INDUSTRY PERSPECTIVES

Treasury's Long GSE Capital To-Do List: Clearing the Decks for Investors

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Introduction

As 2019 ends, the two Government-Sponsored Enterprises (GSEs) Freddie Mac and Fannie Mae finally have some momentum in ending their conservatorships, the legal status under which they have operated essentially as wards of the US Government for over eleven years now. Specifically, the Treasury and the Federal Housing Finance Agency (FHFA), which is the regulator and conservator of the two companies,[1] have embarked upon ending the conservatorships via administrative means (i.e., without any legislation by Congress).[2]

As background, the GSEs have undergone fundamental reform of their operations during that decade-plus of conservatorship. Their investment portfolios have been shrunk dramatically,[3] they transfer well over half of new guarantee credit risk to institutional investors via the global capital markets, they do not give discounts on guarantee fees (G-fees) to larger lenders, the two companies issue a "single security" for slightly lower interest costs on home mortgages, and so on. They are, in the view of much of the industry, acting today more as professionally-run corporations serving their customers, the marketplace and their mission well than they did prior to the government takeover, when their management was widely regarded as being too focused on lobbying to protect privileges and subsidies.[4]

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[1] The FHFA, acting as what is called the "conservator," is fully in charge of the two companies, having the rights and powers normally associated with the shareholders and the Boards of Directors. This situation is designed to be temporary. The FHFA, permanently, is their regulator as well, just as the Federal Reserve is the regulator of bank holding companies, for example; in this role, the FHFA is responsible for the "safety and soundness" of the two companies.

[2] The Treasury's "Housing Reform Plan" of September, 2019 (https://home.treasury.gov/system/files/136/Treasury-Housing-Finance-Reform-Plan.pdf) has indicated that the administration would prefer that Congress legislate on this topic, but after more than a decade of that not happening, the plan also calls for the administration to pursue reform without such legislation in the resulting vacuum as a first step, with Congress hopefully coming in later to complete the process with appropriate legislation.

[3] Their investment portfolios are widely considered to be subsidized because they are funded with monies obtained at ultra-low cost – well below what a large bank would pay, for example – because the US government has either implicitly or explicitly promised investors that it will not let the companies fail. Prior to conservatorship, they grew these portfolios to extraordinarily large size ($1.5 trillion in aggregate) to generate discretionary profits, largely driven by how ultra-low-cost their funding was; unfortunately, many of the investments turned out to perform poorly in the 2008 Financial Crisis and were the source of large losses to the companies.

[4] During conservatorship, the companies are prohibited from lobbying.

For the exit from conservatorship to take place administratively, besides hopefully locking in these operating reforms, the big agenda item still to be addressed is ***capital*** – in the broadest context, covering a lengthy list of topics. And administrative reform requires that the Treasury and the FHFA collaborate, since both organizations must agree to many of the changes as specified in various legal agreements.

The FHFA's director these last eight months, Mark Calabria, has been unusually open for a regulator, speaking frequently in many venues about capital-raising, with much coverage by specialized industry press and the investment community, both of which take a keen interest in the topic. Not surprisingly, his comments are focused upon the more FHFA-centric aspects of capital – most importantly, developing a new, formal rule on the minimum required capital for a GSE.

Treasury, by comparison, has been quiet, as it is following the more common standard modus operandi of making announcements (especially those that might impact markets) only when decisions are finalized. And the list of capital-related topics that are more Treasury-centric is long, as will be seen below, and sometimes not so much under its direct control.

In fact, the key insight in this article is that, while the FHFA is appropriately focused on preparing the GSEs to be able to do capital-raising (in addition to retaining earnings) as part of ending conservatorship,[5] Treasury has the main responsibility to address and resolve many issues so that potential equity investors can be ready to make extremely large investments on reasonable economic terms – I refer to this task as "clearing the decks for investors" to support eventual capital-raising. Without investor-centric issues being cleared up in this manner, there will likely be no equity raises and the GSEs will just keep retaining earnings for years to come.[6]

[5] The FHFA is also preparing the GSEs and itself for regulation post-conservatorship, when the FHFA will no longer be able to direct the companies as thoroughly as it does as their conservator.
[6] The FHFA and Treasury, today, seem to prefer as a policy to have the GSEs exit conservatorship as soon as possible, which requires external capital-raising in large amounts in addition to retaining earnings. But there is nothing inherently wrong with a strategy of relying primarily upon retained earnings, which would take longer – it's just a policy choice being made today.

To educate the housing finance and investment communities about the capital-related items (mostly) on Treasury's plate, I have written up a comprehensive – but probably not exhaustive – list of fourteen items that need to be addressed. Treasury is the focal point for these issues, sometimes being responsible on its own or jointly with the FHFA, sometimes being the representative for the entire Trump administration, and sometimes just having to deal with an issue where outside parties have a real say in the outcome as well.

I have put this paper into the form of a memo from a fictitious equity capital markets executive at a major investment bank,[7] which naturally is interested in becoming a lead underwriter for an eventual GSE capital raise that will accompany exiting conservatorship, as the fees generated would be quite large. I have included footnotes to explain technical language for a more general audience.

Interoffice Memo

To: Equity Capital Markets Leadership Team
Re: Treasury's GSE Capital Markets To-Do List

You have been reading many comments by FHFA Director Calabria about the GSEs being ready to raise capital externally via re-IPOs,[8] to complement their retaining earnings (which commenced at the end of September, 2019). These include comments about when the first capital raise might take place; the latest of his estimates (which change over time as his thinking evolves and as he addresses the issue in many speeches) seems to be in 2021, maybe even early 2021.

Calabria's comments reflect the FHFA-centric agenda of getting the companies ready to issue equity and operate post-conservatorship. FHFA's preparations for capital-raising, focused on the GSEs, constitute a classic "necessary but not sufficient" set of activities. They must be complemented by the items on Treasury's to-do list, which is overwhelmingly oriented towards clearing the decks of issues that, unresolved, make valuing the shares to be sold difficult if not

[7] "Equity capital markets" is the terminology for the people who specialize in arranging new issues of equity to be sold to investors.
[8] The two GSEs are technically public companies today, with shares trading. Thus, their first new issue is not an "IPO" but a re-IPO, a term invented to describe this type of situation. AIG did such a transaction as part of its shedding government control.

impossible; *without those issues being resolved so that investors will purchase any newly issued shares on reasonable economic terms and in astoundingly large (very possibly record-setting) amounts, the companies will just continue to rely upon retained earnings to build up capital.* And, as will be made clear below, the timing of these actions by Treasury probably extends past the date estimated by Calabria above; in fact, the timing of a few of the items is beyond the control of Treasury, making any prediction of timing quite uncertain.

I note that a limited equity raise, which would be justified on some basis (such as "establishing the track record to do large equity issues in the future" but which would probably be called a "publicity stunt" by some in the media),[9] could be done early to deliver a policy or political victory for the FHFA and Treasury. Such a raise may be worth exploring as we seek to be hired as an underwriter by one of the two GSEs. (Note – as far as we can tell, the FHFA will not be choosing actual underwriters; they have nearly completed hiring an adviser for themselves, but the two companies would hire the underwriters, probably subject to FHFA and/or Treasury approval, at some future date.)

Reminder:

- The first objective of a re-IPO is to be able to raise extremely large amounts – in the tens of billions of dollars of common equity, very possibly the largest such transactions in US history. (The two GSEs together will need common equity well in excess of $100 billion between them, to be raised via a combination of retained earnings and external issuances.)
- The second objective is for the cost of capital being raised to be typical of a very large, publicly-traded FI,[10] which today translates into the 9% to 10% range; today's politically sensitive G-fees are in fact predicated upon that 9% to 10% range for the cost of capital.[11]

Obviously, then, an ultra-important requirement for a successful re-IPO is that the GSEs be as operationally and financially understandable to the public as possible, so we (as an underwriter) and then potential investors can value the shares properly by knowing *exactly* what is being invested in, with forward financial projections having no more uncertainty than is conventional in equity raises. And the level of uncertainty should ideally be lower than usual, as the amounts to be raised are so large that it will require the new-issue-purchase capacity of a very large share of the entire global market of institutional equity investors.

[9] The recent IPO of Aramco is an example of this.
[10] "FI" – Wall Street terminology for "financial institution."
[11] "G-fees" mean "guarantee fees," the amount charged by the two GSEs to take on the credit risk of the mortgages they purchase above and beyond what the market charges via the mortgage-backed securities into which a mortgage loan is placed. About two-thirds of the cost of a G-fee is the cost of capital.

The current equity stack of the GSEs is as follows[12]:

- Senior preferred, owned exclusively by Treasury, projected outstanding to be about $240 billion at the time of a potential re-IPO
- Junior preferred[13], owned by the public, at $33 billion
- Common equity, owned by the public; Treasury has a warrant[14] on 79.9% of the common shares

CAVEAT: You may have read about the Treasury and FHFA together keeping the option alive to put the companies through receivership, as specified in HERA (the law which applies to how the GSEs are regulated). At this time, I am dismissing that option as too risky, given its potential to upset the fundamental workings of US mortgage markets, including the TBA market that Treasury has made clear it does not want disturbed.[15] Also, the formal Housing Reform Plan issued by Treasury does not reference this option.

Here is my list of fourteen investor-centric items that need to be resolved to have the best possible underwriting for a GSE given the immense amount of capital involved and the need for it to be at low-cost. I have divided them up into two groups. First, those where Treasury has the clear responsibility and authority to address the issue (sometimes jointly with FHFA).[16] Second, those where Treasury's role is more advisory, working as the expert on and liaison to the financial markets, to help ensure that actions by others are consistent with investors' being ready to purchase GSE shares at the right price and in large quantities when the time comes.

The reality is that a successful underwriting does not require 100% of these issues to be 100% resolved; but it requires something close to that mark, or the underwriting will be out of the conventional mainstream in terms of riskiness, and that will impact both volume of dollars available and capital cost. If that impact is too material, then the companies would presumably just continue to retain earnings longer and defer doing re-IPOs.

I also want to note that I believe Treasury knows about all these items. We just don't know what their (and FHFA's) plans are to resolve them in terms of either substance or timing.

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[12] The economic rights associated with ownership of the GSEs are thus divided up into these three classes of shares – senior preferred, junior preferred and common equity. The "priority" is that, in general, the senior preferred gets the value of the company first until its position is paid off; junior preferred comes second, and common comes last.

[13] This is the preferred shares outstanding that were issued and trading prior to conservatorship. It was made junior in the equity stack to the funding Treasury provided the company.

[14] The warrant is an option to purchase, in this case for a negligible amount, common shares of the company.

[15] This is the "to be announced" market. Without going into the mechanics, which are not necessary for this article, the TBA market is the means by which the underlying MBS behind mortgages are made ultra-liquid (second only to US Treasury securities), which translates into the lowest mortgage rates possible for the American homeowner. It also enables the homeowner to lock in a mortgage rate months before an actual home purchase.

[16] Treasury is, of course, part of the presidential administration, so its actions may have to reflect views of others in the administration rather than just its own. But that is behind the scenes – we will just see Treasury acting.

Group 1: Treasury Has Authority to Act

1. Support Fee (joint with FHFA). What will Treasury charge the GSEs for providing the PSPA-structured credit support to the two companies, which they absolutely need for their business model to continue?[17] When earnings began to be retained earlier this year, Treasury was expected to announce its policy regarding the fee. Instead, the issue was punted to the future. I note that whatever level is picked will likely be politically controversial – with DC-based interest groups complaining that it is too low or too high, depending on their interests or philosophy. In terms of doing an underwriting, the size of this fee will materially impact earnings forecasts of the companies. I know that Freddie Mac, in doing certain internal forecasts, assumes the fee is at least 5 bp per dollar of their $2 trillion of liabilities; extrapolating for both GSEs, the fees would then amount to at least $2.5 billion per year, or ballpark 10% of after-tax earnings. They could be quite a bit higher.

2. Treatment of Senior Preferred. There will be about $240 billion of senior preferred equity outstanding between the two companies by the time a re-IPO would occur,[18] and its disposition must be known before external capital-raising can take place. This is going to be one of the very toughest issues for Treasury and the entire Trump administration to deal with. One alternative is to deem it "paid" due to the historic net worth sweep's payments.[19] This alternative would, however, create a major political brouhaha, with virtually all the Democrats in Congress, and probably a significant percentage of the Republicans, likely calling it a "giveaway to hedge funds."[20] (Note: if Congress is upset enough about it, they can pass legislation to stop administrative reform; it is unclear if the president would sign such a bill, or whether a veto could be overridden.) The other obvious alternative is to convert it to common shares, as was done for AIG, the closest precedent at hand, at some to-be-decided valuation.[21] Treasury will very much be thinking about how much the second alternative could negatively impact markets long-run, because it will look to some like legitimate shareholder rights were violated. And

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[17] PSPA: Preferred Stock Purchase Agreement. This is the agreement by which Treasury promises the financial marketplace that it will not let the companies fail. Until just recently, Treasury was compensated for this in the prior six-plus years by taking almost all the profits of the two companies – known as the "net worth sweep"– which proved very controversial. Post-conservatorship, Treasury will charge a fee instead, called a "periodic commitment fee" in the PSPA.

[18] This equity is owned by Treasury, and represents the amount of the investment made into the two GSEs to preserve their ability to continue operating during conservatorship.

[19] Such payments have been in excess of what money the Treasury invested in the two companies, plus a 10% return, which was specified as the required compensation in the earliest days of conservatorship.

[20] Some hedge funds and private equity firms have very publicly purchased junior preferred and common shares of the company in the open markets, at post-conservatorship discounted prices. They are behind many of the lawsuits related to the net worth sweep, and would benefit by the senior preferred, above them in the equity stack, being eliminated by it being deemed paid in full. In Congress, this is usually shortened to just "hedge funds."

[21] On this alternative, the dollar value of the outstanding senior preferred would become a certain number of common shares, based upon an "exchange rate." Were this to happen, the ownership of the common would be overwhelmingly in the hands of Treasury, given the very large amount outstanding of the senior preferred.

the existing court cases (see item 4, below), many of them ongoing, are likely to impact how this all plays out.[22]

3. Treatment of Junior Preferred. There is $33 billion of face amount of such junior preferred which must be addressed. One alternative is to do nothing, and the junior preferred will eventually go to 100 cents-on-the-dollar, as it would be the most senior class of equity remaining after the senior preferred is disposed of. (This alternative could similarly be criticized as a give-away, although it is more indirect and less visible and so perhaps less concerning to the administration.) A second alternative is some sort of tender offer, paying common shares for the existing owners of junior preferred to give up their position, at some discount to the $33 billion face value. A third is a negotiated settlement; such a settlement will take time and will be overlapping with the court cases impacting the same securities. The political profile of how the junior preferred is resolved is low in comparison to the much larger amounts related to the senior preferred, but nevertheless it must be addressed before investors could value common shares in an underwriting. We know almost nothing of the timing of such a resolution.

4. Lawsuits Disposition (joint with FHFA). You are all well aware of the many shareholder lawsuits against Treasury and the FHFA over the net worth sweep and related issues (including the single-director structure of the FHFA); some also include the two GSEs in the lawsuits. The potential implications of these lawsuits are so severe that, unless they are decided by the courts or otherwise settled prior to any capital raise, their unresolved status would be a source of significant uncertainty to investors, precluding a successful underwriting. There has been talk about a potential indemnification of the two companies by Treasury – but that is probably not realistic and I doubt investors would be comfortable with it. The timing of all this is totally uncertain.

   Note: The shareholder lawsuits, the resolution of the senior and junior preferred shares, and the exercise of the 79.9% warrants held by Treasury are all interconnected. Timing is uncertain, and any rush by Treasury and the FHFA to resolve all these issues will just be taken by the existing investors as an opportunity to raise their settlement demands. We do not know if settlement discussions are being seriously contemplated and, if so, on what terms. And depending upon what court rulings eventually are made, these issues could take several years to work through.

5. PSPA Revision Specifics (joint with FHFA). The nature of administrative reform means that, after conservatorship, an amended PSPA will continue to provide the marketplace (i.e., the buyers of MBS and other liabilities of the companies) with the assurance that

[22] Several large institutional investors (mainly hedge funds and private equity funds who bought the shares after 2008 at discount prices) in the historic common and junior preferred equity are suing Treasury and the FHFA that the net worth sweep clause is just too penalizing, and amounts to an illegal "taking" by the government. The cases are winding their way through federal courts, with both wins and losses for Treasury. There is a reasonable expectation, absent a settlement by the parties involved, that these cases will end up in the Supreme Court to get finally decided one way or another.

the credit of each GSE is near-Treasury quality; this assurance is needed to maintain the existing business model (esp. the TBA market). The PSPA will have to be amended to reflect post-conservatorship requirements, including the following: (1) an investment portfolio limit, either the one currently in place or a modified version of it, as in its Housing Reform Plan, Treasury has indicated it wishes to modify the current limit, an action which would have earnings implications for the GSEs; (2) establishing, if there is to be a utility-style regulation regime (see below), its legal basis – that is, the GSEs would contractually agree to subject themselves to this regime in exchange for government support; (3) the support fee (as described above) to be paid to Treasury by the GSEs; and (4) that G-fees will be kept "level" regardless of the size of lending customers. Some further secondary items may also need to be addressed.

I also want to note that the PSPA revision must be very carefully worded to keep giving investors in 30-year MBS the comfort that the PSPA will stay in place until replaced by a full-faith-and-credit guarantee or some equally strong mechanism. This assurance is needed because of the fear, in the absence of such wording, that a future presidential administration could withdraw the PSPA-based support in some fashion, leaving the MBS to be worth considerably less in the marketplace.[23]

6. Coordinating Two GSE Capital Raises (joint with FHFA). All of the above issues apply to both GSEs, each of which requires record-setting amounts of common equity to be fully capitalized. Treasury will have to take the lead in ensuring that the companies' efforts are coordinated and do not crash into each other in the marketplace: they must not compete for the same investors at about the same time. Investors will demand to know how that coordination will be done, or they will be very wary of investing in the common equity of the first GSE to come to market, for a giant equity raise by the other GSE shortly afterwards could then put downward pressure on the first GSE's stock price. It is unclear how this coordination would work if there are to be multiple equity raises by each GSE – the situation is simply unprecedented. I do note that the more the companies rely upon retained earnings, the less concerning this issue will be.

7. Secondary Offering Clear Market Clause.[24] The focus by Director Calabria and the media has been upon the primary capital-raising by the GSEs to get equity on their books, ahead of the taxpayer, so that the taxpayer's support to the companies becomes only for catastrophic risk. However, the Treasury will end up owning a significant share of the companies by exercising its 79.9% warrant on the common equity shares of each;

[23] Beyond investor requirements for an amended PSPA, there is a public policy issue of whether the PSPA is structured to make investors whole, or to both make investors whole and also keep the companies operating (as opposed to going into liquidation). The current PSPA structure does the first only. It would be better public policy that the revision of the PSPA accomplishes both so that the GSEs can also continue to support America's housing markets and economy.

[24] A "primary" equity raise is when the cash raised from the share sales goes to the company, in this case the two GSEs. A "secondary" equity raise is when an outside investor – in this case Treasury – sells its shares, taking the cash for itself; no cash goes to the company – it is just one shareholder selling to other shareholders.

adding in a potential conversion of the senior preferred to common, Treasury could end up owning an even greater share of the company. (Treasury ended up owning more than 90% of AIG at one point.) In the future, Treasury will need to dispose of these shares in a secondary market transaction; it will therefore need to make a clear market promise as part of the re-IPO,[25] so new investors do not worry about such a secondary sale unduly hurting share prices. The timeframe for such a secondary clear market clause is likely to be long – and to investors in new shares, the longer the better. We are talking years here.

8. Treasury Voting "Promise." The Treasury will very likely, depending upon specific choices made, be the controlling shareholder of the GSEs as the two companies initially seek to raise capital. Between its 79.9% warrant and any common acquired through potentially converting the approximately $240 billion of senior preferred, it will have a very high percentage of ownership for some time to come. (The more that retained earnings are built up prior to a re-IPO, the higher Treasury's share will be even after the re-IPO.) With Treasury as such a controlling shareholder, new investors will not invest at a full valuation because they will be minority investors with less say in corporate affairs than usual. In the precedent case of AIG, the Treasury substantively ameliorated this probable valuation discount by promising to vote its ownership interest pro rata with public share voting, except for a very limited set of specified corporate governance items. Treasury will need to dust off the promises it made in AIG's case and re-issue something similar.

Group 2: Treasury Has Advisory and Market Liaison Role

9. FHFA Capital Rule Completion Implications. FHFA Director Calabria announced a month ago, on November 19th, that he will fully re-issue the then-outstanding GSE minimum required capital rule proposal. He did not formally specify what about the existing proposal he found deficient. So, we do not know if this re-proposal will be substantive or just involve some limited changes. Calabria's announcement has made it uncertain when the rule will be finalized; while he did promise that the re-proposal will not hold up the re-IPO timeline, coming out as early as January of 2020, such activities have historically taken longer than originally expected.

   Since the GSEs have been directed by the FHFA to use the (now withdrawn) proposed capital rule as a guidepost for their current pricing of G-fees, if the revised capital rule results in a materially higher required amount of capital, then there will be an imbalance – with profits too low to produce an acceptable ROE.[26] The implication is that G-fees

[25] A "clear market" promise means, in this case, a promise by Treasury to not sell its shares for a set time period or until some defined event occurs. The promise would give investors in a primary equity raise a buffer of time before Treasury could put downward pressure on their investment by selling its large shareholding.
[26] ROE – return on equity. This is the key measure of whether a financial institution is generating an appropriate level of profit versus the risk it takes. If the ROE is below the 9% to 10% range, the GSEs will be considered to be

would have to go up to compensate, which would be very sensitive politically as it will directly cause mortgage rates to rise by the same amount. The first objective of such an increase in G-fees would be that *new* mortgage purchases produce a proper ROE in the 9% to 10% range. But as the existing book of guarantees can't be repriced by the GSEs, it would take years to improve the overall corporate average ROE. It is unclear how an under-market ROE caused by the revised rule raising the capital requirement would be received by investors in a potential underwriting – but it would not be a positive.

Treasury, in its role as the administration's liaison to the financial market, will need to represent this concern to the FHFA, which has authority to define the minimum required capital rule. If the result, nevertheless, is a material increase in the required capital, it will be destabilizing to the process of issuing equity in the public markets, likely delaying it, possibly for an extended time.

10. Shareholder Rights Re-established/Consent Decree Contents. In conservatorship, all the rights of shareholders (like voting for the Board, shareholder resolutions, say on pay, etc.) are held instead by the FHFA acting as conservator. Thus, no capital raise will happen if, upon the close, a GSE would still be in conservatorship because the investors would literally have no proper authority over the affairs of the company. Since a record-setting large equity raise would still provide just a fraction of the total needed for the GSEs to become well-capitalized, the plan to raise enough equity (as defined by the new capital rule) would likely then be to (1) retain earnings for about 5 or more years, and then (2) do a single external capital raise, where the legal closing of the raise would be simultaneous with, and contingent upon, the ending of conservatorship.

    However, Director Calabria has begun to talk about a consent decree bifurcating the conservatorship period[27] – a shorter period of official legal conservatorship (possibly ending as soon as late 2020) followed by a period of the GSEs' operating under a strong consent decree. That consent decree would put extra controls on the two companies so that they prioritize increasing their capital ratios (and would require them to get FHFA approval for many things) until they reach a "well-capitalized" status according to the new capital rule (some would call this a "capital forbearance agreement" or "capital restoration plan"). The consent decree is a creative approach that would allow an external capital raise much earlier because shareholders would gain back their voting rights upon the end of legal conservatorship at the beginning of the consent decree period.[28] The unresolved issue concerns the contents of such a consent decree: if it is

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under-earning versus their risk, and thus any share sales in a re-IPO would be at discount prices. Today, the average ROE generated by guarantee fees is at a proper level according to the now-withdrawn capital rule, but it would become too low in the scenario of a significantly increased capital requirement.

[27] A consent decree is an agreement between a regulator and a regulatee (in this case, respectively, the FHFA and each GSE) to do certain things as required for safety and soundness. In this case, it would really be imposed by the FHFA onto the two companies.

[28] There is one interesting "glitch" in the notion of a consent decree period. If the decree prohibits dividends from being paid until the GSEs become "well capitalized," which is common in such situation, then it will hurt the share

conservatorship by another name, with a material reduction in shareholder say in the affairs of the company, investors will likely be scared away. We have no information at all as to what would be in the consent decree at this time.[29]

The FHFA is clearly responsible for these matters. However, Treasury should be advising the FHFA about the market implications of a consent decree that is too "heavy" in how it defines the FHFA's authority over the GSEs.

11. Disposition of Reform Plan Studies. The Treasury's Housing Reform Plan document, issued this past September, lists approximately a dozen studies or other actions to be done to inform the ultimate result of how the GSEs would operate after exiting conservatorship via administrative means (and even more studies are required if legislation were to be passed). They break down into two relevant groups.

    a. *Concrete actions in the works*. This group includes the CFPB's finalizing a revision of the qualified mortgage (or QM) patch,[30] and the FHFA and Treasury's revising the limits on the investment portfolios, etc. These are things that will happen in one form or another, and need to be decided so that investors (and we as underwriters) are able to forecast future revenues and profits of the two companies.

    b. *Footprint studies*. This group includes a list of more speculative topics, not generally supported by the mortgage industry but by conservative policy specialists. The FHFA has generally been assigned to do such studies. They include studies of things like prohibiting cash-out refinancings, switching MBS issuance to Ginnie Mae, and so on. The general view in the industry is that nothing will come of these studies, but they are a potential overhang on any re-IPO if not resolved one way or another. Treasury's Housing Reform Plan did not have any deadlines for the resolution of these studies, and nothing has been announced since. Again, Treasury has to advise the FHFA that the studies, at

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sale, as otherwise the nature of the GSEs' financial profile is consistent with stocks that are dividend-paying (rather than growth-oriented, like technology firms). As a result, the FHFA should be advised, relative to a consent decree, that a dividend prohibition might delay a major stock sale, possibly for years.

[29] Director Calabria has talked of setting goals for the GSEs to meet in order to exit conservatorship, and then leaving it to their managements to execute to reach those goals. That would be fine for a typical FI. However, the usual procedure to reach such a capital goal would be to both raise equity and reduce the need for equity by in turn reducing risk. The GSEs have a statutory duty to maintain a robust secondary mortgage market, and so some of the usual "tools" to improve capital ratios (e.g., to raise pricing, reduce new loan volumes, etc.) would be inconsistent with that public policy duty. The consent decree will have to be carefully constructed to not incent this type of behavior, but to incent only things such as disposing of legacy assets faster, doing more credit risk transfer on new and old business, etc.

[30] This is an important but technical issue that could reduce the new business flow of the GSEs by 10% to 20% or more. The CFPB is working, reportedly in coordination with Treasury and the FHFA, to get a resolution that is high-quality but does not materially reduce the availability of mortgage credit as a result.

least those with a potentially material impact on the GSEs' revenues and profits, must be completed and put to bed before a re-IPO is really practical.

12. Utility-Style Regulation. The Treasury's Housing Reform Plan did not propose to regulate the pricing (mainly the G-fee) of the GSEs. It instead focused, especially in its legislative reform recommendations, on competition amongst a larger number of GSEs to ensure that there is no tacit collusion between just two GSEs to keep G-fees inordinately high. However, in administrative reform – where there will be just the two existing GSEs – such tacit collusion is of concern to the mortgage industry (which consequently seems to favor utility-style price regulation at this time). In Congressional testimony, Director Calabria said he wanted to control pricing, which implies at least some narrow form of utility-style regulation. (The FHFA is doing this now, in conservatorship; Calabria's comment seems to be that he wishes to continue to do so post-conservatorship). This issue just needs to be resolved by the Treasury and FHFA before an equity raise, so potential shareholders know whether the profits of the company are limited and targeted at a set level by the FHFA acting as a price-setting regulator, or whether they are more volatile and set by competitive factors. Both would be acceptable to investors, but the market does need to know which it will be. If the FHFA is to continue regulating prices post-conservatorship, however, it will have to issue guidance as to its policies; this guidance would include specifying the targeted "fair return" (the phrase used in state-level utility regulation legislation) that investors will earn, so there is no suspicion that investors' money will be "expropriated" after they invest by the FHFA keeping G-fees too low; it would also include specifying how, if by being very efficient a GSE earned a higher return than targeted, the resulting savings would be distributed, going either to shareholders or towards lower G-fees going forward.

13. Addressing Congressional Action Overhang. Secretary Mnuchin has stated many times he would prefer congressional action to obtain a full legislative solution to GSE reform rather than an administrative one. However, with such congressional action unlikely in any predictable timeframe, he and Director Calabria are meanwhile embarking upon administrative reform. Inside DC, administrative reform has been marketed as merely the first step of GSE reform – as a prelude to rather than a pre-emption of congressional action, which will be the second step. This all sounds fine . . . except to potential investors, to whom it announces a strategically uncertain situation, with the rules to be changed by Congress *after* they have invested. And it is well known in DC that once a bill opens up a topic – in this case how the GSEs operate – it is hard to control exactly what ends up in it.

    Congressional action is not, of course, a technical Treasury issue (as most of the above items are), but it is a likely investor concern that Treasury, as the liaison to the financial markets, will hear on behalf of the whole administration and the FHFA. It is not clear how Treasury can address the concern. Treasury could, perhaps, draft a sample bill and work to get Congress to pass it as the "second step" of GSE reform, before the re-IPOs. But it is unlikely any such effort would bear fruit given Congress's difficulty in agreeing on GSE-related issues. The uncertainties surrounding congressional action are just something everyone has to realize will likely be an overhang on the re-IPO.

14. CFPB Single Director Court Decision. In the spring of 2020, the Supreme Court will hear a case challenging the single director structure of the CFPB (as opposed to the commission structure used by the SEC or CFTC). This case appears to be directly applicable to the FHFA, which has the same structure. While one can never fully predict such things, the odds are pretty good that the current structure, in which the single director cannot be fired by the president except "for cause," will be overturned. The courts cannot obviously demand, as a remedy, the creation of a commission – that would be up to Congress. The lower courts defined the remedy as the removal of the "for cause" restriction. If that is the ultimate outcome, and the Democrats win the upcoming presidential election, it is likely Director Calabria would be removed by a new Democratic president in early 2021 and replaced. As a second-order risk, if the "for cause" restriction is removed, Congress may work to pass legislation instituting a bipartisan five-person commission (as found at the SEC and the CFTC) for the FHFA. While this issue is unresolved, it could be the source of significant regulatory risk in the eyes of investors, at least until a transition is complete.

    Like some of the issues above, this is not a Treasury issue directly; rather, Treasury will hear of the concern in its role as a liaison to the financial markets. There is nothing to be done about it, but it will factor into decisions as to the timing of a re-IPO.

Conclusion

Director Calabria's comments about the timing of a re-IPO are naturally focused on the FHFA-centric issues of *whether the two GSEs (with the FHFA as their regulator) are ready to sell equity and exit conservatorship*; they do not address the Treasury-centric issues that impact *whether investors will be ready to invest* at a proper valuation and in extremely large amounts. The above list of issues to address investor concerns is long and sometimes politically challenging, and several are very hard to predict as to timing. Treasury has made clear its commitment to getting the GSEs out of conservatorship; to achieve that goal, it will have to resolve virtually all of these issues, making the necessary decisions and then announcing the results consistent with a timetable for a re-IPO.

So, my prediction:

- The earliest date for a proper external capital raise is almost undoubtedly later than currently expected, probably getting into late 2021 at the very earliest, and I would predict likely not until even later than that. (This excludes a market-testing capital raise, something small and perhaps unusual, to claim a policy/political victory.)

- To the degree the above list of investor-centric issues takes a long time to resolve, the GSEs will have to rely more upon retained earnings and less upon external capital raises. *There is nothing problematic about this financially.* The current administration would like to move faster for its policy reasons, but it is unclear that Democrats, should they win the next presidential election, would agree. In fact, a strategy of recapitalizing the two GSEs over four or five years through retained earnings and then just issuing a single new equity underwriting at the end makes a lot of sense: it would also reduce the difficulty of addressing certain of the above fourteen issues. (In this case, Treasury would do secondary sales only after these other actions had been taken.)

- To summarize, the timing and specifics of actual new issues (excluding a small market-testing one) is very much up in the air, and my bias is "probably longer." We should calibrate our pitch to become a lead underwriter for the GSEs accordingly, perhaps aiming for such a small, market-testing transaction to give the administration a policy victory, earlier than would be possible for a major and more conventional raise.

- And, just to be complete, let me point out that, if the FHFA and Treasury decided not to prioritize the speed of exiting conservatorship (or becoming "well capitalized" to satisfy and end a consent decree), the simplest and cleanest approach to this entire situation would be as follows: 1) The two GSEs recapitalize *solely* via retained earnings, taking as long as it takes (probably well over five years); and 2) Treasury, with no competition from primary equity raising, cleanly accesses the public markets to sell its shares on a secondary offering basis, potentially allowing the taxpayer to sell off its interest sooner. This is more akin to what happened at AIG. If this is a possible outcome, it means our underwriting marketing efforts should be directed mainly at Treasury, and not so much at the two GSEs or the FHFA.