Washington Policy Flash Note

GSE Policy Change Allows Capital Retention, First Step in Road to Recap

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On September 30, the FHFA and UST announced an agreement that permits the GSEs to retain up to $45B in aggregate capital. Specifically, Fannie Mae and Freddie Mac will be allowed to retain a total of $25B and $20B, respectively. As part of the agreement, the liquidation preference of the Treasury Department's senior preferred positions will be increased by commensurate amounts. Although the road ahead remains lengthy, finalizing this amendment to the PSPAs should be viewed as the first step in the road to recapitalization. *Please contact Chris Gamaitoni for questions relating to fundamentals/valuation and Isaac Boltansky for questions relating to policy.*

GSEs Can Retain Slightly More than Current Required Core Capital. As we previously noted, we believe there is an important distinction between required risk-based capital (to be finalized with the pending GSE capital rules from the FHFA) and statutory minimum capital. The nuance is that the GSEs would technically be determined "undercapitalized" once they reach statutory minimum capital, but not yet risk-based requirements. Under this classification, the GSEs could be released from conservatorship and operate under a consent order (with a capital restoration plan) until such time that risk-based capital requirements are reached and the companies move to "adequately capitalized." The distinction is important because while there would likely still be hefty restrictions on operations under consent orders, once the GSEs are released from conservatorship, significant legal protections for shareholders are regained. Based on media reports, we believe such a plan is being envisioned by the FHFA, though we do not yet know what level of capital will be sufficient for them to exit conservatorship under a consent order (this is at the discretion of the FHFA and UST). The announcement this morning allows Fannie Mae to retain up to $25B of capital and Freddie Mac up to $20B. Both are above their minimum required core capital levels at 2Q19 of $22.3B and $18.4B, respectively. Based on our earnings forecast, it would take Fannie Mae until 4Q20 or 1Q21 to reach this level from retained earnings and it would take Freddie Mac until 2Q21 to 3Q21 (there is a little more uncertainty with Freddie Mac because it has not disclosed its CECL impact yet – though we anticipate that will be smaller than Fannie Mae's due to reserving policies). The other unknown is whether there will be any credit to the GSEs for theoretical excess payment over a retroactive 10% dividend payment following PSPA negotiations. *Please contact Chris Gamaitoni to discuss the aforementioned capital dynamics.*

Is the Liquidation Preference Increase a Surprise? No, the corresponding increase in the UST's senior preferred position was expected given the mechanics of the PSPAs. With this change, the liquidation preference for Fannie Mae and Freddie Mac now stand at $145.8B and $92.6B, respectively. We view the commensurate increase in the senior preferred as a technical dynamic given that the Treasury Department listed "[e]liminating all or a portion" of the senior preferred's liquidation preference as an option in its mortgage reform plan. Effectively, this letter agreement is an interim step that will begin the capital retention process in advance of a holistic PSPA amendment in late 4Q19 or 1Q20.

Two Notable Comments Contour the Road Ahead. In reviewing the documents and statements, there were two noteworthy comments that warranted highlighting. First, the letter agreement states that the GSEs and the Treasury Department "agree to negotiate and execute an additional amendment to the Agreement that further enhances taxpayer protections by adopting covenants broadly consistent with recommendations for administrative reform contained in Treasury's September 2019 Housing Reform Plan." Second, the Treasury Department's press release noted that the Trump administration's mortgage finance reform plan "recommended that Treasury and FHFA develop recapitalization plans for Fannie Mae and Freddie Mac after identifying and assessing the full range of strategic options." Taken together, this letter agreement should be viewed as an interim step that begins the capital retention process while more structural reforms are undertaken.

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We, Isaac Boltansky, Chris Gamaitoni and Matthew Gaudioso, hereby certify that the views expressed in this research report accurately reflect our personal views about the subject securities or issues. We further certify that we have not received direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

Isaac Boltansky is Compass Point's Washington Policy Strategist. His contributions to this document relate solely to Washington Policy and should not be attributed to any company specific research, ratings, or conclusions.

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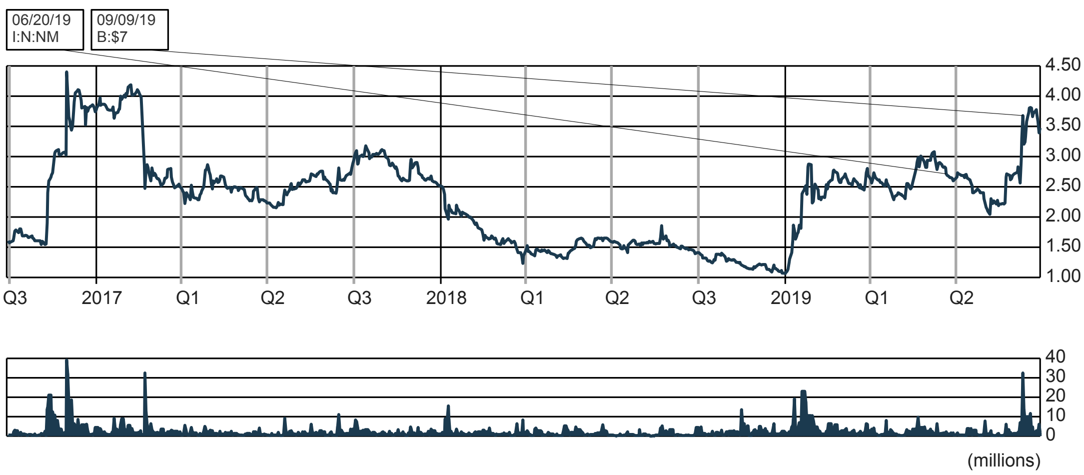

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