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Comments On The Revised Capital Rule (RIN) 2590-AA95
For the Government Sponsored Enterprises (GSEs)

Introduction

The revised capital proposal or "Enterprise Regulatory Capital Framework" for the government-sponsored enterprises (GSEs) calls for more capital than the 2018 capital plan, which itself required more than necessary to maintain the companies in safe and sound financial condition. The reasons given for the re-proposal, and additional capital, center on the regulator's desire to increase the level of assurance regarding the safety and soundness of the GSEs, address counter-cyclicality, and address the end of conservatorship — which may not be reflected in the 2018 proposal.

All GSE stakeholders share the common goal of maintaining safe and sound conditions post conservatorship, including the regulator, company executives, board members, and shareholders. While united in achieving these important goals, the additional cash required under the new proposal is incrementally detrimental and restrictive. The proposed cash requirements for credit risk, market risk, operational risk, and various other capital buffers, in totality, are rather onerous for the GSEs. Such cash levels have never been needed in the history of the GSEs and they are highly unlikely ever to be.

An adequate, but not excess, level of cash capital is required. These are publicly-owned companies, and while they are fully regulated, there should be practical limits on the cash capital they are required to hold, especially if there is no historical basis for needing such large cash sums. With less restrictive capital requirements, post conservatorship the GSEs could raise vast additional sums if and when needed via debt or equity offerings on the open market.

Restrictively regulating and capitalizing the GSEs is not the answer. Mind you, my views are through the lens of a former AT&T employee and Investor Relations Director who has seen vast telecom industry regulation and deregulation first hand, as a former AT&T staffer, member of the investment community, and private shareholder. AT&T and the telecommunications industry has always been fully regulated — similar in many respects to the regulation of GSEs.

The Revised Capital Rule Proposes "Bank Like" Capital For The GSEs

The revised capital proposal anticipates the full release of the GSEs from conservatorship upon achieving cash capital of 2.5% plus an additional 1.5% buffer, for a total requirement of 4%. This figure appears very "bank like" and seems far from:

i) the most recent GSE Dodd-Frank stress test results for a “severely adverse” economic scenario. The Dodd-Frank stress test takes into account a 10% national unemployment rate and 8% decline in real GDP, resulting in 25% and 30% declines in residential and commercial real estate prices, respectively. The result: very minimal credit losses of 0.22% at Fannie Mae and 0.26% at Freddie Mac. The Dodd-Frank stress test results are very illustrative and demonstrate minimal anticipated credit losses even during a “severely adverse” economic downturn. Credit losses are a key element of GSE risk profiles.

ii) the amount of cash losses and capital required during the 2008 and 2009 financial crisis. If 4% cash capital was not necessary during the financial crisis, it is less likely to be needed after all the reforms that have taken place at the GSEs while in conservatorship.

iii) the cash needs during the current Covid-19 pandemic, which represents a real-time economic stress test, with the GSEs managing through the economic conditions very well, with minimal impact, despite constraints imposed on their retained earnings.

iv) the July 12, 2020 commentary of former Fannie Mae CFO Timothy Howard submitted to the regulator. Mr. Howard noted in his comments that the proposed capital requirements are:

- *arbitrarily high;*
- *more capital than necessary;* and
- *overcapitalizing Fannie and Freddie to the point of inefficiency and non-competitiveness.*

Some believe that the 4% capital requirement is not all “required” capital, and that only the 2.5% figure is. Others believe that any company unable to make traditional corporate decisions such as setting executive compensation levels until a higher cash capital level is achieved, is clearly a requirement of traditional self governance. In practicality, executive compensation is often a fairly small percentage of total corporate expenses.

<u>Capital Re-Proposal Appears To Be A “One Size Fits All” Solution</u>

Having a similar capital requirement for banking institutions and GSEs alike appears to be a “one size fits all” solution for large financial institutions, despite drastically different business models and risk profiles.

It is unclear what economic scenario is being prepared for with proposed cash capital including various buffers of 4%. The Dodd-Frank conditions of 10% unemployment and 8% decline in real

GDP are clearer. As such, the capital proposal appears to be more of a “top down” solution which treats the GSEs essentially like banks for capital purposes, with Basel-based requirements, regardless of their many differences.

The proposed capital requirement would increase costs borne by home buyers to the detriment of home affordability. The effects would be disproportionally impactful to first time home buyers, lower-income households, and minority communities.

The GSEs are less diversified, and operate at much lower risk profiles, in comparison to when they were originally placed into conservatorship. With many difference in operations today, including the addition of credit risk transfer agreements and reductions to retained GSE portfolios, the reduced level of risk is reflected in the anticipated Dodd-Frank credit losses. Both companies have become even more streamlined as they anticipate a future outside of conservatorship.

They GSEs undertake far less risk than financial institutions which operate complex and diversified banking models. The GSEs should not be required to retain the same cash capital levels as banks. It’s unclear if there are structural changes desired to shift securitization market share toward banking institutions, and away from the GSEs.

<u>The Power of Retained Earnings Has Been Largely Unharnessed; Net Worth Sweep (NWS)</u>

The GSEs have notable earnings power, and could meet reasonable capital requirements by retained earnings alone, if given sufficient time and a Treasury backstop, during an accumulation period. The companies would be well on their way toward being adequately recapitalized had much of GSE earning power not be garnished by the NWS.

The NWS has been counter productive to the inevitable release from conservatorship. Cash removed via the NWS also exceeded the original conservatorship agreement for a 10% return on capital advances. The excess payments could be restored to the companies’ balance sheets, thereby reducing the amount of any new paid-in-capital which may ultimately be raised in order to meet capital levels faster than on a retained earnings basis alone with a Federal backstop / credit line.

More recently, while GSE earnings are now adding to their expanded capital buffers, Treasury’s liquidation preference is also increasing dollar-for-dollar. It’s unclear how this helps the companies exit conservatorship.

<u>Re-proposed GSE Capital Levels Are Without Historic Precedent or Need</u>

The prior GSE headline losses were largely non-cash asset write downs due to accounting changes. The distinction between cash losses and accounting write-downs is highly material, as decisions are ultimately made for required cash capital retention levels.

It is uncertain if a distinction is made between possible future cash needs and non-cash asset write downs, or if the higher capital levels could be used to purchase mortgage securities from other entities in the event of extreme economic conditions.

On a cash basis, the GSEs performed extraordinarily well even during the most challenging days of the 2008 and 2009 financial crisis. If 4% cash capital was not necessary during the 2008 and 2009 financial crisis, it is even more unlikely to be needed after the implementation of many operational reforms.

The regulator states:

"A 2.5 percent leverage ratio and a 1.5 percent PLBA that would together serve as a credible backstop to the risk-based capital requirements and mitigate the inherent risks and limitations of any methodology for calibrating those requirements."

"A stress capital buffer and a separate leverage buffer that will, in addition to enhancing the resiliency of the Enterprises, dampen pro-cyclicality by encouraging each Enterprise to retain capital during good times while remaining able to provide stability and ongoing assistance to the secondary mortgage market during a period of financial stress by utilizing capital buffers as losses are experienced."

Under this set of requirements, risks mitigation would be unnecessarily large and remove too much capital from the system.

Re-Proposed Capital Requirements Lead To A More Difficult Capital Raise

Increased capital requirements for the GSEs will make raising external capital more difficult. High-quality, long-term investors, such as pension funds and endowments are known for owning quality large cap securities in their portfolios. As prospective investors in any newly-issued GSE securities, they will likely view the expanded capital requirements as excessively conservative.

Retaining too much capital will greatly inhibit the companies' growth potential and earnings power. This in turn will limit the amount of interested investors in a potential capital raise of GSE securities. It will also reduce the value of the companies, common shares, and warrants.

Higher Capital Requirements Will Reduce The Value of the Warrants

The expanded capital requirements will result in a paradox for Treasury. Higher capital requirements will reduce the desirability of the companies and any new securities, negatively impacting the value of warrants held by the Treasury.

During the 2008 and 2009 financial crisis, it was in the interest of the U.S. economy to render assistance to a wide range of industry sectors including banking, insurance, housing finance, and automotive. Treasury received warrants for nearly 80% of GSE common shares. The two companies have also repaid Treasury in full plus more than the originally-agreed-upon 10% return.

The NWS itself was enacted after the GSEs were under the control of the regulator, with a single director structure. As such, it is unclear if the NWS will ultimately be upheld or invalidated, given the recent Seila decision, and structural similarities between the Consumer Financial Protection Bureau ("CFPB") and the regulator. It's unclear if exercising the warrants held by Treasury would face legal challenges if not used for the benefit of the GSEs or their shareholders.

At nearly 80%, the scale of GSE warrants is much larger than Treasury received from other companies during the financial crisis, and other companies were allowed to repay sums advanced, and at a lower rate than 10%. It remains unclear what will happen to the GSE warrants and extra capital payments, as these elements will have a great deal of materiality on the GSEs, their cash positions, and overall balance sheets.

The warrants held by Treasury could be used in whole or part to recapitalize the GSE balance sheets. Excess payments over the 10% threshold can also be repatriated to assist with GSEs balance sheet restoration plans.

Common shareholders such as myself would prefer to maintain the integrity of their holdings and avoid excess dilution.

While there are opinions that the senior preferred shares held by Treasury will be cancelled and that the junior preferred shares will be converted into common shares, Fortune 100 companies generally have complex balance sheets and such conversion does not need to occur.

Existing junior preferred shares can be carried forward as part of any prospective IPO or secondary offering. The existence of preferred shares, debt securities, equity securities, credit lines, as well as cash, are highly typical, not atypical, of the balance sheets of large public companies.

Prospective shareholders consider all of these elements during their investment evaluations. There is no perfectly "clean" balance sheet and the GSEs should not be held to an atypical standard.

The market value of the GSEs has been greatly reduced since conservatorship, as reflected in the low share price of GSE common shares today.

Among factors which have negatively impacted the value of GSE shares: a lengthy period of conservatorship; market concerns over real and perceived regulatory risk; uncertain outcome for the warrants on 80% of GSE common shares; the NWS and its use of funding a budgetary shortfall for the Affordable Care Act, according to the Treasury Secretary; the increasing liquidation preference; increasing proposed cash capital requirements and buffers; and potential dilution to common shares from possible conversion of junior preferred shares into common.

Common shareholders like myself appeal for relief as final decisions are made regarding required GSE capital levels — and the sources of such capital.

Higher Capital Requirements Lead To Perceptions of Regulatory Risk

While final decisions by the regulator have not been made, the higher level of capital proposed, the ultimate handling of the GSE warrants, and liquidation preference, will also be in focus during a potential capital raise.

Investor observations about the handling of prior investors highlight elements of real and perceived levels of regulatory risk. As part of any future capital raise, prospective investors will evaluate the treatment of prior investors. These investors may be one and the same.

Reasonable Capital Levels Benefit The Borrower and Aid Home Affordability

The GSEs have proven highly resilient. They are highly efficient and essential providers of liquidity. They support affordable housing mandates and participate in the markets during both good and bad economic times. They do not geographically “cherry pick” more profitable geographic market segments at the expense of less profitable ones.

Additional costs will likely be passed onto home buyers, in the form of higher guaranty fees. Requiring extra balance sheet capital hinders the GSEs’ ability, and mandate, to encourage greater home ownership and home affordability.

To my knowledge, no detailed analysis has been published on how increased capital requirements imposed on the GSEs will effect home affordability.

Consequences To Independent Community Banks

Independent community banks use the GSE securitization platforms to effectively compete as mortgage originators, even with much lower origination volume and scale. Increased capital requirements placed on the GSEs will likely reduce the relative competitiveness of independent community banks.

Higher levels of regulatory capital required of the GSEs can result in large banking institutions garnering more market share from the GSEs (securitization) and local community banks (origination), alike.

With higher costs resulting from the higher capital requirements placed on the GSEs and independent community banks, large banking institutions may increasingly offer end-to-end mortgage services (origination, securitization, servicing, etc.).

It's unclear if an expansion in market share by large banking institutions would also increase their own risk profiles, or how such expansion may impact smaller lending institutions, as they try to adapt to higher industry cost structures and new competitive dynamics.

The increased costs resulting from higher capital requirements will likely act to the detriment of the GSEs, home buyers, and smaller independent community banks alike.

To my knowledge, no detailed analysis has been published on how increased capital requirements imposed on the GSEs will effect independent community banks or large banks.

Commentary of Timothy Howard, Former CFO of Fannie Mae

The published commentary of former Fannie Mae CFO Timothy Howard on July 12, 2020 has been notable in terms of its detailed analysis and critique of the newly proposed capital requirements.

Among the many points made by Timothy Howard in the July 12, 2020 commentary:

- *The re-proposed 'Enterprise Regulatory Capital Framework'…takes a problematic capital proposal…and, instead of improving upon it, makes it inarguably worse*

- *Fannie and Freddie's capital must be based on data, not Basel risk weights*

- *Excessive Fannie and Freddie capital leads to severe pricing and market anomalies"*

- *There are market limits to increases in guaranty fees*

- *FHFA must re-do, and greatly simply and clarify, its risk-based capital standard*

- *Other required capital must be clearly identified, described and defended.*

Mr. Howard has also indicated that the proposed capital requirements are:

- *"arbitrarily high;"*

- *"more capital than necessary;" and*

- *"overcapitalizing Fannie and Freddie to the point of inefficiency and non-competitiveness…"*

Personal Commentary and Conclusions

My comments are made as a private individual and GSE common shareholder. No recommendation is made regarding GSE or other securities.

I have been an owner and advocate on the GSEs for several years and have previously sent my opinions on the topic to Treasury Secretary Steven Mnuchin in a letter dated November 21, 2018. The letter is available electronically on my Twitter profile @TomLauria — in a Twitter post dated the same. As noted in my letter, "It is prudent to impart caution over significant deregulation or structural changes to U.S. housing finance, which remains very efficient." This statement remains true today.

As personal background, I have been FINRA/NASD licensed 7, 63, and 65 with various affiliations over the years. Before the passage of the Telecom Act, I was a competitive intelligence analyst for AT&T. Afterwards, I was Investor Relations Director for the IPO of AT&T's equipment division, which included Bell Laboratories. AT&T has always been fully regulated, similar to the GSEs.

Our IPO from AT&T was done after the passage of the Telecom Act, when Congress encouraged new telecom carriers to enter the market. The market fully embraced new competition. When the AT&T divisions, which were comprised of nearly 150,000 employees, spun off from AT&T, the equity offering was the World's largest at the time. As a stand-alone entity, it was NYSE-listed and ranked in the Fortune 20.

I left AT&T to join the sell-side as a sr. equity analyst and director for ING Barings, the same equity research team as economic advisor Larry Kudlow, who served as chief U.S. economist at the time. ING was later acquired by rival ABN Amro.

Regulation, whether or not of telecom or housing finance, remains an art more than a science. After the Congressional passage of the Telecom Act, many changes resulted to the competitive landscape. The U.S. wireless and wireline carrier markets went from regulated to fully competitive ones, virtually overnight. Deregulation raised billions for Treasury via proceeds from wireless spectrum auctions but also later saw the bankruptcy of Canada's Nortel Networks, and fraud at Worldcom. The successful AT&T IPO that I speak of, was ultimately acquired by Finland's Nokia.

For its part, Europe had a vastly different approach toward telecom regulation, as it embraced a more standardized technology platform and less competition. Lessons abound and the story of telecom deregulation is told in my book, *The Fall of Telecom.* There are many parallels between telecom and housing finance regulation.

Should the GSEs ultimately get the "green light" from their regulator, as Fortune 50 companies, the potential stock offerings would likely be among the World's largest capital raises. Congress, for its part, may deregulate housing finance by chartering new entrants, just as it did with the telecom markets. In the case of telecom service providers, after deregulation, they largely consolidated back to the original few license holders.

Finding the right balance between under- and over-regulation is always challenging, as the landscape is complex. U.S. housing finance is highly efficient and responsibly managed. The current capital proposal is notably more conservative than necessary. A balance must be achieved in setting reasonable capital requirements. Too little regulation and required cash capital will be as detrimental and destabilizing as too much regulation and required cash capital.

Among other things, overcapitalization of the GSEs will serve no constructive end, as it will likely raise borrower costs and hinder home affordability, particularly for first time home buyers and lower income households; make a potential capital raise more difficult; reduce the value of warrants currently held by Treasury; increased perceived and real ongoing regulatory risk; and have uncertain consequences to independent community banks.

The current proposal is more onerous than the 2018 plan. The GSEs have never needed, and do not need now, cash capital of 4%. My views are respectfully submitted and I hope that this commentary adds to the important discussions taking place about the future of these two very important companies, their required capital levels, and the sources of that capital.

Respectfully Submitted,

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