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- **WRG Financial Services**
- **WRG Housing**

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Housing Finance Friday: Can GSE Reform Pass Absent Settlement?

The Cowen Insight

One lingering question is whether the government needs to settle shareholder litigation over Fannie and Freddie in order to successfully reform the enterprises. To us, a settlement would facilitate reform by making it easier to repurpose the existing Fannie and Freddie as bond guarantors. That could make cutting a deal attractive to Congress and the White House.

Welcome to Friday, which means it is time for our weekly housing finance note. Our focus today is on whether Housing Finance Reform can advance absent a settlement of the shareholder litigation.

This came up earlier today when Mortgage Bankers Association President David Stevens appeared on CNBC to discuss housing finance reform. Stevens pushed for Congress to decide the fate of Fannie and Freddie.

What we found interesting was when the conversation shifted to whether the shareholder litigation over the third amended dividend agreement was distinct from what Congress does to reform the enterprises. Or are the two issues linked?

On that front, we offer the following observations:

- As we have argued in prior notes, we believe there is a path forward on GSE reform as there are leaders in Treasury, the House and the Senate who are committed to legislation. It is why we have placed a 65% probability on legislation in the 115th Congress.
- Treasury Secretary Steve Mnuchin's televised comments yesterday only reinforce our view as he discussed how he had a team at Treasury already looking at GSE reform as part of his push for a bipartisan legislative solution.
- We believe the probability for legislation improves as the plan to overhaul Fannie and Freddie gets simpler. The fewer new entities created and the greater the reliance on existing structures then the less risk Congress is likely to perceive in voting for reform.
- It is a primary reason why we have found the outline of the DeMarco-Bright white paper so interesting. It transforms Fannie and Freddie into bond guarantors who hold more capital and engage in mandatory credit risk transfers. And it uses the Ginnie Mae platform so the resulting MBS has a sovereign guarantee. These are proven structures that Congress knows.
- Our view is that the easiest way to get to this type of legislative solution is to settle the litigation as part of the enactment of reform. This is because we believe it is simpler to use the existing enterprises rather than create New Fannie and New Freddie.

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- We believe it may be difficult for the enterprises to raise fresh capital if there are questions swirling about whether prior shareholders are entitled to value.
- It is not just the issue of whether new investors would be willing to recapitalize enterprises that the government had previously seized. To us, the market has a short memory and would look past what happened in 2008.
- The bigger complication would be what happens down the road if the shareholder lawsuits prevail? Does that alter the ownership structure or impact existing capital levels? Or could such a victory provide a President and Congress with an excuse to jack up GSE capital requirements or take other steps that would make them less profitable? Or does a future White House try to unwind the enterprises because of the legal situation or turn them into government corporations?
- It is not that we would expect any of those outcomes. It is more that the existence of the litigation is a wild card that could complicate efforts to raise fresh capital.
- The solution would be to create New Fannie and New Freddie as the bond guarantors in the legislation while Old Fannie and Old Freddie are liquidated. The existing shareholder suits would then be isolated from the new system.
- For us, the problem with that option is that it creates added risk as the government would both need to create two new entities and figure out how to put the existing enterprises into liquidation without hurting liquidity in the MBS market.
- It is not an impossible task. Yet it is a complication that could be avoided if there was a settlement that provided existing shareholders with some value in the new enterprises. How much value would go to holders of common and preferred shares is beyond our political assessment. And it might depend upon whether existing shareholders help recapitalize the enterprises.
- Yet it seems to us that combining a settlement with legislative reform might offer the least risky path for reform. As a result, we believe this is an option that should interest Congress and the White House.

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