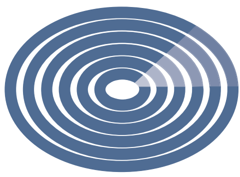

Bove Briefing

Sunday, March 03, 2019

REFERENCED COMPANIES

FNMA: $2.74
(Not Rated)

FMCC: $2.63
(Not Rated)

Fannie Mae/Freddie Mac Waiting for Court Decision

Recommendation

Last Wednesday evening Odeon Capital Group hosted an event to discuss the current status of the two Government Sponsored Enterprises (GSEs), Fannie Mae and Freddie Mac. The key issue discussed was: "When will there be some resolution to the current impasse that has locked these companies up for a decade?" Moreover, just as importantly, it was asked: "What is the value of the outstanding equities in these two companies?"

There is some hope that there will be positive action to resolve the status of these two companies in the coming six months. Congress is unlikely to act. The Administration has no plan. However, after five years it does appear that the courts may take action. There is particular emphasis on the Fifth Circuit Appeals Court in Houston in this regard.

It is simply not possible to set a valuation on these stocks at this point, although many have tried. The uncertainty is due to the lack of knowledge as to what the structure of these companies will be. Logic argues that they should be put back in place as they once were. There is a growing consensus that this makes sense but when does Washington do what makes sense?

It is clear, however, that if the government loses any of the current lawsuits these equities are worth multiples of their present values. Fannie Mae and Freddie Mac preferreds appear to be a solid investment at this point.

Key Points

There were four speakers at the Odeon Capital Group event:

- I introduced the proceedings discussing why the GSEs exist and why they are so necessary today.
- Gary Hindes, the Chairman of The Delaware Bay Company, reviewed three documents that raised questions as to the reasons for the government's takeover of these two entities.
- Tim Pagliara, the Chairman and CIO of CapWealth Group, reviewed the current status of the court cases. He was particularly compelling
- Peter Chapman, editor and chief of the Beard Group provided the valuation assumptions.

The speakers had a clear bias in favor of the plaintiffs in the law cases. There was no offsetting argument supporting the government's view. I am also deeply compromised in this regard, because I am literally astounded at what the government has done in this situation believing its actions to be illegal. Keep that bias in mind when you read this commentary.

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The Economic Argument

This section deals with the history of the relationship between the GSEs and the government. It makes the argument that the nation needs Fannie Mae, Freddie Mac, and the 30-year fixed-rate mortgage if it wants

- Housing activity to grow to meet the demographic need; and
- The economy to grow to offset a potential slowdown.

Those who are primarily interested in current status of the legislation and court proceedings should start at page 5.

Why Do We Need Fannie Mae and Freddie Mac

The Beginnings

From 1837 to 1844, the United States was in an economic depression as deep as the one it suffered in the 1930s, 100 years later. President Martin van Buren sent a bill to Congress seeking aid for the economy. It was rejected by Congress as being inappropriate. Fast forward to 1893 to 1897, called by some the worst Depression in the history of the United States. President Grover Cleveland famously said words to the effect that it was not the job of the United States government to assist the American people; it was the job of the American people to assist the United States government.

By 1930, the view of what the government's obligations were to yet another financial collapse had changed meaningfully. The government was now to aid the American people. Resuscitating housing was at the core of this effort. President Herbert Hoover created the Federal Home Loan Bank in 1932 to provide funds to lenders so that they could withstand defaults on home loans. It was not successful because the banking industry was composed of tens of thousands of very small banks who themselves were unable to stay afloat due to multiple cash flow issues.

The point here is that the nation needed a housing recovery to restart economic growth and the private sector could not provide the mortgage finance needed to get housing going whether it was in 1837, 1893, or 1932. Thus, under Franklin Roosevelt a new approach was attempted. The government would step in to provide money directly to the housing industry, and, also, to indirectly incent money flows that would be available for mortgage loans. Plus, it would change the structure of mortgage lending.

The old techniques of using 3-year to 5-year non-amortizing balloon mortgages and 10 to 12-year amortizing mortgages were swept away. The government created a 15-year amortizing mortgage that was funded by the borrowing of the newly created Home Owners Loan Corporation.

This was still not good enough so the government went ahead with a new, comprehensive set of programs that adjusted interest rates; guaranteed mortgages; lengthened mortgage durations; loaned money to banking institutions; and allowed the United States to buy mortgages directly through a new company called the Federal National Mortgage Association.

This is the critically important point. The United States learned that the private sector, on its own, going back 100 years, could not resuscitate housing and "kick" start the economy. It needed to work with the government.

Housing starts did recover in the 1930s following the implementation of the new programs. They went from 93,000 in 1933 to 706,000 in 1941. World War II then interrupted production but after the war, starts exploded to 1,952,000 in 1950.

Phase II

The government recognized the power of its new system and it used this power to stimulate housing whenever there was a recession. By increasing the number of mortgages that the Federal National Mortgage Association purchased in each economic downturn it could, and did, reverse recessions.

However, in the mid to late 1960s, the United States was facing a major budgetary problem. It was fighting the war in Vietnam and "baby boomers" had reached the age when they needed jobs – jobs that did not exist. Social unrest soared and major cities started burning.

The two commissions that were set up to explore why people would burn down the neighborhoods where they lived. The commissions came to the realization that if people owned these homes, they would not burn them down. The government reacted by mandating that the nation build 26 million housing units in the 10-year period from 1968 to 1978.

To achieve this goal, it was recognized that the mortgage finance systems built in the 1930's could not do the job of providing the money needed to sell 26 million houses. The government could not step up its purchase of mortgages through the Federal National Mortgage Association. The money was not there.

Therefore, two Acts were passed by Congress to allow the government to make good on its promise to build the new housing units. They were the Omnibus Housing Act of 1968 and the Emergency Home Finance Act of 1970.

Once again government action changed the structure of the home finance industry in the United States. New entities were created; the status of existing entities was changed; interest rate policies were impacted; new financial insurance policies were put in place; and home finance was put on par with the financing of commercial and industrial activities.

It also worked. Housing starts went from 1,196,000 in 1966, when riots started in the Hough District in Cleveland Ohio, to 2,357,000 in 1972 – the all-time record. The combination of government actions and private initiatives worked to help solve a difficult economic and social problem. Housing was the answer.

Phase III

One might argue, however, that the solutions put in place were too effective. Housing activity grew but so did theft, corruption, and fraud in the housing industry. Tens of thousands of homes were built that later had to be bulldozed. President Nixon was actually the leader in reigning in these excesses.

However, the "genie was out of the bottle." The profound changes in the structure of home finance initiated by the government were expanded upon by financial companies in the private sector. There were other influences, notably the huge flows of funds, but a series of questionable practices developed. They included

off-balance sheet entities; sub-prime lending; and the creation of a myriad number of financial instruments such as CDOs, CDO², CDO³, and synthetic money.

Housing boomed once again from 1,193,000 housing starts in 1990 to 2,068,000 units in 2005. This boom was unique in that it was not driven by demographic demand. There were 43.2 million people aged 25 to 34 (the first-time homebuyers), in 1990, and 39.7 million in 2005. The boom was driven by the availability of funds and the willingness of Americans to live in one and two-person households.

Current Phase

As is well known the system then collapsed. Too many people bought houses that they could not afford using questionable loans. The householders could not repay this debt and the well-known financial panic of 2007-2008 developed.

Once again, the Federal government stepped in. This time, and for the first time ever, the government stepped in to restrain the mortgage finance market and to reduce housing production. The Dodd Frank Act resulted in the elimination of financial instruments; the elimination of financial structures; the adjustment of underwriting policies; constraints on money flows; demands for more capital in the banking system; and literally thousands of other minor changes.

The changes have impacted housing activities. In 2018, housing starts are estimated to have been 1,246,600 units. In December 2018, the estimated seasonally adjusted housing start figures were 1,078,000 – approximately half of what they were 13 years ago in 2005.

Conclusion

The purpose for relaying this history is to demonstrate:

The history of this country indicates that there is a definite link between government policy, housing, and economic growth. History makes clear that housing activity is more dependent on funding availability than demographic demand.

The current situation is proof of this thesis. The government wants to get out of housing. Its policies are all oriented toward this result. Consequently, housing is flatlining at a decades old level and demographic demands are being ignored. The economy would be growing at a faster pace if housing were not so weak.

While Fannie Mae and Freddie Mac were only one part of what the government did first in stimulating, and then reducing, mortgage activity, one might argue that they were the most important part. They funneled money into buying houses. Time and again, when the government needed to stimulate economic activity by bolstering housing it reached out first to the Federal National Mortgage Association, and then later, to Fannie Mae and Freddie Mac.

Most important, this system worked. Looking forward, without this flow of funds, I would strongly submit that housing will never get back to the levels of 1951, 1972, or 2005. The housing industry in the United States needs Fannie Mae and Freddie Mac. Therefore, the economy of the United States needs Fannie Mae and Freddie Mac. This realization is growing in Congress.

Dial Back to 2007-2008

During the financial crisis, it was understood that if the wrong policy decisions were made, the United States would be back into Depression for the first time in 75 years. Therefore, the policy makers attempted multiple approaches to liquify the economy. They ultimately came upon a series of techniques using the Federal Reserve, Treasury lending, and, I am going to argue, Fannie Mae and Freddie Mac to obtain the needed liquidity.

First Point of Contention (for this discussion only the reported data from Fannie Mae is used)

Government View

The government argued at the time that Fannie Mae and Freddie Mae were bankrupt and had to be bailed out. As proof of this they pointed to the following audited statements which showed Fannie Mae GAAP net income losses of $2.1 billion in 2007; $58.3 billion in 2008, $72.0 billion in 2009; $14.0 billion in 2010; and $16.9 billion in 2011.

These losses resulted in the net worth of the firm dropping from a positive $32.4 billion in 2006 to a negative $136.3 billion in 2011. Due to the size of the losses and the lack of positive net worth it was concluded by Congress that the firm had to be placed into a conservatorship. Plus, it was determined that the Treasury had to invest $117.1 billion in the company though the mechanism of a senior preferred stock.

Sounds pretty straight forward. The company was bleeding and the government bailed it out. In so doing, the government convinced the Congress and the press that this company was close to being enemy #1 of the American people.

Opposing View (Which I share)

There are two ways to look at a company's net income. One is to use GAAP accounting which takes into account both cash and non-cash charges. The key here is the non-cash charges. There were three critical ones at Fannie Mae:

- Estimated loan loss charges and reserve builds
- Mark down of portfolio holdings
- Deferred taxes.

None of these charges impacted the firm's cash flows. They were put onto the income statement to reflect future expectations. The forensic accountants Adam Spittler and Mike Ciklin took a look at the income statement of Fannie Mae separating the non-cash charges from the totals. By doing this, they were able to develop an income statement based on the actual company cash flows. This is what they discovered

Reported income	($58.7)	($72.1)	($13.9)
Non-cash charges	$66.3	$77.1	$24.9
Cash income	$7.6	$5.0	$11.0

Source: Adam Spittler & Mike Ciklin

In essence, these accountants were indicating that Fannie Mae never needed a bailout because the company was cash flow positive. So which side is right? Was the company at death's door or was it healthy with a strong balance sheet and positive cash flows?

The company's income statement provides the answer. In 2012, it paid the Treasury $15.8 billion dividend on the senior preferred; in 2013 - $85.4 billion; in 2014 - $15.3 billion, and in 2015 - $11.2 billion. It is now averaging payments of $9 to $11 billion a year to the Treasury.

How can the company afford to make these payments? It was decided in 2013 that the loan loss charges were inaccurate and that the elimination of the firm's deferred tax was incorrect. Therefore, since 2011, Fannie Mae has lowered its loan loss allowance every year and in 2013 it recovered its deferred tax item. When the company took these actions, it generated a huge GAAP net income figure.

Since the Treasury was entitled to all of Fannie Mae's net income as a dividend on its senior preferred, it forced the company to make cash dividend payments in the amounts shown above. Think about this. The false non-cash charges the company was forced to take in 2008 to 2010 were converted into huge cash dividend payments to the Treasury.

Also, consider this. If the company really lost the money it was accused of losing using the GAAP standards, where did it get the cash to pay these dividends?

One final thought here. Gary Hindes, one of the speakers at the Odeon Capital Group event provided a copy of an internal Treasury document at the time. The document states the possibility that if the Treasury took over Fannie Mae it could use the company's strong balance sheet and positive cash flows to help bail the banks out of bad mortgages.

This was done. Fannie Mae started buying mortgages from the banks taking losses on the so-called "scratch and dent" loans to help the banks avoid taking losses. In subsequent years when the bank balance sheets had been repaired, Fannie then turned around and forced the banks to buy back the troubled loans.

One quote from the material that Mr. Hindes provided is in a memo from Treasury officer Michael Farrell to a co-executive Robert Steele in 2008. It states:

> "From where I sit, the big picture is that right now whatever is best for the economy and the financial security of America trumps the ROI for Fannie and Freddie shareholders. … the "balance of risks" between returns to shareholders and serving the nation are currently tilted toward serving the nation."

In 2008, the policymakers were under extreme stress and they took whatever measures that they thought best to serve the nation. I agree with this. However, they could have accomplished what they wanted by giving Fannie Mae a line of credit, instead of investing in the company. In hindsight, this line would never have been used even if Fannie's regulator at the time, OFHEO, demanded that Fannie buy the "scratch and dent" loans.

If this had been done, the hysteria surrounding Fannie and Freddie would never have developed. The shareholders would not have been dislocated, and instead of Fannie and Freddie being subjected to the

depredations of the past decade, they would be serving the mortgage industry, the economy, and the nation today rather than the mess in which we now find ourselves.

Second Point of Contention

Government Point of View

In August 2012, the government claimed that Fannie Mae (and Freddie Mac) were losing so much money that they would not be able to pay the cash dividend of 10% on the senior preferred stock. In fact, the government was so concerned about the GSEs ability to pay a cash dividend that for the third time since 2008, it changed the terms of the senior preferred that it had created in 2008. There were three key changes:

- Instead of paying a fixed 10% dividend on the preferred, the companies would now pay a dividend based on their earnings. The dividend would essentially be all of their earnings and some of their capital.
- In addition, the new terms of the preferred re-affirmed that these companies could not own more than $250 billion in mortgage loans for their own accounts; and
- The two GSEs were to take their capital down to zero by December 31, 2018. This last requirement was changed to $3 billion in the case of each company.

The justification for these changes was that the GSEs had serious earnings problems. This was publicly announced with an unquestioning press repeating every word to the public. It so inflamed Congress that no objections were raised.

Additionally, Mario Ugoletti, the Under Secretary of the Treasury testified in Judge Royce Lamberth's Federal District Court to the "fact" that these two companies had financial difficulties requiring the imposition of the third change to the senior preferred's indenture. The change is now popularly known as the "Net Worth Sweep."

Opposing View

The first problem that one encounters with the government's contention is its claim that Fannie Mae and Freddie Mac were required to pay a 10% dividend on the senior preferred in cash on a quarterly basis. This is simply factually incorrect. The senior preferred's indenture states quite clearly that if the cash dividend cannot be paid Fannie and Freddie can pay 12% in stock.

Think about it. What is the justification for unilaterally changing the terms of the senior preferred if there is no requirement that these companies pay the Treasury in cash? Is it appropriate to unilaterally change a contract without the knowledge or consent of the other parties involved – particularly on false information?

The second problem relates to discovery items. Federal Claims Court Judge Margaret Sweeney has allowed plaintiffs in her court to seek discovery documents from the government. Some 12,000 items have been requested. Some of these documents have been delivered.

One critical item is a note from Fannie Mae to the FHFA and, though that agency, to the Treasury Department. The note indicated that Fannie Mae had entered into a "Golden Age" (their words) whereby its profits would rise for the foreseeable future. The FHFA and the Treasury received this information prior to creating the Net Worth Sweep.

Let me state this differently. The Treasury Department receives information that Fannie Mae is very profitable. It then states that Fannie Mae (and Freddie Mac) is in financial difficulty. It tells this to Congress, and the press. At a later date it testifies to this in a Federal Court. It knows when it states this that the companies involved are saying the exact opposite.

Based on the false information the Treasury Department then expropriates the property rights of Fannie Mae shareholders in perpetuity. The shareholders are to lose everything they own in this company despite the fact that the Housing and Economic Act of 2008 (HERA) clearly states that these two companies are to be reconstituted on a healthy financial basis and returned to the public. The then Director of the FHFA publicly argued that this was the case.

Think about this last point. HERA clearly states that it is the obligation of the FHFA to bring these two companies back to a healthy financial condition. Instead, the Net Worth Sweep mandates that they be put into bankruptcy. The Treasury and the FHFA simply chose to ignore Congress and publicly stated that they would not do what Congress requested. If Congress did not like it then Congress could have done something about it. Congress did nothing.

Legislation

Immediate Reaction to the Housing Collapse

Let's rewind the tape once again back to 2008. In a book entitled *Act of Congress* written by Robert Kaiser, it was pointed out that members of Congress had no idea why the financial collapse occurred or what to do about it. They did have a passion, however, to punish all those they perceived to be involved in creating the disaster. From my perspective, it was if hysteria had taken over Congress and, therefore, one amendment after another was offered to the Dodd Frank Bill to root out and penalize transgressors.

At the top of the list of those who should be punished was Fannie Mae and Freddie Mac. The belief was, and still is for some today, that these companies should be eliminated. The government and the press fed this sentiment. Therefore, after the Dodd Frank Bill was passed and the Dodd Frank Act was being put in place, other legislative thrusts were made to eliminate these entities:

- The Johnson Crapo Bill would have created a new Federal superstructure that nationalized the mortgage finance industry and gutted Fannie and Freddie.
- The Corker Warner Bill backed off many of the bureaucratic concepts of Johnson Crapo but not the antipathy toward Fannie and Freddie.
- The Shelby Banking Bill did not treat these companies well.
- The Hensarling Banking Bill was not as punitive but still unfriendly to these companies.

Reality Raises its Ugly Head

None of these bills passed. They did not become law. The reason, in my view, was the growing recognition that Fannie and Freddie are critical to the value of the nation's housing stock. These companies guaranteed the payments on the 30-year fixed-rate mortgages (FRM) held in the mortgage backed securities that they helped issue.

This guarantee was believed to be backed by the full faith and credit of the United States government. It is definitely not explicitly backed by the government but the marketplace functions as if it is. Of course, in the real world, the events of 2008 showed that the marketplace is correct in its assumption.

Numbers are not clear but it is being indicated in the press that 85% to 90% of the home loans in the United States may now be funded with a 30-year fixed rate mortgages (30-year FRM). If the supposed government guarantee is perceived to be removed from these instruments, it is unlikely that the private sector will step in and buy these mortgages.

No savvy investor wants to commit to a 30-year loan when interest rates are hovering around historic lows. Moreover, I believe that the only other nation in the world where 30-year FRMs exists is Singapore. Therefore, if these mortgages are eliminated:

- The monthly cost of owning most homes in the United States will rise;
- The prices of all homes in the United States will fall; and
- There will be a recession.

It is clear that Congress now understands this. Therefore, it is demanding that any change in the status of Fannie Mae and Freddie Mac salvages the 30-year fixed rate mortgage. However, it is clear that Congress does not know how to eliminate the GSEs and still maintain the 30-year FRM. The net result is Congress does not know what to do and is unable to act.

The current offering by Senator Crapo is unlikely to go anywhere. It is apparent if one listens to the hearings of the FHFA, and the questions being raised by the attending Congressional committee members that there is no sense that these men and women are willing to give up Fannie Mae and Freddie Mac.

Recap

I am arguing that there is a clear economic necessity to have Fannie and Freddie in order to maintain the flow of funds into the housing market and that there is a clear need for housing to grow in order to meet:

- The demographic needs of the burgeoning 25-34 year olds (from the low of 2005 to 2018, their number has risen back to an estimated 45.7 million or an all-time high); and
- The economy.

Yet Congress is incapable of doing anything; and housing starts are currently at levels first seen in 1946.

The Courts

Despite the information now being revealed that the Treasury may have continually misinformed the public, the press, and the courts all Treasury Secretaries, Democratic and Republican, have insisted that there has been no harm done. Therefore, a number of lawsuits have been introduced to redress perceived wrongs.

Initially, the most important one was in the Federal District Court in Washington. However, there is also a different lawsuit in the Federal Claims Court also in Washington. Plus, there is a case in front of the Fifth Circuit Appeals Court in Houston.

Let's take them one by one.

United States District Court for the District of Columbia

Royce Lamberth is the Senior United States District Judge in this court. He initially heard the case against the government related to the Net Worth Sweep in October2014. His opinion simply stated by a non-lawyer (me) was that the government had every right to seize all of the profits of Fannie Mae and Freddie Mac. Consequently, he threw out the case that challenged this right.

His decision was upheld by other Federal District Courts in numerous cases in other jurisdictions. It would have been unusual for any Federal District Court to challenge Judge Royce's decision and they did not do so.

However, two significant events then followed. The decision was appealed. The U.S Appeals Court found on a two to one basis that Judge Royce was correct in the main but it remanded the case back to his court. Judge Janice Brown had written a strong dissent. Plus, the Appeals Court had questions concerning the possible breach of contract with the holders of the preferred stock.

Second, the Claims Court had shared the discovery material, it had received in its hearings, with Judge Lamberth. He became aware that he had been lied to and that the witness who had lied was now out of the country supposedly in Ecuador. (To this day, former Under-Secretary of the Treasury Ugoletti has not surfaced and a lot of people are looking for him)

Therefore, in October 2018, Judge Lamberth took a new approach to the case. He argued that the investors in these stocks could not have known that the government would put a Net Worth Sweep in place that would eliminate all of their rights to Fannie Mae and Freddie Mac dividends. This was a breach of faith. Therefore, he is allowing the plaintiffs suit to go forward.

Many observers believe that the government made a blatant error in deceiving a Senior Federal Judge. Not only is it an affront to his intelligence but it may have resulted in his decision being overturned, in part, by the Appeals Court. This is a public embarrassment. The result is that a trial will now go forward with a Judge that may not trust the government's statements at all.

United States Court of Federal Claims

Margaret Sweeney is the Chief Judge of the Federal Claims Court. She was put on the court in 2005 and made Chief Judge by President Trump last July. Judge Sweeney has been in a running battle with the government in the "takings" case. She has repeatedly required the government to turn over 12,000 documents to the plaintiffs in this case.

The government has just as steadfastly refused to provide most of these documents. The government has claimed executive privilege even though the executive – i.e., President – is not involved in the lawsuit. Judge Sweeney has rejected this argument. She may also be upset by the fact that the government has claimed executive privilege on documents that were already part of the public record – some were articles in the *Wall Street Journal.*

To this point, the only activity in this court is related to turning over documents. At some point a trial is likely to ensue. This is another unhappy judge however, given the government's stance.

<u>United States Court of Appeals for the Fifth Circuit</u>

At the moment, this court offers the best hope for a decision that is pro-plaintiff. There are two issues of note here. In the first, the Court is questioning the legality of the Federal Housing Finance Agency, itself. This entity was constructed by Congress to eliminate any oversight of its decisions.

This suggests that the very existence of the FHFA is unconstitutional because it does not meet the requirement of balance of power. There must be some oversight of its activities and there is none. If the FHFA is unconstitutional then had no authority to change the indenture of the senior preferred and the changes must be rolled back. This leaves perhaps $16 billion to be shared among equity holders in the GSEs.

More compelling is the belief that this court actually believes in the law. In my view, there has been no evidence of this by anyone in these lawsuits to this point. It is as if the law does not exist or if it does exist no one is compelled to follow it.

The law in this case is the Housing and Economic Recovery Act of 2008 (HERA). That law as noted above requires the FHFA to rebuild the financial stability of the GSEs. The FHFA has done the opposite; it has actively destroyed the financial stability of these companies. The FHFA has so damaged these companies that Congress had to specifically demand that each company be given $3.0 billion for use as capital by the Treasury so that they would not be insolvent.

This court's decisions in multiple cases tends to require that the participants in lawsuits adhere to the nation's laws. It is virtually unbelievable that anyone could argue that the FHFA has adhered to HERA. Thus, the plaintiffs are looking very strong here. The government simply cannot argue that it is obeying the law. If the case gets to the Supreme Court the demand for the government to obey HERA is likely to be even stronger. (the whole fight over Justice Gorsuch, at its core, is his belief that the law must be obeyed as it was written)

The lawyer for the plaintiffs in this case, David Thompson, has indicated to me in a private conversation that a decision from this court could be received in 6 months. He is highly confident that he has won his case.

Note: Tim Pagliara has sponsored a web site Investors Unite that is the best source of information on court developments.

The FHFA

On January 1, 2019 the term of the Director of the FHFA expired. The President nominated Mark Calabria to take his place. A few days ago, the Senate Banking Committee voted by a tight 13 to 12 to support Calabria for the position. It is highly likely that Mr. Calabria will be nominated. His mentor is Senator Richard Shelby of Alabama. He is also supported by Vice President Mike Pence, his current boss.

Mr. Calabria's background suggests that he may know more about housing and mortgage finance than anyone in the country. He participated in writing HERA when he was a Senate aide. In his nomination hearing, he held a copy of HERA and strongly suggested that he would abide by the law. Implicit in this statement is that he believes that HERA has been violated and this needs to be corrected.

At the moment, if he is the Director of FHFA, he can make the required adjustments to get the shareholders paid. His writings suggest he intends to do this. As indicated above, until some entity declares the FHFA unconstitutional, its Director has no oversight, and he can do as he chooses.

In terms of what other moves Mr. Calabria will make, there is only confusion. For 20 years or so, Mr. Calabria has written that

- He does not like the 30-year FRM, where payments are guaranteed by the government;
- Fannie and Freddie should be separated from the government and eliminated or turned into banks; and
- Other companies in the private sector should have the same rights as Fannie and Freddie.

In his testimony at his nomination hearing he basically disavowed all of these beliefs. Thus, he is an unknown quantity beyond wanting HERA to be obeyed.

Valuation

Let me be very clear.

- If the government continues to win all of the lawsuits currently in place;
- Congress continues to do nothing; and
- The FHFA takes no definitive action to save the two GSEs
- All of the equities in these companies are worthless.

Clearly, I do not believe that this will happen because:

- The country and the economy need Fannie Mae and Freddie Mac.
- The government is very likely to lose the Fifth Circuit case.
- The FHFA is likely to reaffirm HERA.

Peter Chapman of the Beard Group has provided us with three valuation theses based on information now in the marketplace. It is understood that if the common shares have value the junior preferred shares have been paid off at par ($25 per share).

<u>Pershing Square</u>

Common shares are worth $23 to $47 per share. Assumes that senior preferred has been paid off. Combined companies earn $16 to $17 billion. This number assumes that guarantee fees are increased; the GSEs raise more capital and the Treasury's warrants are converted.

<u>Moelis</u>

Common shares are worth $11.73 to $17.75 per share. Assumes that senior preferred has been paid off. The government has exercised its warrant. The companies earn $20 billion in a rising housing market. More capital is raised and the stock sells at 11 times earnings.

<u>Adam Spittler</u>

Fannie Mae common is worth $15 to $16 per share. Freddie Mac is worth more. Assumes that senior preferred has been paid off and the government exercises its warrants. The companies earn slightly under $20 billion. All of the junior preferred is converted into common.

<u>Additional Thoughts</u>

There are core assumptions in these projections. They are;

- The government accepts the fact that it has been paid both the initial cash layout to the two GSEs along with all of the required interest on these securities. In fact, this has happened but the government rejects the concept.
- The government exercises its warrants in the companies increasing their shares by approximately 4.0 million.
- Not explicitly stated, but it is assumed by many that the junior preferreds are converted into common stock at par.

There is a lack of clarity concerning other issues:

- How much capital will be needed to run the companies in the future. The assumptions here vary widely.
- Whether the government must pay a penalty to preferred shareholders for dividends that could have been paid. There is no cumulative provision that entitles preferred shareholders to anything.
- The earnings potential of these companies:
    - Will they have access to any type of government guarantee?
    - Will they be regulated utilities?
    - Are they at risk on their non-qualified mortgages?
    - Will they face competition from other GSE companies created by FHFA?
    - Will they have pricing power?
    - How robust will housing be?
    - Can guarantee fees be raised?
    - How will the government "tax" these companies?
    - Plus, much more.
- What is the fair valuation of common shares in mortgage companies?

Despite these unknowns, two facts do seem clear:

- Any break for the plaintiffs in the law cases will result in the preferreds going to par.
- If the government wants to obtain any value in for its warrants, it must put value in the common shares.

ANALYST CERTIFICATION

I, Dick Bove, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject companies and referenced securities. I also certify that I have not, will not, nor am I presently receiving direct and/or indirect compensation in exchange for any specific recommendation in this report. In addition, said analyst has not received compensation from any subject company in the last 12 months.

RATINGS DISTRIBUTION & DEFINITIONS

Rating	Equity	%	Definition
Buy	8	50.00%	Anticipated total return of 10%+ over the next 12 months including dividend payments and/or the ability to perform better than the leading stock market averages or stocks within its particular industry sector.
Hold	6	37.50%	Anticipated trading levels at or near the current price and generally in line with the leading market averages and/or will perform less well than higher rated companies within its peer group.
Sell	2	12.50%	Anticipated depreciation of 10% or more in price within the next 12 months, due to fundamental weakness perceived in the company or for valuation reasons and/or are expected to perform significantly worse than equities within the peer group.

Ratings definitions revised as of May 7th, 2013.

RISKS
Changes to government policy, changing macroeconomic conditions.

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Hold	0 (0%)	0 (0.0%)	0 (0%)
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