Superior Washington Intelligence For Investors

CAPITAL ALPHA PARTNERS LLC

Mortgages

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Mortgages/GSE Preferreds:

Why Weak in the Week Since Our Call?

Highlights

- Shares of GSE junior preferreds **(FNMAS, FNMAT, FMCKJ)** lost momentum over the past week, perhaps partially due to chatter that a bipartisan reform bill might soon emerge in the Senate. While final details of that measure remain uncertain, sources tell us it will largely mirror a draft that had been floated by Sen. Robert Corker (R-TN) back in early March. The rub for GSE shareholders is that that bill not only mirrored the Bipartisan Policy Center's (BPC) approach of phasing out Fannie and Freddie within five years, in favor of a new entity modeled after the FDIC, but it also stipulated that "preferred shareholders do not become shareholders in anything new and have no rights to any future cashflows." Sources say that the Mortgage Bankers Association (MBA), and perhaps the Realtors or Home Builders might endorse the bill (which may or may not carry such specifically prohibitive language toward the GSE preferreds), even though community banks will likely oppose and passage in the Senate, much less the House, is doubtful.

- Separately, at an American Enterprise Institute (AEI) event last week, entitled What Should be Done With Fannie and Freddie? , former White House/NEC housing advisor Jim Parrott used an analogy to explain the stasis in GSE reform debate that the Obama administration, internally, seems to have held up as its vision since late 2010. Specifically, Parrott suggested that policymakers from both sides of the aisle have been "standing in a parking lot, generally agreed that they should head west, but unable to start out because they can't decide whether to ultimately stop in Kansas or go all the way to California." Even though House Republicans and groups like AEI have compounded this irrational status quo by voicing heart-felt concerns, as in their insistence on liquidation and no replacement for the GSEs or a non-FHA government guarantee, there still should be some way for the two sides to get started, and steer towards transitioning reforms -- allowing a decision on whether to stop or go all the way once Fannie and Freddie are throttled down, Parrott mused. But just as any new Corker bill is unlikely to be acceptable to liquidation-minded conservatives in the House, last week's conference ended with AEI scholar and long-time GSE skeptic Peter Wallison effectively stealing the keys, saying that agreeing on the "end-state" first is still important. *And the question lingers: Is there room for a neutered but freed Fannie and Freddie in Kansas?*

- Finally, on Friday, May 10, Capital Alpha hosted former Freddie Mac lobbyist Rob Zimmer in a conference call to discuss the recently heightened interest in the junior preferred stocks of the GSEs. A transcript of the call is available here. For convenience, main takeaways are segregated and summarized in the Discussion part of this note, with particular emphasis on:
  - What's at work behind investors' renewed interest?

Ticker(s):
FNMAS, FNMAT, FMCKJ, FNMA, JPM, C, WFC, BAC, STI, RDN, GNW, MTG, LPS.

- What are the bull and bear cases for the GSE preferreds?
- A Revolutionary War Bonds Parallel
- The Low Income Housing Incentive
- Community Bankers' Interests
- The significance of Rep. Mell Watt's likely failing nomination to head the FHFA
- Implications of the FHFA's Strategic Plan

Discussion
We have taken the liberty to segregate, and, at times, paraphrase or annotate Rob's comments so as to make them a more efficient read. The result, and key points, follow below.

What's At Work?
From a balance sheet perspective, Fannie and Freddie have cured faster than anybody modeled out. Meanwhile related information out there was very poor -- double counting losses, no projection for future gains. The prevailing wisdom was that these things were endless black holes. Well, we still have to solve the political calculus, but the balance sheets are *not* endless black holes. Nobody had really modeled out what would happen when one raised guarantee fees to, historically speaking, *stratospheric* levels while effectively backing a book that was increasingly pristine. News flash – it's a super safe book, and we're charging more and more money for it. It's in the public domain that *they're not even done* raising G-fees. So investors are saying there is something here.

Bull Case
Number one bull case is that they can't *ever* decide what to do with the GSEs, aside from the regulatory world. So Congress deadlocks, and FHFA continues working with industry to devise ways to do risk sharing. They cross the net repayment line. I'm fully aware that the negative PSPA terms exist, and we all know what they are. But at some point, there's increasing industry pressure to do something. There's a small percentage, no more than 25 percent and maybe smaller, that, as per the suggestion of Jim Millstein, Congress decides to recapitalize Freddie and Fannie as part of a budget agreement, to grab essentially the up-front value. It's also factually possible for Treasury to pull the trigger and do it administratively, with Congress having no say. Or they could eventually allow resuscitation for the preferreds, allow them to stay in place, and at some point it could end in resumed payment of dividends. Finally, the holders could someday win a takings clause in the courts, although that's hard to predict with any conviction.

War Bonds Parallel
Let's go all the way back to Revolutionary War Bonds. Nothing in Washington is ever truly new. The states had issued bonds to soldiers and suppliers of the Revolutionary War. Since states weren't exactly robust in repayment to holders, the value plummeted. The federal government hadn't really been set up yet; capital markets were very primitive. And at some point, speculators began buying up Revolutionary War Bonds at a steep discount. Alexander Hamilton comes to town. He's trying to establish a country where people trust the government to repay its debts, relatively on time. The issue of assumption arose, and the debate in the capital was: 'We want to establish the currency of the federal government, the rules for capital markets in this young country -- what do we do? And the same debate went on, back then as now.

Number one, "we cannot reward the quote, 'vile speculators.' We need to reward only the original holders." So that was debated over and over, and there was a substantial side that said that they looked for a way to discriminate amongst holders. But once Hamilton got the upper hand, he said, "we're going to do a conversion, and we're going to treat everybody equally. The second thing that came up was, "Is this going to be a mandatory conversion or not?" And Hamilton said "No. It hurts capital markets to do mandatory conversions when you don't have a good reason. We're seeing the same kind of discussion

today in Washington. The Hill's always going to take a very skeptical eye to people who "make lots of money, who weren't the original holders." Many, and not just Democrats, view speculation as evil, rather than a constructive part of price discovery. Ultimately, Hamilton prevailed on the discrimination question, and the conversion question, and we're going to run through that same kind of thing now. We are.

Bear Scenarios

The bear case is that Treasury ignores over 200 years of precedent, and establishes a brand new precedent. The most likely bear scenario would be interminable conservatorship into some kind of strange new purgatory. The notion simply is that nothing gets decided for many, many years -- this gets pushed off into a future administration. The GSEs stay in conservatorship for ten plus more years, and the present value calculations get mangled. Investors move on.

The other bear case, obviously, is the notional passage of a bill in Congress that overtly hurts the juniors. [The GSEs' return to profitability will make Republicans uncomfortable --and there's at least a chance that this might prompt them to back away from their initial calls for Fannie-Freddie liquidation without any replacement. The net effect could help move Washington out of gridlock on reform, perhaps as early as 2015 or 2016.] Nevertheless, it's going to be extremely hard for a bill -- any bill -- to pass in the first place, so I discount that Bear scenario.

Low income Housing Incentive

The last piece of legislation, HERA in 2008, took a percentage of Fannie's and Freddie's profits and sent it directly to affordable housing. So if you're an affordable housing advocate, or someone in Congress who cares about it, your affordable housing funds right now are getting swept up by the Treasury into the general budget. You're losing, too. Every year that the GSEs are kept in conservatorship, the affordable-housing side of the Democratic Party islosing money to the general treasury. I'll bet you that while this is not well understood now, it will become so over time. It's not a silver bullet by itself, but it's part of what I'll call the changing storyline as time goes by. Every quarter they'll make profits, and some affordable housing advocacy group is going to crunch the numbers and say, "you know, but for the fact that they're in conservatorship, we would have had xx tens of millions of dollars, and we don't have it."

Community Banks Could Provide Headwinds Against Future Gains. . .

Most of the preferreds, or a substantial portion, are still held by community banks. Most have not pulled their stakes. But I wouldn't guarantee that to stay in place forever. And the reason is that a 2009 tax bill provided them with an accelerated write-off, thanks to Rep. Barney Frank and Treasury. So once they sell these securities, they do get a cash asset -- a write-off -- which goes right to the bottom line. Combine that with the fact that they are getting additional cash from the actual value of the security and my educated bet is that you'll see more and more community banks simply pull the trigger. And if you say, "well, why wouldn't they hold or lobby for full par? Maybe they will, but I think the average community bank doesn't want to spend all their time trying to figure this out. It's not worth it to them. They have other things to do. And they're not going to sit around and try to scope out the odds of their getting, what, 25% of par, or 50% par?

. . . **But Also A Crucial Swing Vote In The Political Debate**

Freddie and Fannie have been the bulwark to prevent the large lenders from swallowing the entire market.

Small lenders have looked at Fannie and Freddie as their protection from the JP's and the Wells', and they're still up there today saying that if you turn this over to a guarantor model, the only winners by the laws of mortgage-finance economics are going to be big-balance-sheet players. There's simply no dispute in the industry that if we move to a guarantor system, large-balance-sheet players win, small-balance-sheet players lose. Small lenders have been told they can aggregate, but they still want their direct relationship with Fannie and Freddie. They believe that their destiny is best controlled with direct conversations with the entities that access the capital markets. So the small and large lender debate is always out there,

though it's not covered by the press. It's one of at least two key factors likely blocking movement toward GSE reform, even if other current barriers begin to dissolve.

Primary Threats Are A Primary Obstacle

The second trend line that's not violated by a newly profitable Fannie and Freddie is that most members of Congress are now most sensitive to primaries, on both sides. Their biggest fear is not winning a general election. It's being hit with a primary challenge from the left, or, for Republicans, being hit from the right. I do not see the average Republican voting for a new federal guarantee. And the reason is, they will be hit on the right in a primary. I know this sounds hard to believe, because those of you who have followed Fannie and Freddie for decades remember that no one used to know what they were. Or what they did. But now they do. Meanwhile, passage of legislation without a new federal guarantee of some sort is almost inconceivable.

Implications of Watt Nomination To Head FHFA?

My theory is that the White House, and even Mel Watt, knows that he doesn't get confirmed. I'm being told by smart people that there currently aren't 60 votes for him in the Senate.

Why did they do this? Well, because Treasury and the White House aren't really trying to solve the GSEs, they're trying to keep all our markets calm. And they weren't even sure they could get anyone confirmed anyway, so why not have Mel Watt out there, as a good man? The liberal side likes him. It's a win for the White House. "We're doing all we can. Look at these Senate Republicans blocking him. We can't believe this."

While bond markets will stay nice and calm, it doesn't hurt Mel Watt. There's no down side to the White House strategy for Mel Watt, either. If he wants to be Chair of House Financial Services someday he can say, "I'm so qualified, I was even nominated once to head up the $5 trillion mortgage finance sector."

As for effect, though, there had been some movement towards bipartisan bill-making on the Senate side, vis-à-vis the GSEs -- baby steps. And this has caused it to be a more partisan issue again. People who were likely to work together have had to stop and take a pause now.

Building Their Own Coffin Under FHFA Strategic Plan?

While continuation of acting Director Ed DeMarco's tenure at FHFA will lead to continued pressures on the GSEs to combine back office operations and invest in a separately-run entity to manage a Common Securitization Plan -- that could someday be used by others to displace them, should Congress choose -- the threat to the junior preferred story is probably overrated. Even if one raised G fees to the point where a purely private player could come in, the other substantial market barrier is liquidity. As has been noted in the press, even the Freddie MBS don't trade as well as the Fannies. My take is that that's what FHFA is trying to address [with its Common Securitization Platform], first and foremost. They probably know deep in their hearts that Fannie and Freddie are not going anywhere, and they're simply trying to fold them back, around the edges -- to get some new players and slowly take away market share over many years. And FHFA is right. Unless you address the liquidity premium, you can't substantially shrink Freddie and Fannie. So why not create some platform where the legal language is the same, the data requirements are the same? You could even have a hybrid MBS off this platform. I think it's really a good faith effort to slowly find ways to entice purely private money in, to get Fannie and Freddie back down to 35-40 percent of the market some day. You need a platform like this. And for this and other reasons, community bankers aren't worrying about it.

The Other Balance Sheet Issue

Why were the equity stakeholders left around? Was it because Treasury forgot about them? Was it because Treasury secretly likes these guys and wanted to help them? No. Government acts in its own extreme self-interest, and so the equity shareholders were left around precisely to keep $5 trillion off the U.S. federal government books. Why should they care about that? Well, because no one knew what

would happen if you added $5 trillion to the federal books -- how that would affect the Treasury auctions. It doesn't take much of a change on a basis-point level to add up to a lot of money. So, no, it wasn't some accident or oversight or a secret handshake to help you guys out.

Any investor in the juniors was helping to prevent an increase in cost to the taxpayers in Treasury's regular debt auctions. And what no one's done yet, that someone *should* do, is hire an econometrics firm, or consulting firm to compute that cost. My guess is, it's a substantial cost. And if it were me, I would take that to court. Get it to a sharp PR firm that knows how to work this stuff. And the story suddenly changes to, "these investors saved taxpayers a great deal of money by keeping Fannie and Freddie independent, which they nominally are. And thus, it's really incredibly unfair for the government, once they finish using these investors, to turn around and hurt them."

Better Press Helps

You can't just go to the Hill without air cover. The way to educate members and public officials alike is to make sure that first, there's a different narrative in the press. For the longest time the press was using a gross number on this Fannie, Freddie bailout. Every time they talked about how much assistance the enterprises had gotten, it was the gross number. And no mention of repayments. But in the last six months the press started using *net* numbers. And I think that's another one of the reasons share prices have started to recover, not just because of the DTAs, but because the press story changed. Trust me, that was noticed by members of Congress too. It was suddenly not $187 billion that Fannie and Freddie were in the hole. All the press stories now are talking about, I think the number after this week is down to $60 billion net. The PSPA terms are still there, but the net number is being reported in the press. Even a member of Congress can understand that $187 billion is different from $60 billion. And by the way, when Freddie reports its DTAs (in the second quarter), it's down to *$30 billion*.

White House Victory Declaration?

At some point, the Obama Administration wants to declare victory on all of the various bailouts [which could eventually lead them to allow GSE privatization after all]. Because they don't call them bailouts, they call them investments. And they will want to declare victory - and if they do that, that's the trump card in the press. I'm not talking about Congress, I'm talking about the Executive Branch. But they're not going to worry about how some speculators made some money on juniors. The dominant story could be, 'all of these financial services companies got federal assistance, and not only have they all paid it back, but the taxpayers made money in every single instance.' On a macro level, my bet is that's what the administration wants to say. 'Look, we were good stewards for the taxpayers. We had tough terms out there, but taxpayers weren't just made whole. They came out ahead.'

Previous Notes on This Topic

Mortgage Miscellany: DTA-Boosted GSE Gains Flag Reform Issue, Preferreds Call; Realtors on the Hill; New Gambit Toward HARP Expansion; Watt Nomination Seen Failing - May 9, 2013

Potomac Perspective: Watt's Up With The Fannie-Freddie Preferreds? – May 2, 2013

Mortgages: Millstein's Perfected Pitch Fails to Move GSE Privatization Needle – April 29, 2013

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