Profitis Capital Services LLC

Market Commentary

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The Importance of Being Prudent

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The colossal failures of Fannie Mae (FNM) and Freddie Mac (FRE) have had an impact on both monetary and fiscal policy over the last three years. The risk that the federal government (i.e., the taxpayer) has accepted is both dramatic in scale and unprecedented in nature. However, the actions taken by the Treasury Department and Federal Reserve only serve as the starting point of the requisite investigation: what are the lasting implications for the housing market created by the malfunctions of FNM and FRE?

Established in 1938[1], Fannie Mae was charged with providing liquidity to the secondary mortgage market. Lending institutions were able to increase mortgage activity in an effort to expand home ownership. Similarly, Freddie Mac was created (1970) in response to what President Nixon described as the "Nation's critical housing shortage."[2]

The structure and ownership of Fannie Mae and Freddie Mac changed over the years. At the time of their failures, they were structured as public corporations. Their relationship to the federal government was that of a "government sponsored enterprise (GSE)[3]". This is in contrast to a true "agency[4]" of the federal government. No explicit federal government guarantee exists to this day for the repayment of Fannie Mae's or Freddie Mac's debt payments or obligations. What the GSEs did benefit from was the implicit guarantee of the federal government because they were providing the necessary market lubrication consistent with the goal of virtually every presidential administration: increasing the level of home ownership. This is highlighted by the Housing and Community Development Act of 1992 and 1999's decision by Fannie Mae to expand low-income and moderate income lending programs[5]. The capital markets postulated that the federal government would not allow the housing market to be disrupted by the default of its largest providers of liquidity. *(continued on page 2)*

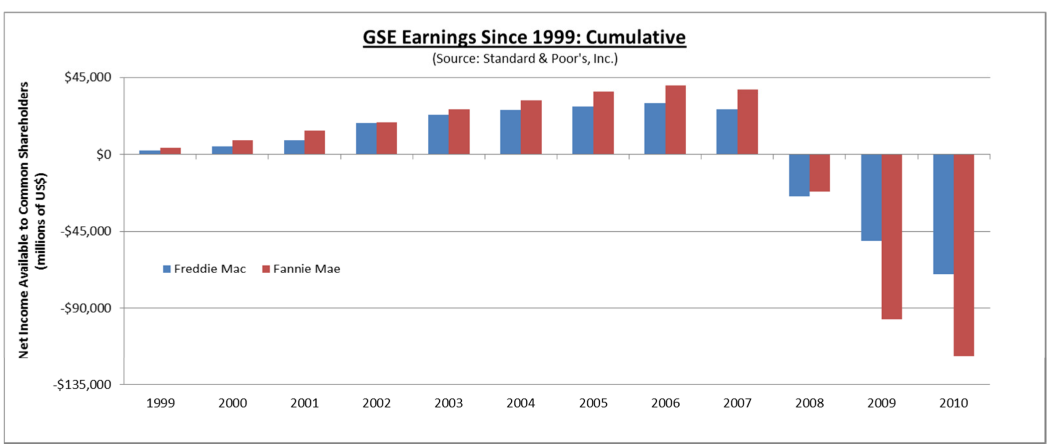
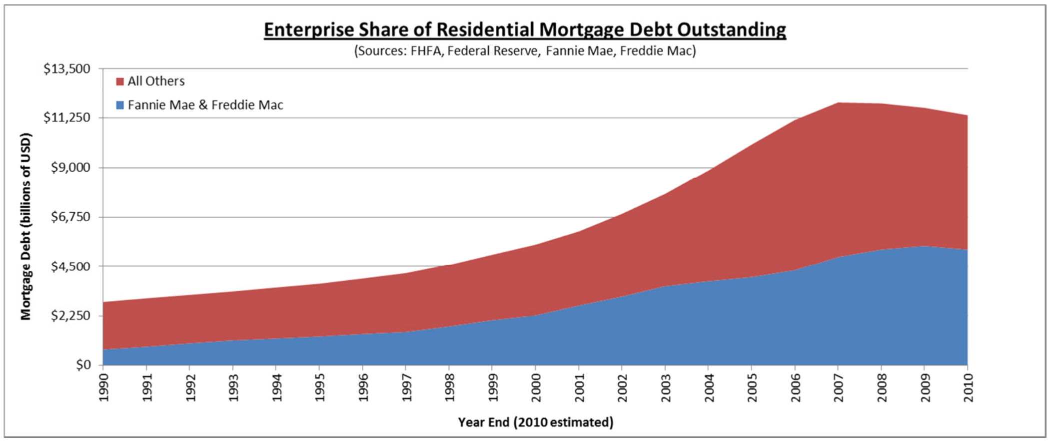


Chart 1: Earnings Trend
In the last 12 years, Fannie Mae (FNM) and Freddie Mac (FRE) have lost over $188 billion. On September 7, 2008 FNM & FRE were placed into conservatorship of the Federal Housing Finance Agency (FHFA). Unlike FNM & FRE, the FHFA is an *agency* of the U.S. Government.[6]

Chart 2: Enterprise Share
Fannie Mae and Freddie Mac either hold or provide mortgage guarantees on over 46% of the total U.S. mortgage debt. Their share of the market stood at 25.7% back in 1990. From 2000-2007, FNM & FRE averaged $33.00 & $29.26 in total assets per $1.00 of total equity, respectively.



The market's perception of an implied guaranty enables Fannie Mae and Freddie Mac to borrow funds at a discount to other financial market institutions.

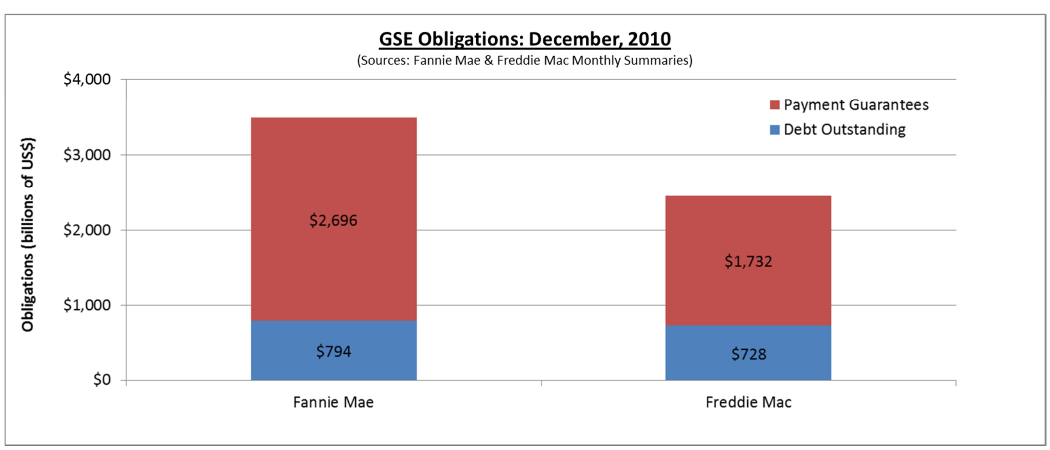
How Fannie & Freddie Do That Thing They Do

Fannie Mae and Freddie Mac purchased and held mortgages from financial institutions. This direct method of providing market liquidity was a relatively small part of their operations, accounting for (on average, 1990-2009) 32% of their combined exposure. The principal method of providing liquidity is the securitization of acquired mortgages. These newly minted mortgage backed securities (MBS) are attractive to investors because the payment of principal and interest is guaranteed by the issuer. The GSE collects a fee for providing this guaranty in the form of a rate differential on the MBS. Therefore, Fannie Mae and Freddie Mac are similar to insurance companies. As such, the financial strength of these GSEs is a function of capital reserves, premium collection and risk management.

By the end of the second quarter of 2008, Fannie Mae owed $811 billion in debt and provided $2.56 trillion in payment guarantees. Against these claims, Fannie held $41.2 billion in total equity and earned quarterly fee income (average from Q3 2007 – Q2 2008) of $1.66 billion. Similarly, Freddie Mac owed $836 billion in debt and provided $1.82 trillion in payment guarantees. Freddie Mac's total equity stood at $13 billion and guaranty fee income averaged $748 million per quarter.

After adjusting for guarantees outstanding, *(continued on page 3)*

Chart 3: GSE Obligations
At the end of 2010, Fannie Mae and Freddie Mac owed $1.52 trillion in debt and provided $4.43 trillion in payment guarantees. The federal government offers no explicit backing of either obligation (potential or existing).



Fannie Mae and Freddie Mac averaged guaranty fee income of 28.1 basis points and 17.3 basis points, respectively.

Let's pause for a few calculations:

Pre Conservatorship (6/2008)

Fannie Mae		Freddie Mac	
Guaranty Balance	$2,560,000,000,000	Guaranty Balance	$1,820,000,000,000
Reserve for Losses	$7,450,000,000	Reserve for Losses	$3,516,000,000
Total Equity	$41,200,000,000	Total Equity	$13,000,000,000
Loss Buffer	**1.90%**	**Loss Buffer**	**0.91%**

Guaranty fee income would provide additional funds for offsetting losses, yet the picture is clear: the GSEs were operating on a woefully undercapitalized basis.

The U.S. housing market benefitted greatly from this hyper-leveraged business plan. The GSEs were able to borrow funds in the debt markets at superior rates, thereby creating a steady stream of cash to acquire assets. The GSEs were charging a small fee for their payment guaranty, assuring a market for their MBS. The GSEs were able to operate at a leverage ratio in excess of their financial institution counterparts, which enabled them to greatly expand market share.

In the absence of aggressive GSEs, it is difficult to determine the true bottom of the housing market, in addition to forecasting a return to the housing market highs of the early 2000s. The elimination of such market distortions is the first step in allowing this massive market to reach equilibrium.

On February 11 of this year, the Department of the Treasury and the U.S. Department of Housing and Urban Development released their joint paper on the reformation of the housing finance market. Although the timing of its proposed actions is subject to debate, it is clear that Fannie Mae and Freddie Mac will have a greatly reduced role in the future of the mortgage market. This will leave the bulk of the home financing decisions in the hands of banks and other financial institutions. What price will they charge for payment guarantees?

Senior Preferred Stock Purchase Transactions

Fannie Mae

Date	Net Worth (billions US$)	Draw From Treasury Program* (billions of US$)
26-Sep-08	n/a	$1.0
31-Mar-09	($15.2)	$15.2
8-May-09	($18.9)	$19.0
6-Aug-09	($10.6)	$10.7
5-Nov-09	($15.0)	$15.0
26-Feb-10	($15.3)	$15.3
10-May-10	($8.4)	$8.4
5-Aug-10	($1.4)	$1.5
5-Nov-10	($2.4)	$2.5
24-Feb-11	($2.5)	$2.6
		$91.2

Freddie Mac

Date	Net Worth (billions US$)	Draw From Treasury Program* (billions of US$)
26-Sep-08	n/a	$1.0
29-Nov-08	($13.7)	$13.8
31-Mar-09	($30.6)	$30.8
12-May-09	($6.0)	$6.1
5-May-10	($10.5)	$10.6
9-Aug-10	($1.7)	$1.8
3-Nov-10	($0.1)	$0.1
24-Feb-11	($0.4)	$0.5
		$64.7

Total Draw (billions of US$)	$155.9
Potential Commitment* (billions of US$)	$400.0

*Authorized by the Housing & Economic Recovery Act of 2008 (Public Law 110 - 289)
The Treasury Department increased the potential commitment level to $400 billion on 2/18/09.
For details on the Senior Preferred Stock Purchase Agreements, visit:
http://www.treas.gov/press/releases/reports/seniorpreferredstockpurchaseagreementfnm1.pdf
http://www.treas.gov/press/releases/reports/seniorpreferredstockpurchaseagreementfrea.pdf

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[1]National Housing Act of 1934, amended in 1938.

[2]Statement on Signing the Emergency Home Finance Act of 1970

[3]Government-sponsored enterprise is defined in the Omnibus Reconciliation Act of 1990.The Act, in part, states that a GSE "has a Federal charter authorized by law." However a GSE "does not have the power to commit the Government financially".

[4]An agency is defined in Title 5, Part 1 of the United Sates Code.

[5]Holmes, Steven A. "Fannie Mae Eases Credit To Aid Mortgage Lending" New York Times September 30, 1999

[6]The Federal Housing Finance Agency (FHFA) is the successor agency to the Office of Federal Housing Enterprise Oversight (OFHEO). http://www.fhfa.gov/