ODEON

Bove Briefing

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The Treasury Report on the GSEs Delivers
Its Proposals Would Help Everyone

Treasury Report Released

As expected, the United States Treasury released its report on the Government Sponsored Enterprises (GSEs) after the market closed yesterday. The report does not explicitly state that the Net Worth Sweep will be eliminated or the Junior Preferreds will receive some payment.

However, in the second paragraph of the first page of the Treasury report, the third sentence argues that the GSEs need more capital and better regulation. In addition, that sentence has these critical words:

> "… they [the GSEs] remain critical to the functioning of that [housing finance] system … ."

On the second page of the report, second paragraph, third sentence, it states:

> "Treasury would support legislation that authorizes an explicit, paid-for guarantee backed by the full faith and credit of the Federal Government that is limited to the timely principal and interest on qualifying mortgage-backed securities."

These two sentences certify the continued existence of Fannie Mae and Freddie Mac. The report argues that the two GSEs should be recapitalized and released from their conservatorship. Further, it also suggests the creation of a secondary mortgage market structure that would allow Fannie Mae and Freddie Mac to operate, with some changes, but much like they did before they were placed into their conservatorship. For this to happen, the junior preferreds must be paid off.

The Treasury report sets up a scenario which now allows the Federal Housing Finance Agency (FHFA) to set out the specifics as to how these companies would operate. In sum, the Treasury report provides the outline. The FHFA is to provide the specifics.

Multiple Winners

If I understand what is being suggested here

- investors in the preferred issues of both Fannie Mae and Freddie Mac are about to make a great deal of money.
- Beyond this, Wall Street, itself, may be about to raise the largest amount of money in its history for what would now be private companies.
- Finally, if the banking industry can get Congress to agree, it will be given the right to set up secondary mortgage companies that would compete with the traditional GSEs.

Everyone could make money here including the taxpayers, the United States economy, the housing industry, holders of GSE preferred issues, and possibly even the investors in the GSE common shares.

The road to making this happen will not be without numerous road blocks. However, Treasury Secretary Steve Mnuchin has done a remarkably good job here outlining a plan that would benefit everyone in this country. Now it is up to FHFA Director Mark Calabria to put theory into action, which seems highly likely.

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The Outline

On Thursday, Odeon Capital Group published its view of what the Treasury report would be likely to recommend. This commentary discusses the Treasury report along the lines of that outline, point-by-point:

- The 30-year fixed rate mortgage will be guaranteed by the government for a fee.
- Fannie Mae and Freddie Mac will remain at the core of the nation's secondary mortgage markets.
- Opportunities will be made available so that other companies might enter the business with the same powers as the two GSEs
- The Net Worth Sweep whereby the government takes all of the profits of these companies will be eliminated.
- The senior preferred stock that the government owns in the two GSEs will be declared paid in full.
- The $200 billion Treasury draw facility for each company will remain in place.
- The "patch" arrangement will be grandfathered.
- The junior preferred stock holders will receive some payments
  - Probably in common stock; and
  - Probably at a slight discount to their par value.
- The capital position of the two companies will be bolstered by
  - The build-up in retained earnings;
  - Possibly the conversion of the junior preferreds to common;
  - A tiny contribution as the government converts its warrants into common stock; and
  - Possibly a stock offering.

30-Year Fixed Rate Mortgage

The Treasury report indicates that 86% of the home mortgages handled by the two GSEs are 30-year fixed-rate mortgages. It is expected that the principal and interest on these mortgages would be guaranteed by the government if these financial instruments were in mortgage backed securities underwritten by Fannie, Freddie and the hoped for newer secondary mortgage market entities.

Fannie and Freddie Will Remain at the Core of the Nation's Secondary Mortgage Markets

It is clear from reading the Treasury report that Fannie and Freddie will be the basis of the secondary market. There are numerous statements suggesting that other competitors will be created. However, it will take decades and possibly forever for new entrants in these markets to weaken Fannie and Freddie's hold -- unless the big banks are allowed in, which is not being offered by the Treasury plan.

Net Worth Sweep Will Be Eliminated and Be Declared Paid in Full

The Treasury is suggesting a total recapitalization of the two GSEs. This would include using preferred and convertible bonds. It is also relying on the companies to regain control of their profits. Implicit in these assumptions would be the elimination of the Net Worth Sweep and the Senior Preferred, itself.

The $200 Million Draw Facility Will Remain in Place

The Treasury recommends that this facility remain in place. It is hoped that by recapitalizing the GSEs, the facility will never be needed. However, it is felt that the existence of this facility will help protect the taxpayer.

The "Patch" Arrangement Will Be Grandfathered

The patch would not be grandfathered. However, the qualified mortgage rule which gave need to create the patch is to be eliminated. This, of course, would be better since it would basically certify the reason for the patch and the patch itself.

The Junior Preferred Would Receive Some Payments

This has not been explicitly stated. However, Mark Calabria has written words to the effect that the government has an obligation to protect the rights of these shareholders. More importantly, in order to raise well over $150 billion to recapitalize these companies the government would be forced re-establish credibility with investors. To do this the junior preferreds must be paid.

The Capital Position of the Two Companies will be Bolstered

The plan I outlined in the Thursday report is as follows.

	Fannie Mae			Freddie Mac	
	Capital (mil)	Shares (mil)		Capital (mil)	Shares (mil)
Estimated Requirement					
Required 4% of assets	$140,000			$85,000	
Sources					
Current	$3,000	1,158		$3,000	726
Retained Eranings Year 1	$12,000			$6,000	
Warrant exercise	$47	4,735		$25	2,508
Preferred Conversion @$2.50/Share	$19,130	7,652		$14,109	5,644
Stock Offering @$2.50/Share	$105,823	42,329		$61,866	24,746
Amount raised	$140,000	55,874		$85,000	33,624
Estimated EPS		$0.21			$0.18
Estimated Dividend		$0.10			$0.09
Estimated ROEs	8.6%			7.1%	

Source: Odeon Capital Group

It has flaws in many respects but it is the basis of how these two companies would be recapitalized. Secretary Mnuchin wants a far more sophisticated capital structure but bottom line the figures in the table above are close to what the final outcome is likely to be.

Core Argument

The primary argument as to why this set of proposals should go forward was stated in the September 5, Odeon report:

> "In all of the comments I have written over the past decade on this subject I come down to these points:
>
> - The current system works; and
> - Changing it will create major economic disruption."

I believe that the arguments that will be made in support of the Treasury Plan will rely heavily on the arguments proposed in 1968 and 1970 to get the Omnibus Housing and Emergency Finance Acts passed. The Treasury report has already referenced them. We know and understand what happened then and it could happen again.

The Treasury report puts us on the right track. The FHFA is likely to certify the Treasury's approach. A great deal of money is going to be made by all – most importantly the U.S. economy.

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