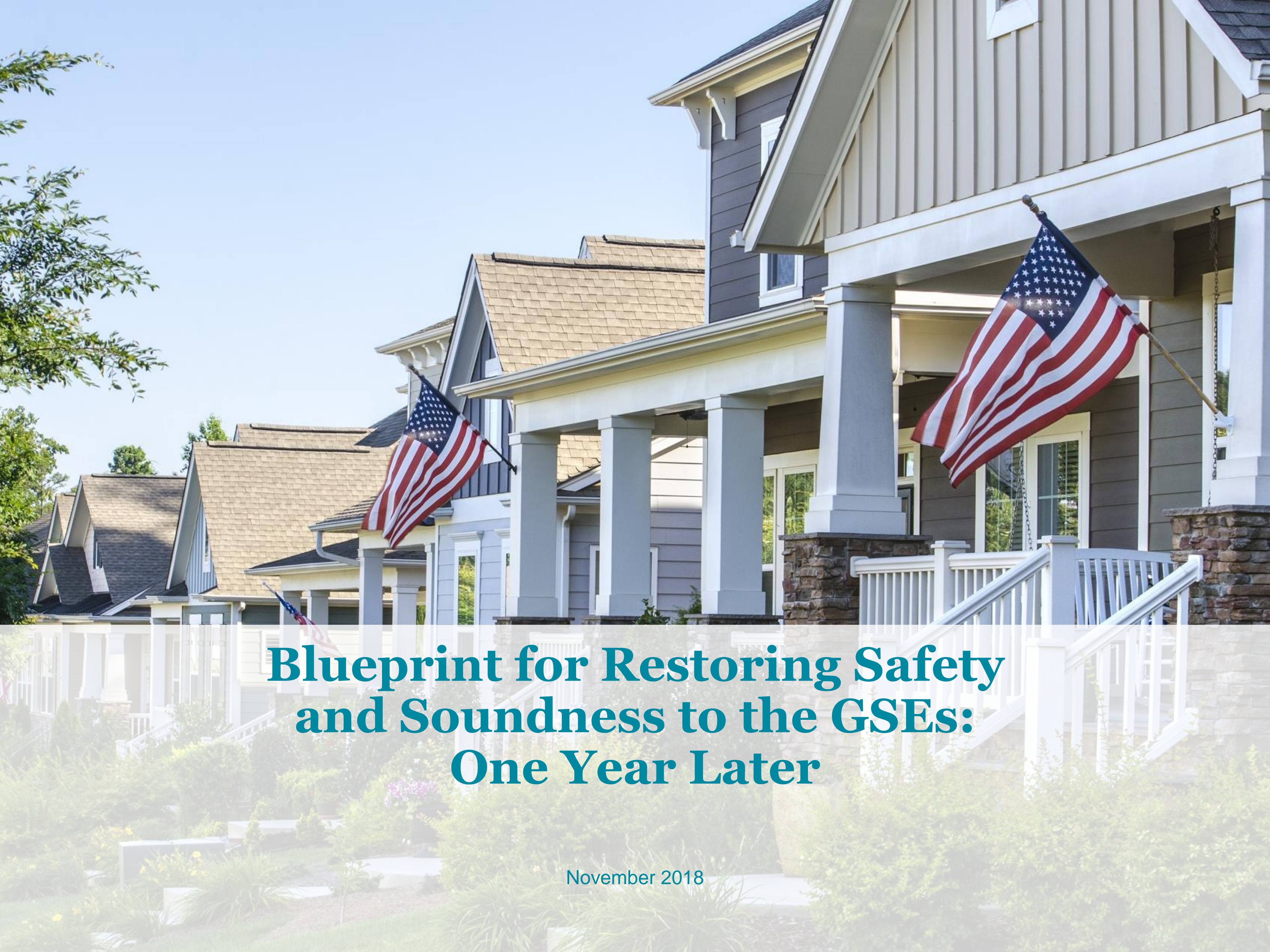

# Blueprint for Restoring Safety and Soundness to the GSEs: One Year Later

November 2018

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**This presentation summarizes the update to the *Blueprint for Restoring Safety and Soundness to the GSEs* originally released in June 2017. The *Blueprint* was developed by Moelis & Company LLC as financial advisors to certain non-litigating preferred stockholders of Fannie Mae and Freddie Mac.**

## Safety and Soundness Blueprint: One Year Later

# Blueprint Key Principles

**The Safety and Soundness Blueprint was built upon a foundation of seven key principles designed to benefit American taxpayers and support the US housing finance system:**

1. Protect Taxpayers from Future Bailouts
2. Promote Home Ownership and Preserve the 30-Year Mortgage
3. Reposition the GSEs as Single-Purpose Insurers
4. Rebuild Private Equity Capital While Winding Down the Government Backstop
5. Repay the Government in Full for its Investment During the Great Recession
6. Produce an Additional $100 to $125 Billion of Profit for Taxpayers
7. Implement Reform Under Existing Authority

# Safety and Soundness Blueprint: One Year Later

# Summary Highlights

**1 Improved Valuation**

- Moelis' estimate of the value that can be realized from the warrants held by the Treasury Department has increased to a range of $100 billion to $125 billion,[1] reflecting:
  - Lower corporate tax rates resulting from the Tax Cuts and Jobs Act of 2017
  - Better-than-expected credit performance at Fannie and Freddie
  - Updated equity market valuations

**2 The 10% Moment**

- The government has now been completely repaid under the original terms of the senior preferred stock as the GSEs have paid back all money borrowed plus an additional $94 billion
  - The returns realized by Treasury now exceed the original required 10% annualized rate

**3 Growing Consensus**

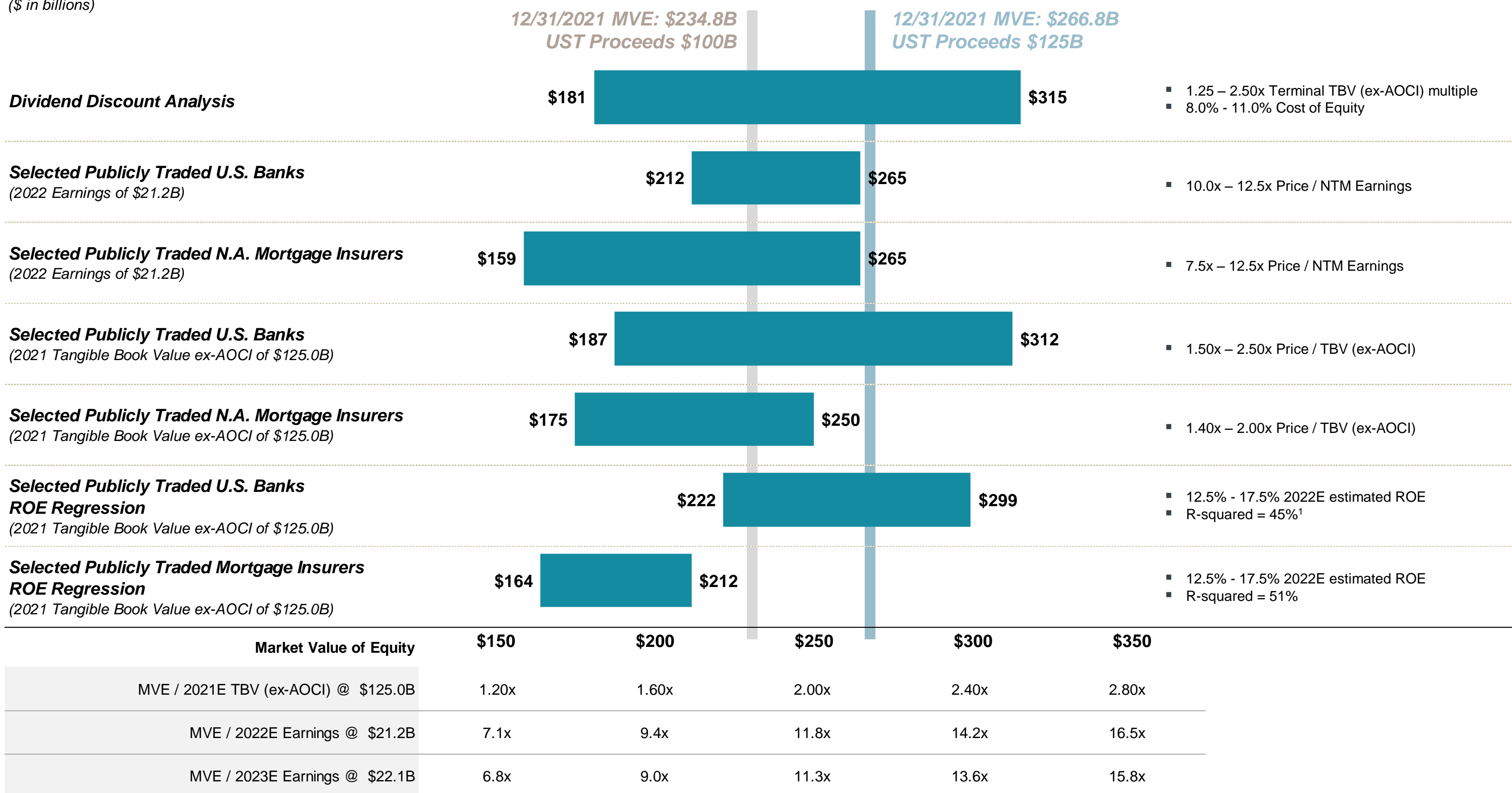
- There is an increasing convergence in the views of industry and other stakeholders that the Trump Administration should have the GSEs start building capital and must lead efforts to remove the GSEs from conservatorship



1. Calculations as of September 30, 2018. See "Blueprint for Restoring Safety and Soundness to the GSEs: One Year Later" (November 2018) for further details

# Safety and Soundness Blueprint: One Year Later

# Updated Illustrative Valuation




| Market Value of Equity | $150 | $200 | $250 | $300 | $350 |
|---|---|---|---|---|---|
| MVE / 2021E TBV (ex-AOCI) @ $125.0B | 1.20x | 1.60x | 2.00x | 2.40x | 2.80x |
| MVE / 2022E Earnings @ $21.2B | 7.1x | 9.4x | 11.8x | 14.2x | 16.5x |
| MVE / 2023E Earnings @ $22.1B | 6.8x | 9.0x | 11.3x | 13.6x | 15.8x |



Source: SNL, CapitalIQ, Company Filings, Moelis estimates, Wall Street estimates. Market data as of September 30, 2018

Note: Earnings defined as Net Income available to Common Equity (i.e. Net Income less dividends to Junior Preferred Stock)

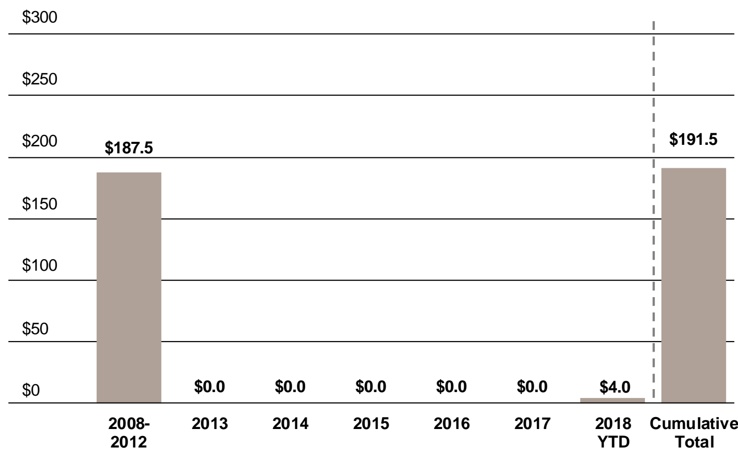
1. Selected Publicly Traded U.S. Banks ROE regression analysis excludes BB&T and M&T Bank

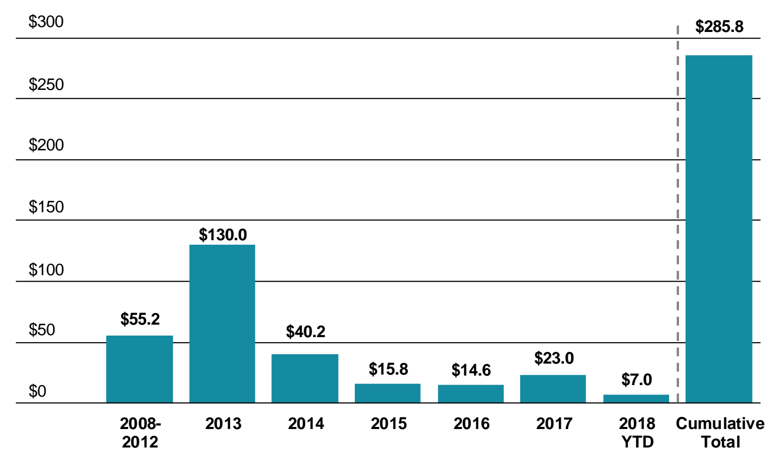
# Safety and Soundness Blueprint: One Year Later

# The 10% Moment

**Returns received by Treasury from its investment in Fannie and Freddie now exceed the 10% annualized rate established at the start of the conservatorship**

$ Billions




**The government has received $285 billion in total, nearly $95 billion more than the $191.5 billion invested.[1] This is equivalent to an annualized return of over 10%.**



Source: FHFA, Company Filings

1. Includes dividends paid through September 30, 2018

Safety and Soundness Blueprint: One Year Later

# Developments in Housing Finance Reform

**A strong and growing consensus is growing that now is the time for administrative action around common goals as Congress has been unable to develop a practical solution for GSE reform**

**Trade Group Perspectives**

- In September 2018, a group of 29 trade associations including the ICBA, MBA, NAR, and USMI sent an open letter to the Administration and Congress calling for retaining adequate capital and ending the conservatorship

**OMB**

- In June 2018, OMB published its proposals for substantial reorganization of several US government entities, including those in the housing finance system; many of the key private market solutions OMB suggests for the GSEs are compatible with the Blueprint, including ending the conservatorship and transitioning the Companies to fully private entities

- Over the course of 2018 FHFA has taken significant steps to advance GSE reform
  1. In January, FHFA released its own vision of GSE reform which calls for significant amounts of private capital, keeping in place reforms made to date, and robust capital requirements
  2. In June, FHFA released for public comment its new proposed post-conservatorship capital framework where differences from US bank capital requirements are ***minor***, ***explainable***, and ***defensible***

# Blueprint Components

**The Administration continues to voice two core principles to GSE reform:**

1. Protecting the taxpayer, ensuring there will not be another bailout of the GSEs
2. Maintaining liquidity and stability in the mortgage market

**Treasury Secretary Steve Mnuchin**
April 2017

**"We can't put taxpayers at risk. We can't have a system where we have a bailout of housing finance"**

**"…liquidity in the 30 year mortgage, that's been very important for the middle income in terms of being able to have homeownership"**

**Key components of the Blueprint that achieve the Administration's goals include:**

- Continuation of existing reforms
- Compliance with an enhanced regulatory capital framework
- Robust private capital build
- Government exit from GSE ownership
- Reduction and/or transition of Treasury backstop

**The components of this Update are consistent with those of the original 2017 Blueprint.**
**The Blueprint establishes a path to build capital at Fannie Mae and Freddie Mac as shareholder-owned insurers, focused on their core mortgage guarantee business, substantially de-levered, and held to the highest regulatory standards.**

# Key Developments Since the Blueprint's Original Release

- **Tax Reform:** The December 2017 passage of the Tax Cut & Jobs Act ("TCJA") reduced the federal corporate tax rate from 35% to 21%.
  - This resulted in a substantial reduction of deferred tax assets ("DTAs") at Fannie Mae and Freddie Mac, and has improved post-tax earnings projections for the GSEs.

- **Capital Buffer:** Also in December 2017, Treasury and FHFA worked together to put in place a permanent but small $3 billion capital floor for each of Fannie's and Freddie's individual capital reserve amounts through execution of a letter agreement. This represents only 0.1% of assets and a tiny fraction of the capital called for by FHFA's proposed capital rule (see below).

- **New Proposed Regulatory Capital Framework:** FHFA developed and released for public comment, its new post-conservatorship regulatory capital framework for the GSEs.
  - The proposed framework, when implemented, would establish core capital requirements equivalent to ~4x the GSEs' pre-crisis requirements.
  - These proposed regulatory capital minimums are broadly consistent with those of other regulated financial institutions.

# Safety and Soundness Blueprint: One Year Later

# FHFA Enterprise Capital Requirements

## The updated Blueprint assumes implementation of FHFA's proposed Enterprise Capital Requirements[1]

- Differences between FHFA's proposed rule and U.S. bank capital requirements, or the requirements proposed in the Moelis Blueprint, are minor, explainable and defensible

| Item | FHFA's Proposed Rule | Moelis Blueprint | BASEL III (GSIB) |
|---|---|---|---|
| **Leverage Ratio** | 2.50%[2] | 3.00%[3] | 3.75 - 4.00%[4] |
| **Calculation of Credit Risk-Based Capital** | PMIERs-style grids based on LTV, FICO and documentation terms | 50% of RWA, adjusted for CRT | 50% of RWA, potentially adjusted for CRT |
| **Risk-Based Capital Requirements (Pro Forma 2020)** | 2.54%[5] | 3.00%[6] | 3.60%[7] |
| **Deferred Tax Asset Treatment** | Excess DTAs are added to risk-based capital requirement[8] | DTAs included in core capital | Excess DTAs deducted from Tier 1 Capital |
| **Limitations on Junior Preferred Stock** | No limitations (JPS included in core capital) | No limitations (JPS included in core capital) | JPS effectively limited to 1.5% of RWAs (or ~$30B) at minimum capital requirements[9] |

**The Moelis Blueprint largely borrowed from international Basel III standards, with some minor adjustments to reflect the unique business model of the GSEs. FHFA's proposed rule makes further adjustments resulting in a more granular, but slightly less onerous, set of capital requirements than those used under the Basel III standard or outlined in the Blueprint**



Source: FHFA, Company Filings, Federal Reserve, Bank for International Settlements (BIS), Moelis Blueprint
Note: See Appendix for corresponding footnotes

## Safety and Soundness Blueprint: One Year Later

# Recommended Next Steps

**The Administration and FHFA have the legal authority to end the conservatorship and begin the process of building capital at Fannie and Freddie, and should immediately work together in:**

1. Allowing the GSEs to rebuild capital by suspending the dividends paid to Treasury
2. Recognizing that the government's investment in Fannie and Freddie has been repaid in full with interest. As long as Treasury's senior preferred stock remains outstanding, it will not be possible for the GSEs to raise equity from the private markets
3. Directing Fannie and Freddie to submit capital restoration plans as authorized by HERA

**Taking these three steps immediately begins the process of restoring safety and soundness to protect American taxpayers**

# Safety and Soundness Blueprint: One Year Later

# Building a Fortress Balance Sheet

| $ Billions | | BUILDING CORE CAPITAL | % ASSETS[3] |
|---|---|---|---|
| **Adj. 2018P Core Capital[1]** | SPS principal reduced to reflect original contractual terms[2], earnings begin to be retained | **$12B** | **+0.2%** |
| **Retained Earnings[4]** | Dividends suspended until capital build is completed | **$54B** | **+1.0%** |
| **Common Equity Raised** | Relisting offering, follow-on offering(s) | **Initial $37.5B** / **Follow-on $37.5B** | **+1.4%** |
| **Preferred Stock Issuances** | Augment existing junior preferred stock (to the extent not converted) | **$25B** | **+0.5%** |
| **Core Capital[5]** | Dividends resume | **$167B** | **~3.0%** |

Source: Company filings, Moelis estimates

1. Reflects $3.0 billion per GSE of net worth as of June 30, 2018 pro forma for dividends paid on September 30, 2018 plus Moelis projected net income for 2H 2018. Note, these projections may differ from actual 2H 2018 results
2. SPS principal is reduced to $0 at Freddie Mac, reflecting amortization of past payments in excess of a 10% annualized rate. SPS principal balance at Fannie Mae, reflecting amortization of dividends paid in excess of a 10% annualized rate through Sep 30, 2018, is equal to $276 million – which is assumed to be converted into common equity in connection with the relisting offering
3. Based on projected 2021 total assets & off balance sheet securitizations of $5.5 trillion. In the June 2017 Safety and Soundness Blueprint, core capital of 3.25% was based on 2020 projected total assets of $5.1 trillion
4. Retained earnings, 2019 through 2021, net of common and preferred dividends – as applicable
5. Minimum capital requirements expected to be met by 2021 year-end, at which point dividends would resume

**The Blueprint builds capital through retained earnings, partial conversion of existing preferred stock, and new issuance of common and preferred stock**

# Safety and Soundness Blueprint: One Year Later
# Implementation

| | 2018 Q4 | 2019 | 2020 | 2021 | $ Capital | % Assets[1] |
|---|---|---|---|---|---|---|
| Turn off Net Worth Sweep and retain earnings until regulated minimum first-loss equity is built[2] | ◆ | | | | $67B | +1.2% |
| Adjust SPS balance to reflect original contractual terms | ◆ | | | | | |
| Announce future, not immediate, exit from conservatorship | | ◆ | | | | |
| Establish regulatory framework and mechanics for G-fees | | ◆ | | | | |
| Agree on terms to partially equitize JPS[3] | | ◆ | | | | |
| Companies issue primary common equity through an IPO | | ◆ | | | $37.5B | +0.7% |
| Companies issue primary common equity through a follow-on offering | | | ◆ | | $37.5B | +0.7% |
| Companies issue new junior preferred stock | | | ◆ | | $25B | +0.5% |
| Treasury sells remaining equity interest via secondary offerings | | | | | | |
| **GSEs emerge as rebuilt organizations and taxpayers profitably exit their only remaining financial crisis federal financial assistance program** | | | | ✓ | **$167B** | **3.0%** |



Source: Company filings, Moelis estimates
1. Based on projected 2021 total assets & off balance sheet securitizations of $5.5 trillion. In the June 2017 Safety and Soundness Blueprint, core capital of 3.25% was based on 2020 projected total assets of $5.1 trillion
2. Retained earnings net of common and preferred dividends
3. Conversion price and terms can be pre-established (consistent with the approach used by Treasury in AIG), or can be set at the IPO price

# Reform Considerations

## Many GSE reform proposals would have significant negative side effects and unintended consequences for the markets, including:

1. Revoking Fannie and Freddie's federal charters
    - Removing affordable housing goals and duty to serve will not pass in a divided Congress – this is an unnecessary distraction
2. Requiring multiple mortgage guarantors
    - Proposed market share caps would be cumbersome; the magnitude of capital needed for a start-up to meet capital regulations would most likely be unattainable; the barriers to entry for new players are significant; a better alternative would be to regulate a very small number including Fannie and Freddie; compatible with Blueprint on a very limited basis
3. Changing the government's current entity-based backstop to an unlimited security-based guarantee
    - Compatible with our Blueprint, adding qualified debt to fund the cash windows and delinquency buybacks would be necessary to maintain a level-playing field for smaller seller/servicers
4. Expanding the role of Ginnie Mae to largely replace Fannie and Freddie
    - Implementation issues are significant; necessary infrastructure does not exist; amplifies an uneven playing field between smaller seller/servicers and large banks; cumbersome mechanics; Ginnie only has ~350 issuers, while Fannie and Freddie combined have ~2,000 seller/servicers
5. Placing the GSEs in receivership
    - Infeasible due to magnitude of resulting claims resolution process; would most likely have unintended consequences for the market; would compromise value of GSE assets and completely eliminate the value of Treasury's 79.9% warrants

# Appendix

# Safety and Soundness Blueprint: One Year Later

# Notes to Page 10

1. The Blueprint assumes that the GSEs will target core capital equal to 120% of FHFA's proposed minimums (as estimated in Moelis projections).

2. FHFA's proposal presents two alternative leverage ratio methodologies. The first methodology is a simple leverage ratio, requiring that core capital exceed 2.50% of total on-and-off balance sheet assets and guarantees. The second methodology (1.50% of on-balance sheet assets) + (4.0% of off-balance sheet guarantees) produces a lower result which is equivalent to approximately 1.9% of total assets and guarantees.

3. The Moelis Blueprint's primary leverage ratio requires core capital to exceed 3.0% of total on-and-off balance sheet assets. Note that the Blueprint also includes a secondary leverage ratio (core capital + outstanding CRT >= 5.0% of total assets), which could increase core capital requirements to the extent CRT issued and outstanding is below 2.0%. This secondary leverage ratio has been excluded from the table for the purposes of simplification.

4. The U.S. Basel III enhanced Supplementary Leverage Ratio ("eSLR") requires GSIBs to hold Tier 1 Capital (roughly, but not exactly, analogous to core capital) in excess of 5.0% of total on-and-off balance sheet assets plus other adjustments for bank holding companies. However, international Basel III standards only require banks to hold Tier 1 Capital in excess of 3.0% of total on-and-off balance sheet assets plus other adjustments. U.S. and international regulators appear to be converging towards a new approach with GSIB leverage ratios being set at 3.0% + 50% x (GSIB Add-On), which would put U.S. GSIB requirements (e.g., for JPM, Citi, BONY, etc.) in the 3.5% - 4.25% range. Using the FSB framework, Moelis estimates the GSIB add-ons for Fannie Mae and Freddie Mac at 2.0% and 1.50% respectively, implying a leverage ratio of 3.75% - 4.0% for the GSEs to the extent they were subject to the proposed U.S. and international banks standards.

5. FHFA proposed rule contained a headline capital requirement of $180.9B (3.24%); on closer examination, tax reform has reduced DTA-related capital requirements by $15.6B as of Q4 2017, taking the required core capital to ~$165B (or ~2.96%), ceteris paribus; further reductions in capital requirements, related to continued CRT transactions as well as run-off of legacy risk, should reduce aggregate risk-based capital requirements to ~2.54% by 2020 year end.

6. Based on figures from the Moelis Blueprint.

7. The Moelis Blueprint uses an RBC requirement of 8.5% x Risk-Weighted Assets and estimates application of the international Basel III approach using the SSFA to provide RBC-relief for CRT transactions. The Blueprint projects 2020 RWAs at ~36% of balance sheet assets, leading to an RBC requirement of ~3.0% (equal to 36% x 8.5% RBC requirement). GSIB capital requirements of ~10% of RWAs for the GSEs would increase the RBC requirement to ~3.6% (equal to 36% x 10%). Note further that, unlike international regulators, U.S. bank regulators have not granted RBC-relief for synthetic securitizations.

8. Note that, while FHFA's framework in some ways mirrors bank requirements (which deduct NOL DTAs and timing DTAs in excess of 10% of minimum capital), there are 2 key differences: 1) FHFA's proposed rule adds excess DTAs to the minimum capital requirement, rather than deducting them from the definition of capital (this has the effect of grossing up the headline number, e.g., in Q3 2017 FHFA's definition of core capital must exceed $181B – o/w $26B is excess DTAs, equivalent to a Tier 1 Capital requirement of $155B), and 2) FHFA's adjustment for DTAs applies only to the risk-based capital requirements (and not to the leverage ratio requirement).

9. Basel III rules include risk-based capital minimums of: 1) Tier 1 Capital > 8.5% (+ GSIB add-on) x RWA, and 2) Common Equity Tier 1 Capital > 7.0% (+ GSIB add-on) x RWA. While a bank can issue more than 1.5% junior preferred stock, which can be counted as Tier 1 capital, the minimum of 7.0% CET1 would effectively limit Junior Preferred Stock to 1.5% of RWAs (at minimum capital standards).