August 20, 2020

Dr. Mark Calabria
Director
Federal Housing Finance Agency
400 Seventh Street, SW
Washington, DC 20219

Re: Notice of Proposed Rulemaking and Request for Comments – RIN 2590–AA95

Dear Director Calabria:

We appreciate the opportunity to comment on FHFA's Re-Proposed Rule on Enterprise Capital (the "Re-Proposed Rule"). Pershing Square's current investment in Fannie Mae and Freddie Mac ("Fannie" and "Freddie," respectively, and collectively the "GSEs" or the "Enterprises") began in the fall of 2013. Since that time, we have been one of the largest private common stockholders of each of the GSEs, aligned with the United States Treasury, which continues to hold warrants for 79.9% of the common stock of both companies. While most of our investment in the GSEs is in the form of common stock, we are also a sizeable investor in the junior preferred stock of each Enterprise.

The Re-Proposed Rule contains several significant improvements from the version proposed in 2018 (the "2018 Proposal"). As we discussed in our comment letter on the 2018 Proposal, we believe that the pro-cyclicality embedded in the prior rule would have made any private capital raise infeasible, and would have also likely led to another taxpayer bailout in the next housing crisis. The addition of a long-term, single-family house price index trend and collar methodology in the Re-Proposed Rule substantially reduces, but does not fully eliminate, the pro-cyclicality of the risk-based capital ("RBC") framework.

We also concur with FHFA's view that credit risk transfer ("CRT"), while effective at reducing some portion of the GSEs' credit risks, is an inferior form of capital to equity. We believe the less favorable treatment of CRT in the Re-Proposed Rule appropriately incentivizes the Enterprises to hold equity capital rather than utilize CRT. The less favorable treatment for CRT also serves to further reduce pro-cyclicality, as CRT as a capital source is only available on attractive terms during good times, as evidenced most recently by the CRT market's failure during the COVID-19 crisis.

The most important enhancement in the Re-Proposed Rule, in our view, is FHFA's pursuit of a clear policy goal of responsibly ending the conservatorships of the Enterprises. We commend FHFA for the tangible actions taken to date to achieve this goal, including the suspension of the

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Net Worth Sweep to allow the Enterprises to start to build capital through retained earnings, as well as the hiring of financial and legal advisors for both FHFA and the Enterprises. As we have advocated for the last seven years, a successful reform and restructuring of the GSEs, including substantial private capital in a first-loss position ahead of the taxpayer, is the only way to maintain the availability and affordability of the 30-year, fixed-rate, prepayable mortgage, the bedrock of housing finance in the United States.

Unfortunately, we believe that there are several elements of the Re-Proposed Rule that would make it impossible for Fannie and Freddie to raise the massive amount of private capital needed to exit conservatorship. Most critically, the new minimum capital level of 4.0% is far too high and fails to balance the objective of safety and soundness of the Enterprises with the need to deliver affordable mortgage rates to consumers and market returns to investors. This capital level treats the GSEs as if they are banks, when in reality they are monoline insurers. We also continue to believe that required capital levels should be set at a sufficiently high level and then be fixed rather than dynamic in order to provide the visibility and transparency that investors will require before committing fresh equity capital.

Quantity of Capital

As we initially recommended publicly in the spring of 2014, we believe the required capital level for the GSEs should be approximately 2.5% of total assets and off-balance sheet guarantees, unchanged from the 2018 Proposal. Equity capital of 2.5% would amount to 2.7 times the cumulative losses in the GSEs' single-family guarantee business during the Global Financial Crisis.(1) If one adjusts historical results to exclude credit losses from subprime and Alt-A mortgage-backed securities ("MBS"), which the GSEs do not and will no longer issue, required capital of 2.5% would amount to 4.6 times cumulative Global Financial Crisis losses.

The GSEs' historical required capital levels of 45 basis points would have been nearly sufficient during the Global Financial Crisis absent over-provisioning and the issuance of MBS backed by subprime and Alt-A loans. Required capital of 2.5% would be over five times this amount. By prohibiting the GSEs from their riskiest transactions of the past, FHFA has effectively reduced the GSEs' future exposure to the most volatile and loss-generating parts of their past activities. This reduces the amount of capital required to prudently and amply face any future downturns, which, simultaneously, makes the GSEs a more attractive and more stable investment to equity investors.

FHFA's mission of safety and soundness would already be achieved with required capital of 2.5%. Increasing this to 4.0% has little incremental benefit and would leave the GSEs unable to satisfy either or both objectives of keeping mortgage costs affordable for middle-class families and delivering an attractive investment proposition for a private capital raise. We believe the minimum return on equity ("ROE") that investors in the GSEs will require is at least 10%. In order to achieve this minimum return threshold at 4.0% capital, we believe that guarantee fees would need to increase approximately 15 basis points, or 25%, from current levels. While 15

(1) Data is based on actual credit losses incurred and excludes provisions of $92 billion that were subsequently reversed.

basis points may seem like a modest increase, this would cost every prospective American homebuyer nearly $8,500 more in interest, on average, over the life of his or her mortgage. If required capital is left at 2.5%, we believe there is room for a modest reduction in guarantee fees, or average savings of over $2,000 for a new home purchaser, as shown in the table below.

Illustrative Guarantee Fees on New MBS at Various Capital Levels: Fannie Mae(2)

		10% Long-Term Target ROE	
	Current	**4.0% Capital**	**2.5% Capital**
Guarantee Fee (G-Fee, bps)	**56.7**	**71.0**	**53.2**
vs. Current	**-**	***14.3***	***(3.5)***
Less:			
Normalized Credit Losses (bps)	(10.0)	(10.0)	(10.0)
TCCA Fee - Expires 2022 (bps)	(10.0)	0.0	0.0
Illustrative PSPA Commitment Fee (bps)	0.0	(1.8)	(1.8)
Administrative & Other Expenses, net (bps)	(12.3)	(12.3)	(12.3)
Pretax Income before Capital (bps)	**24.4**	**46.9**	**29.1**
Plus: Interest Income on Capital at 1.0% (bps)	0.0	4.0	2.5
Less: Income Taxes at 21.0% (bps)	(5.1)	(10.7)	(6.6)
Net Income on New MBS (bps)	**19.3**	**40.2**	**24.9**
Required Capital Held (bps)	n/a	400.0	250.0
Return on Equity for New MBS	**n/a**	**10.0%**	**10.0%**
Impact to Homeowners			
Average Sales Price of U.S. House (Q2'20)	$368,700	$368,700	$368,700
G-Fees Paid over Life of 30-Year FRM	$32,333	$40,768	$30,286
Cost Increase / (Savings) vs. Current	**-**	**$8,435**	**($2,047)**

Even if guarantee fees are raised to meet investor return thresholds, we do not believe that it is possible to raise the required private capital within a desirable timeframe. In order for Fannie and Freddie to reach 4.0% capital by the end of Director Calabria's term in early 2024, we believe they would need to raise approximately $140 billion of fresh private capital. This assumes the GSEs retain all earnings during this timeframe, and that they receive full credit for the $25 billion of excess dividends that have been paid on Treasury's Senior Preferred Stock over and above the originally bargained-for 10% annualized return.

We believe a $140 billion public offering would be impossible to achieve, as this would be nearly six times as large as the largest U.S.-listed IPO ever completed, Alibaba, and would also be $20 billion greater than the combined value of the ten largest U.S.-listed IPOs of all time.(3) A capital ratio of 2.5%, by contrast, would require a combined public offering of approximately $50 billion, which we believe is still challenging but achievable *if the investment proposition is attractive*.

(2) Current G-Fee as of the second quarter of 2020 as per Fannie Mae earnings release. Normalized credit losses and administrative & other expenses as per Pershing Square estimates. Illustrative PSPA commitment fee assumes a 25-basis point annual payment to Treasury on total PSPA drawn and undrawn funding capacity of $234 billion in exchange for this backstop staying in place in lieu of an explicit MBS-level guarantee. Average sales price of U.S. house as of the second quarter of 2020 as per Federal Reserve Bank of St. Louis.

(3) Includes Alibaba, Visa, General Motors, Facebook, AT&T, Kraft Foods, Uber, UPS, CIT, and Blackstone.

GSE Capital Framework and Claims Paying Resources

It appears to us, as other commentators have noted, that FHFA arrived at a capital ratio of 4.0% by requiring the GSEs to hold the same amount of capital as banks. We believe this is unnecessaary and ultimately counter-productive if the goals here are to stabilize the GSEs, attract substantial first-loss private capital, and preserve affordable 30-year, fixed rate, prepayable mortgages. The GSEs' core single-family guarantee business is fundamentally safer, simpler, and more predictable than commercial banks holding single-family mortgages on balance sheet.

Given that Fannie and Freddie fund their credit guarantee business by issuing fixed-rate MBS, they bear none of the interest rate risk and liquidity risk present in commercial banks, which fund portfolio mortgages with floating-rate deposits that can be withdrawn at any time. The GSEs' single-family guarantee business bears only credit risk, and at a significantly lower level than commercial banks, which issue riskier jumbo and alternative mortgage products, and also do not offload any credit risk through CRT. The GSEs' guarantee business should have a significantly lower capital ratio than banks to reflect the lower risks incurred.

The credit guarantee business of the GSEs has been successfully transformed under FHFA's supervision since the Global Financial Crisis, and today is most analogous to a monoline insurance company. Consistent with an insurance capital framework, we believe that future contractual guarantee fees, while not part of core capital, must be considered when evaluating balance sheet strength. The total claims-paying ability of the Enterprises, which we refer to as Claims Paying Resources, is derived from equity capital plus the tens of billions of dollars of recurring cash flows that the GSEs will collect on their existing book of business, as well as the Enterprises' ability to write new business at higher market shares and credit quality during and after a crisis or downturn.

Although it is a stated objective of the Re-Proposed Rule to not count future Enterprise revenue as capital, we believe it is imprudent, when thinking about whether the GSEs will be able to continue operating as going concerns in a crisis and when setting the GSEs' capital ratios, to ignore the future revenue that Fannie and Freddie will earn – revenue that is contractually-committed for decades into the future. Fannie and Freddie's combined single-family guarantee portfolio generated net guarantee fees(4) of $20.8 billion in 2019, nearly five times the administrative costs incurred to operate this business. This income stream should continue to grow at a mid-single-digit rate over the medium-term as guarantee fees on newly-issued MBS are higher than those on older MBS, and as the size of their guarantee portfolios increases along with the total amount of residential mortgage debt outstanding. The Enterprises are contractually entitled to collect this guarantee fee revenue on their existing book of business until the underlying mortgages are fully repaid. We estimate that future revenues from the existing book are worth approximately $70-$100 billion on a present-value basis, equating to ~170 basis points of the existing single-family guarantee portfolio at the midpoint.(5)

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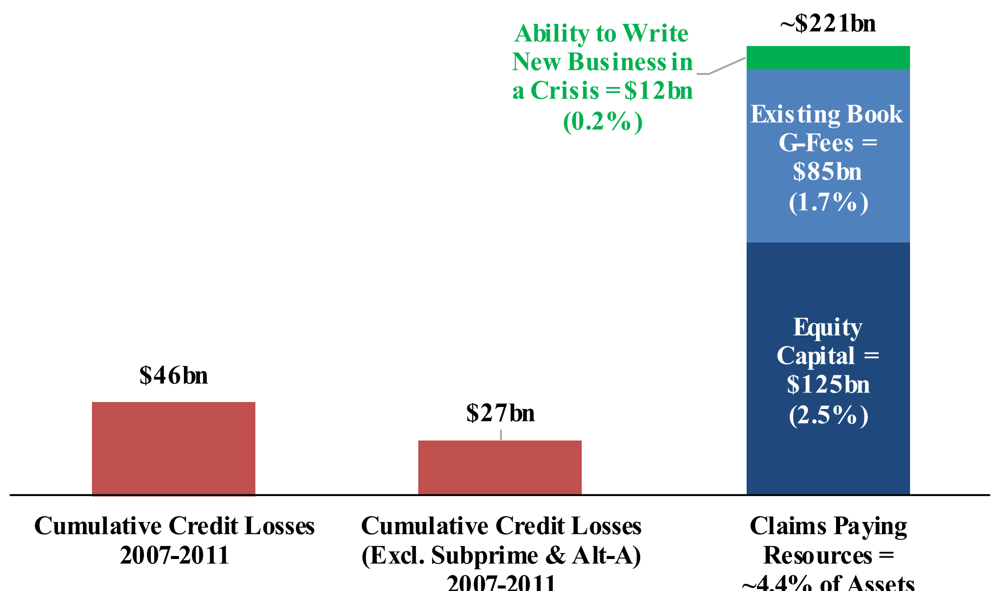
(4) Net of the 10 basis point pass-through guarantee fees remitted to Treasury under the Temporary Payroll Tax Cut Continuation Act of 2011.
(5) Based on a combined single-family guarantee portfolio of $5.0 trillion, net guarantee fees equal to the 2019 averages for each Enterprise, a discount rate equal to current MBS yields, and average portfolio turnover between 11%-17%.

While credit quality of the existing book of business often worsens during a crisis, this is partially offset by greater volumes and superior returns on new business. Typical dynamics during and after a housing crisis include falling home prices and interest rates, tighter underwriting standards, and higher market shares for Fannie and Freddie. During the Global Financial Crisis, Fannie and Freddie were a critical source of funding for the housing market as other institutions reduced their roles or exited the market, with the combined share of residential mortgage originations held or guaranteed by the Enterprises increasing from 27% in 2006 to 70% in 2009. Their market shares increased during the years when credit quality was highest – Fannie's cumulative default rate for conventional single-family loans guaranteed in 2006 is over 13.5%, while the cumulative default rate for the 2009 vintage is less than 1%.

A similar dynamic has started to unfold with the onset of the COVID-19 crisis, with Fannie and Freddie again supporting the market as others have pulled back. Growth in Fannie's single-family guarantee portfolio accelerated to 7% in the second quarter of 2020 from average annual growth of 1% over the preceding three years, while Freddie's growth accelerated to 7% from 4%. Much like a well-capitalized insurance company that can weather a hundred-year storm, a crisis typically causes losses on existing holdings for Fannie and Freddie, but provides them with bountiful amounts of new business at higher levels of profitability. While difficult to quantify precisely, we estimate that this unique ability to write new business during a crisis enhances the Claims Paying Resources of the Enterprises by approximately $12 billion, or 20 basis points of the existing single-family guarantee portfolio.[6]

Claims Paying Resources: Single-Family Guarantee Business



Multiple of Global Financial Crisis Losses		
Equity Capital	2.7x	4.6x
Claims Paying Resources	**4.8x**	**8.2x**

[6] Assumes a 23% increase in the size of the combined single-family guarantee portfolio due to market share gains, similar to what occurred during the Global Financial Crisis, net guarantee fees of 50 basis points, average portfolio turnover of 14%, and a discount rate of 7%.

When accounting for all components of Claims Paying Resources, the Enterprises, assuming they adopt an equity capital ratio of 2.5%, would have capital and future revenues worth over $220 billion, or 4.4% of assets and guarantees, to meet claims and continue operating during a downturn. This equates to over *eight times* the losses that the Enterprises incurred in their single-family guarantee business during the Global Financial Crisis, excluding subprime and Alt-A loans. We believe this level of capital and Claims Paying Resources would create a bulletproof balance sheet to withstand the stresses of any economic environment, while also keeping mortgages affordable and satisfying investor return thresholds for a capital raise.

Necessary Conditions to Raise Capital

If new capital is to be raised, in addition to adequate return thresholds, private market investors will require and must have visibility into the long-term earnings power of Fannie and Freddie so that they can reasonably estimate the valuation of each Enterprise. This visibility decreases as complexity increases around key assumptions such as required capital levels, making the feasibility and cost of a recapitalization more challenging. To that end, we recommend that required capital ratios be fixed rather than dynamic, and we would advocate abandoning the RBC framework entirely, requiring the Enterprises to solely meet a fixed required capital level of 2.5%.

We do not believe that investors will be able to estimate long-term earnings power under the RBC framework, as the dynamic nature of the RBC calculation makes future required capital levels impossible to predict. Even with the improvements from the 2018 Proposal, the RBC is still somewhat pro-cyclical, which would likely preclude any future capital raise due to investor fears of a highly dilutive equity issuance during a downturn. With uncertainty about how RBC might function under a stressed financial market, investors must assume they face material risks in case the GSEs are compelled to seek substantial additional capital at a time of market dislocation. For investors to be comfortable participating in a recapitalization now, they need to be provided transparency and reassurance at the outset that they can predict the GSEs' capital requirements.

Finally, in order for the Enterprises to successfully raise tens of billions of dollars of new private capital, we believe that legacy investors in Fannie and Freddie must be treated fairly. No new investor will invest in Fannie and Freddie unless historic investors are protected from, and compensated for, the expropriation of profits from the two companies that took place with the Net Worth Sweep that has extracted more than $246 billion of profits from the Enterprises since it took effect on January 1, 2013. This amount represents a return to Treasury greater than the bargained-for 10% interest rate on its Senior Preferred Stock investment, including complete repayment of the $191 billion invested by Treasury in the Enterprises.[7]

Wall Street's memory of injecting tens of billions of dollars into Fannie and Freddie just prior to their conservatorship ($24.6 billion of new junior preferred and common equity capital was raised in 2007 and 2008), and the expropriation of both companies' profits forever, just as they

[7] Includes $187 billion invested prior to the Net Worth Sweep and $4 billion invested in December 2017 in conjunction with corporate tax reform.

began to turn profitable, is still fresh. Completing the largest capital raise in history in a newly restructured Fannie and Freddie will not be achievable unless and until investors in the companies are treated fairly and receive commitments that the extra-legal action of the past will be reversed and not recur. This is particularly true as there is likely to be considerable overlap between the current and historic shareholder base of the Enterprises and the group of institutions that is willing and able to invest in a new capital raise.

We would welcome the opportunity to address any questions you may have about our thoughts above.

Sincerely,

William A. Ackman