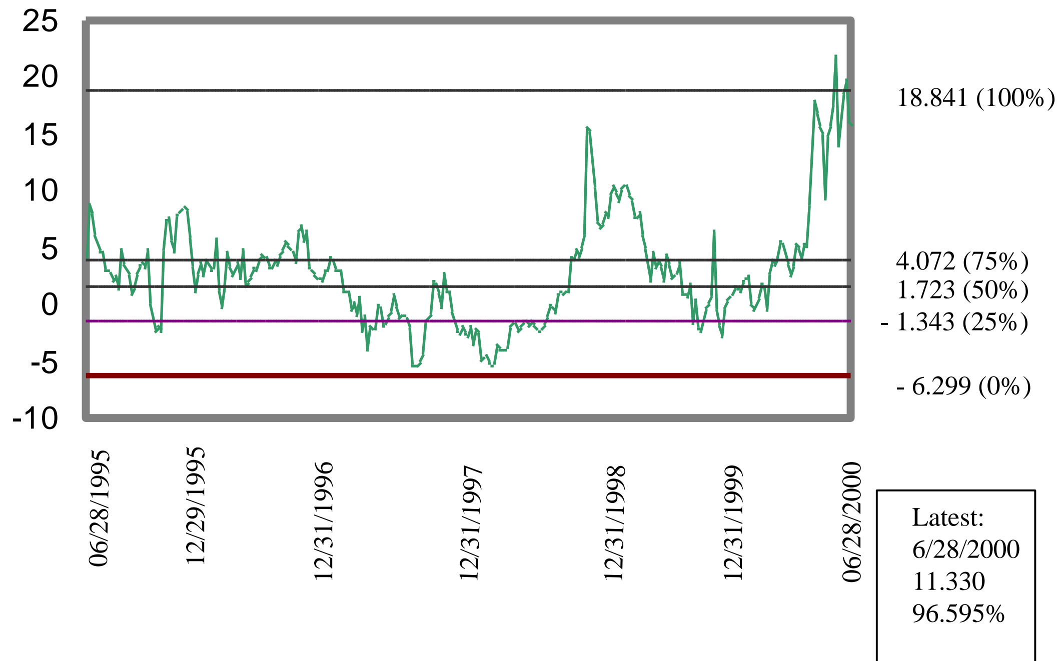
This dislocation in the GSE market is also present in the current price relationship of Fannie Mae and Freddie Mac mortgage pass-through securities to similar debt issued by the Government National Mortgage Association ("GNMA," or "Ginnie Mae". The latter is a true government agency and not a GSE. Typically, this price differential has corresponded to the difference in prepayment assumptions, the timing of cash flow payments, and liquidity between the issuers.

Over the past three years, Ginnie Mae mortgage pass-throughs have average between 4-6/32nds higher or lower in price, depending on the coupon, than GSE pass-throughs. Recently this price differential increased to 26-34/32nds, owing largely to investors' concerns about continued government sponsorship of Freddie Mac and Fannie Mae. Due to this controversy and in appreciation of its absolute government guarantee, investors have bid up the price of Ginnie Mae securities relative to those of GSEs.

Aside from political considerations, the current richening of Ginnie Mae mortgages needs to be addressed from a quantitative viewpoint, which is how we value the underlying assets of any security. According to our analysis, the current situation does not affect the prepayment expectation on the underlying mortgages to any significant degree. In this instance, the value of the underlying collateral (on an option adjusted spread basis) has been decreasing, owing to the current increase in prices. As of the end of May, the OAS on 8% FNMA and GNMA mortgages was 131 and 117 basis points, respectively. This difference in 14 basis points is the richest that GNMAs have traded in FNMAs in over five years (according to our model), indicating that FNMA mortgages are cheap in comparison.

OAS Difference FNMA vs GNMA

Current Coupon



The next step in our analysis was to appraise the underlying structure of the collateral on a forward basis. Historically, GNMAs have traded at a discounted dollar price, owing to their decreased liquidity in the market place (although this is not the case currently). Over the past several months, Ginnie Mae has been evaluating the possibility of changing the way it securitizes its mortgage loans. The proposal (discussed in a conference call with the Mortgage Bankers Association, Ginnie Mae, mortgage dealers, and selected institutional investors, including) is to change the gross coupon stipulations on the GNMA I underwriting program to allow a greater variance in the underlying mortgages backing the pool. Currently, the GNMA I program stipulates a weighted average coupon on the underlying loans backing the pool be 50 basis points higher than the stated coupon on the pool. This proposal would most assuredly hurt the liquidity of GNMAs in the short term and reduce the underlying value of the bonds on an option-adjusted basis, causing their prices to decrease. It is our conclusion that a form of this proposal will be enacted in the near future and will cause GNMAs to cheapen in the short-term, but with overall liquidity increasing over the longer term. The results of our analysis show that GNMA mortgages are rich in comparison to conventionals and should be underweighted in a portfolio in favor of FNMA mortgages. We will look to increase our exposure in GNMAs when their value returns to their historical average.

In sum, the GSEs are large, well run operations, that have successfully participated in the growth of home ownership throughout the US. We believe that Congress will adhere to the notion that "if it's not broke, don't fix it". If so, Under Secretary Gensler's comments have opened a brief and potentially lucrative window in this high quality and liquid sector of the market, one that fixed income investors would be advised to take advantage of before it closes.

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