DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220
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INFORMATION MEMORANDUM FOR SECRETARY GEITHNER

FROM: Mary John Miller, Assistant Secretary for Financial Markets

SUBJECT: Potential GSE Restructuring and Transition Options

Over the coming year, the Administration will face a number of key decisions with respect to the operational and financial challenges of Fannie Mae and Freddie Mac (the GSEs). The GSEs have been under the conservatorship of the Federal Housing Finance Agency (FHFA) for over three years. Given the challenges associated with conservatorship, a range of stakeholders are calling for a transition plan and more comprehensive reform. Moreover, at the end of 2012, the funding caps under the Senior Preferred Stock Purchase Agreements (PSPAs) will be permanently fixed based on the 9/30/12 financial results of the GSEs. After this date, the Administration's ability to restructure the GSEs may be more constrained.

As such, the Administration will need to consider how best to (i) ensure that the GSEs continue to be able to meet current and legacy obligations after the funding caps are fixed at the end of 2012; (ii) establish a more robust plan to end conservatorship of the GSEs and start the process of transition to a mortgage finance system more reliant on private capital, and (iii) manage and resolve the pool of troubled legacy assets on the GSEs' balance sheets.

To address these challenges, this memo presents policy options, which taken together could serve as the basis of a comprehensive non-legislative Administration reform proposal. These options are described in detail below.

Policy Option 1 – Restructure the calculation of Treasury's dividend payments from a fixed 10 percent annual rate to a variable payment based on available positive net worth (i.e. establish an income sweep). This will ensure that remaining PSPA funding capacity is not reduced in the future by draws to pay dividends.

Policy Option 2 – Develop a plan with FHFA to transition the GSEs from their current business model of direct guarantor to a model more aligned with our longer term vision of housing finance. Additional covenants should also be added to the PSPA funding agreements that require the GSEs to take certain specific transition steps, including guarantee price increases and credit risk syndication, over the next five to seven years.

Policy Option 3 – Transfer NPLs and legacy assets to a special purpose vehicle or joint venture (i.e., creation of a "bad bank") at fair market value (FMV) to accelerate the wind down of those legacy assets and recognize a portion of the GAAP / FMV differences. The size of this transfer could be scaled up or down depending on the objectives of the transfer. Today, a transfer of all non-performing loans at fair market value could result in as much as a $62 billion PSPA draw.[1]

If structured appropriately, this combined effort could help accomplish several key objectives:

1) *Address capital adequacy issues* – restructuring the dividend payments and recognizing some portion of the unreserved FMV/GAAP differences prior to 2012 when remaining funding capacity will be limited to $275 billion in aggregate would help reduce concerns about Treasury's ability to support the capital position of the GSEs.

2) *Wind down the GSEs* – Establishing a clear transition plan and addressing legacy troubled assets would reduce the amount of new direct credit risk the GSEs can assume going forward, provide a series of specific, contractual transition steps that can give the financial markets increased clarity and clearly indicate to the taxpayers that the GSEs will be wound down.

3) *Reduce operational risks and increase efficiency* – moving legacy assets into the private market reduces the level of reliance on the operational expertise of the GSEs and concentration of risk. This is particularly salient as the GSEs could face future challenges retaining the human capital needed to manage these assets.

4) *Support the housing market recovery* – Recognizing a portion of losses upfront or putting troubled loans in the hands of private investors can incentivize and accelerate (i) loan modifications, (ii) principal reduction, and (iii) healthy transitions (through short sales, foreclosures, NPL/REO sales, etc) as well as provide the GSEs with greater flexibility in their own approach to loss mitigation management.

This memo evaluates the proposed alternatives based on accounting, corporate finance, financial market and economic considerations. Of course, these policy options would also need to be evaluated from a sequencing, messaging and congressional affairs perspective, which this memo does not specifically address. All actions would require FHFA agreement and approval.[2]

We present the potential policy actions in detail below after a brief review of the current status of the GSE capital position, projections and expected need for further Treasury support. Appendix A also presents additional non-legislative and legislative options which could be considered. (take out appendix?)

<u>Current Projections and GSE Capital Imbalances</u>

As amended on December 24, 2009, the cap on Treasury's financial commitment under the PSPAs equals the greater of $200 billion or $200 billion plus the cumulative net worth deficits experienced during 2010, 2011, and 2012, less any surplus remaining as of December 31, 2012.

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[1] While the funds would originate from existing PSPA authority, the capital would be drawn from Treasury borrowings and would therefore count against the federal debt ceiling.

[2] FHFA agreement and approval is required because the PSPA agreements were signed between Treasury and the GSEs with FHFA acting as the GSEs duly appointed conservator.

Since 2008, Fannie Mae and Freddie Mac have made total gross draws of $111.6 billion and $71.2 billion (Total aggregate gross draws of $182.8 billion). Once accounting for dividends paid back to Treasury, the net draws are $94.4 billion and $56.3 billion, respectively (for a total aggregate net draw of $150.7 billion). Under FHFA's base case stress test forecast, by 2012, total gross draws are expected to reach more than $210 billion in aggregate ($135.0 billion at Fannie Mae and $75.8 billion at Freddie Mac).

At the end of 2012, Treasury's aggregate funding capacity will be capped at $275 billion ($150 billion at Freddie Mac and $125 billion at Fannie Mae).[3] [footnote the math behind this] We anticipate the market will closely evaluate the amount of expected losses still to come and level of dividend payments necessary at the GSEs in relation to the level of available funding that remains.

Minimizing additional draws after 2012 will be important to maintain investor confidence in the sufficiency of US Government support. The expected level of preferred stock outstanding at the end of 2012 is projected to require annual dividends of $11.8 billion and $7.3 billion for Fannie Mae and Freddie Mac, respectively. While Freddie is expected to be net income positive by the end of 2012 and Fannie by the end of 2013, both institutions will struggle to make sufficient income to pay the 10% required dividend over time. This is the result of the high nominal dividends required on a year basis after 2012 and the likely reduction in income at the GSEs over time. The reduced income in the GSE will be driven primarily in the reduction in the size of their investment portfolios which need to be reduce to $250B respectively over the course of the next [eight years].

While the amount of income from the guarantee businesses are projected to increase in size as loan losses decline and fee increases are implemented, it will ultimately be insufficient to cover the lost portfolio investment income and the required dividends under the current projections.

Note: For the purposes of this memo and the analysis presented throughout, the financial models shown assume a 10 basis point guarantee fee increase is made in 2013, which is consistent with calls from the President and Acting Director DeMarco. Additional increases in the guarantee fees would increase the amount of net income that could potentially be generated. To the degree the GSEs could sell first loss credit risk to the market, this guarantee fee income would be offset by a reduction in the portfolios' risk profile and thus, profit of the GSEs. That interplay was not considered for the purpose of this analysis.

The table at the top of the next page shows the expected net income under the FHFA base case forecasts, required dividends (assuming a 10 percent dividend rate on outstanding senior preferred stock) and forecasted gross and net draws from 2012 through 2023.

[3] Math behind the statement….

Projected Net Comprehensive Income (Loss)

$ in billions	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
Base Case Net Income (Loss)												
Fannie Mae	($13.1)	$5.4	$13.1	$13.5	$9.1	$8.5	$8.0	$7.9	$8.5	$8.4	$8.1	$8.0
Freddie Mac	$6.7	$9.5	$10.6	$6.0	$5.5	$5.5	$5.6	$5.3	$5.5	$5.4	$5.4	$5.4
Total	**($6.4)**	**$14.9**	**$23.7**	**$19.5**	**$14.6**	**$14.0**	**$13.7**	**$13.2**	**$14.0**	**$13.8**	**$13.5**	**$13.4**
Stressed Case Net Income (Loss)												
Fannie Mae	($49.0)	($8.8)	$12.9	$18.6	$9.3	$8.7	$8.2	$8.0	$8.7	$8.5	$8.2	$8.1
Freddie Mac	($7.8)	$6.6	$8.9	$6.1	$5.6	$5.6	$5.7	$5.4	$5.5	$5.4	$5.4	$5.4
Total	**($56.8)**	**($2.2)**	**$21.8**	**$24.7**	**$14.9**	**$14.2**	**$13.9**	**$13.4**	**$14.1**	**$14.0**	**$13.6**	**$13.4**
Inc. (Dec.) from Base Case	*($50.4)*	*($17.1)*	*($1.9)*	*$5.2*	*$0.3*	*$0.2*	*$0.2*	*$0.2*	*$0.1*	*$0.1*	*$0.1*	*$0.1*

Projected Dividend Draws (Repayment)

$ in billions	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
Base Case Fannie Mae:												
Gross Draw	$28.7	$11.4	$2.9	$1.2	$7.0	$7.1	$8.2	$9.4	$9.8	$10.7	$12.1	$13.5
Dividend	($11.8)	($14.0)	($14.8)	($15.0)	($15.2)	($15.9)	($16.6)	($17.5)	($18.4)	($19.4)	($20.6)	($21.8)
Net Draw	$16.9	($2.6)	($11.9)	($13.8)	($8.2)	($8.8)	($8.4)	($8.1)	($8.6)	($8.7)	($8.5)	($8.3)
Stressed Case Fannie Mae:												
Gross Draw	$58.1	$34.3	$11.3	$4.5	$18.6	$14.5	$16.5	$18.4	$19.9	$8.7	$0.0	$0.0
Dividend	($12.9)	($18.6)	($21.1)	($21.9)	($22.2)	($23.7)	($25.2)	($26.9)	($28.8)	($30.7)	($31.0)	($31.0)
Net Draw	$45.2	$15.7	($9.8)	($17.4)	($3.6)	($9.2)	($8.7)	($8.5)	($8.9)	($22.0)	($31.0)	($31.0)
Inc. (Dec.) from Base Case	*$28.3*	*$18.3*	*$2.1*	*($3.6)*	*$4.6*	*($0.4)*	*($0.3)*	*($0.5)*	*($0.3)*	*($13.2)*	*($22.5)*	*($22.6)*
Base Case Freddie Mac:												
Gross Draw	$10.5	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$1.5	$2.5	$2.6	$3.0	$3.3
Dividend	($7.3)	($7.7)	($7.7)	($7.7)	($7.7)	($7.7)	($7.7)	($7.7)	($7.9)	($8.2)	($8.4)	($8.7)
Net Draw	$3.2	($7.7)	($7.7)	($7.7)	($7.7)	($7.7)	($7.7)	($6.2)	($5.4)	($5.6)	($5.4)	($5.4)
Stressed Case Freddie Mac:												
Gross Draw	$20.7	$2.3	$0.5	$2.7	$3.6	$4.0	$4.4	$5.1	$5.5	$6.2	$6.8	$7.5
Dividend	($7.6)	($8.8)	($9.0)	($9.1)	($9.4)	($9.7)	($10.2)	($10.6)	($11.2)	($11.7)	($12.4)	($13.1)
Net Draw	$13.1	($6.5)	($8.4)	($6.4)	($5.8)	($5.7)	($5.8)	($5.5)	($5.7)	($5.5)	($5.6)	($5.6)
Inc. (Dec.) from Base Case	*$10.0*	*$1.2*	*($0.8)*	*$1.3*	*$1.9*	*$1.9*	*$1.9*	*$0.7*	*($0.2)*	*$0.0*	*($0.1)*	*($0.1)*
Base Case Combined:												
Gross Draw	$39.2	$11.4	$2.9	$1.2	$7.0	$7.1	$8.2	$10.9	$12.3	$13.3	$15.1	$16.8
Dividend	($19.1)	($21.7)	($22.5)	($22.6)	($22.9)	($23.5)	($24.3)	($25.2)	($26.3)	($27.6)	($29.0)	($30.6)
Net Draw	$20.1	($10.3)	($19.6)	($21.4)	($15.9)	($16.4)	($16.1)	($14.3)	($14.0)	($14.3)	($13.9)	($13.8)
Stressed Case Combined:												
Gross Draw	$78.8	$36.6	$11.8	$7.2	$22.2	$18.5	$20.9	$23.5	$25.4	$14.9	$6.8	$7.5
Dividend	($20.5)	($27.4)	($30.1)	($30.9)	($31.6)	($33.4)	($35.4)	($37.6)	($40.0)	($42.4)	($43.3)	($44.0)
Net Draw	$58.4	$9.2	($18.2)	($23.7)	($9.4)	($14.9)	($14.5)	($14.1)	($14.6)	($27.5)	($36.5)	($36.5)
Inc. (Dec.) from Base Case	*$38.3*	*$19.5*	*$1.4*	*($2.3)*	*$6.5*	*$1.5*	*$1.6*	*$0.2*	*($0.6)*	*($13.2)*	*($22.6)*	*($22.8)*
Cum. Base Case Gross PSPA Draw	$210.8	$222.2	$225.1	$226.3	$233.3	$240.4	$248.6	$259.5	$271.8	$285.1	$300.2	$317.0
Cum. Stress Case Gross PSPA Draw	$250.4	$287.0	$298.8	$306.0	$328.2	$346.7	$367.6	$391.1	$416.5	$431.4	$438.2	$445.7
Inc. (Dec.) from Base Case	*$39.6*	*$64.8*	*$73.8*	*$79.8*	*$95.0*	*$106.4*	*$119.1*	*$131.7*	*$144.8*	*$146.4*	*$138.1*	*$128.8*
Cum. Base Case Net PSPA Draw[1]	$159.6	$149.3	$129.7	$108.3	$92.4	$76.0	$59.9	$45.7	$31.6	$17.3	$3.4	($10.4)
Cum. Stress Case Net PSPA Draw[1]	$197.9	$207.1	$188.8	$165.1	$155.7	$140.8	$126.3	$112.2	$97.6	$70.2	$33.6	($2.9)
Inc. (Dec.) from Base Case	*$38.3*	*$57.7*	*$59.1*	*$56.8*	*$63.3*	*$64.8*	*$66.4*	*$66.6*	*$66.0*	*$52.8*	*$30.2*	*$7.4*
Base Case PSPA Capacity Left	$275.0	$263.6	$260.7	$259.5	$252.5	$245.4	$237.2	$226.3	$214.0	$200.7	$185.6	$168.8
Stress Case PSPA Capacity Left	$275.0	$238.4	$226.6	$219.4	$197.2	$178.7	$157.8	$134.3	$108.9	$94.0	$87.2	$79.7
Inc. (Dec.) from Base Case	*$0.0*	*($25.2)*	*($34.1)*	*($40.1)*	*($55.3)*	*($66.7)*	*($79.4)*	*($92.0)*	*($105.1)*	*($106.7)*	*($98.4)*	*($89.1)*

[1] Accounts for cumulative dividends paid back to U.S. Treasury.
Source: Grant Thorton, U.S. Department of the Treasury

As shown in the combined gross draw line above, the GSEs continue to draw upon the PSPAs throughout the forecast period to pay required dividends to Treasury. Consequently, once the caps are fixed in 2012, the collective PSPA capacity is forecasted to decrease by over $100 billion within the next ten years.

The table above also illustrates a stressed scenario where near term deficiencies are significantly higher than forecasted in the base case. Under the stressed scenario, $195 billion of PSPA capacity is utilized, leaving the GSEs with only $80 billion of remaining capacity. This downside scenario emphasizes the need for reform.

While the GSEs are expected to become net income positive after 2013, net income will still be reduced by the continued realization of losses from the legacy assets on the GSEs books. The current GAAP book values of mortgage loans, securities and REO on the GSEs balance sheets are $182 billion higher than fair market values. This difference includes a component of model forecasted losses (approximately $67 billion) for both performing and non-performing loans that are not yet reserved due to GAAP accrual standards (see Appendix D).

Detailed Description of Policy Options for Consideration

Policy Option 1: Restructure the PSPA agreements to a variable dividend payment

Concept: Subject to the consultation described below, Treasury could restructure the PSPA agreements to replace the current 10 percent fixed dividend with a permanent "net worth sweep." Going forward, all positive net worth would be paid as a dividend to Treasury.

Key Benefits / Risks: This would (i) apply all future net income/profits as reimbursement to taxpayers; (ii) underscore the government will not recapitalize the GSEs in their current form; and (iii) eliminate the need for the GSEs to make gross draws to pay dividends to Treasury, thereby retaining the maximum amount of PSPA funding and thus, Treasury's flexibility to available to offset future operating losses.

Since both Fannie Mae and Freddie Mac are expected to be net income positive (before dividends) on a stable, ongoing basis after 2012, this change would prevent Treasury from incurring additional future draws unless there was either (i) an unexpected downturn in the housing market, or (ii) there was a significant restructuring of the balance sheets of Fannie Mae or Freddie Mac, such as a NPL sale program or separation of assets into a good bank/bad bank structure or receivership (discussed further below).

Path to Execution: This change is relatively straightforward and could be completed by amending the PSPAs and resetting the Periodic Commitment Fee (PCF) to establish a net worth sweep. The PCF was part of the original PSPA, however, Treasury has elected to waive setting the fee since the PSPAs were established. Under the terms of the PSPAs, the PCF must be set by agreement with FHFA serving as conservator of the GSEs and in consultation with the Fed.

Restructuring the dividend payment calculation would require consultation and agreement with the following three entities (i) FHFA, per the agreements currently in place, (ii) the Federal Reserve, with respect to establishing the PCF, and (iii) the Department of Justice (DOJ), because there is a general prohibition on waiving vested contract rights to receive funds owed to the government, so giving up the right to certain amount of money (fixed dividends) for an uncertain amount (a dividend sweep) may require DOJ approval. More work must be done with the DOJ to determine the feasibility of this option.

Costs / Capital Adequacy Considerations: The table at the top of the next page shows the combined impact on draws and dividends paid to Treasury when the dividend payments are converted to a cash flow sweep. The analysis is shown under a base case scenario and a stressed scenario where the losses in 2012 are significantly higher. As shown in the table, the net income before preferred dividends would remain the same under this scenario. Modifying the dividend payment to a cash flow sweep would enable the GSEs to retain the full $275 billion PSPA capacity as it would eliminate any potential gross draws required to fund dividend payments to Treasury.

Base case with 10% dividend versus positive net worth sweep

	Base Case				Stress Case			
	Current 9/30/2011	FY2012	FY2017	FY2022	Current 9/30/2011	FY2012	FY2017	FY2022
Cumulative Gross Draw under 10% dividend	$172	$211	$240	$300	$172	$250	$347	$438
Cumulative Gross Draw under net worth sweep	$172	$211	$211	$211	$172	$250	$266	$266
Increase (Decrease)	***$0***	***$0***	***($30)***	***($89)***	***$0***	***$0***	***($81)***	***($172)***
Cumulative Net Draw under 10% dividend	$140	$160	$76	$3	$140	$198	$141	$34
Cumulative Net Draw under net worth sweep	$140	$160	$76	$3	$140	$198	$141	$34
Increase (Decrease)	***$0***	***$0***	***$0***	***$0***	***$0***	***$0***	***$0***	***$0***
Remaining PSPA Capacity under 10% dividend	$275	$275	$245	$186	$275	$275	$179	$87
Remaining PSPA Capacity under net worth sweep	$275	$275	$275	$275	$275	$275	$259	$259
Increase (Decrease)	***$0***	***$0***	***$30***	***$89***	***$0***	***$0***	***$81***	***$172***

Similar to the base case scenario, Treasury's realized net cash proceeds remain the same and the taxpayer's investment is still repaid by 2023 (on a net draw basis); however, the PSPA funding capacity is not reduced through gross draws incurred to pay dividends.

Policy Option 2: Increase the contractual obligations under the PSPAs to facilitate wind down and accelerate transition to a more private mortgage market

Concept: Amend the PSPAs to add additional contractual obligations for the GSEs and FHFA associated with transition. These would include:

- *Guarantee fee price increases* – pricing for direct GSE guarantees could be increased by a minimum of five to ten basis points per annum (or at a pace determined annually by FHFA and Treasury) until pricing reaches levels that are consistent with those charged by private financial institutions with Basel III capital standards and a specified return on capital. This provision is similar in concept to a bill Representative Neugebauer (HR 1222) introduced in March 2011. This process could also be required to take place within a five-to-seven year period, with guarantee fees gradually approaching 60 to 80 basis points, depending on the profile of the mortgage. The phasing of such increases should also take into account the current housing market.

- *Risk syndication* – Consistent with the phase-in period of guarantee fee increases, the GSEs could be required to sell a first-loss position (or the majority of the credit risk) to the private market on all of their new guarantee book business within a five- or seven-year time period. It is important to note that risk syndication would likely reduce the earnings capacity of the GSEs (similar to how the winding down of the retained portfolios also limits income generation). This further highlights the importance of modifying the PSPAs, as described in policy option 1, and potentially recognizing some level of legacy asset losses, as described in policy option 3, so transition actions such as the ones described in this option are less constrained.

- *Single TBA delivery* – Require the GSEs to align payment standards and issuance processes to establish a fungible TBA market for common delivery of Fannie Mae and Freddie Mac securities. This step would increase the overall liquidity of the TBA market, increase the amount of interchangeable securities in the market and reduce overall rates for borrowers.

- *Additional transition requirements* – additional requirements could also be considered, such as down payment levels, faster retained portfolio wind down (particularly for further growth in NPLs), etc.

Key Benefits / Risks: The policy options above would help facilitate wind down and transition of the GSEs. They will help facilitate a return of private capital to the mortgage market as the policies will help create a clearer and more quantifiable framework to evaluate "mortgage" capital allocation decisions.

Path to execution: Treasury has certain protections and approval rights under the PSPAs with respect to transition and organizational changes to the GSEs. While these are not affirmative rights, Treasury could pre-approve a broad transition plan that would be executed by FHFA. More legal analysis and work with FHFA would be required. In any and all circumstances, the steps outlined above would require FHFA approval and consent as conservator. **(Jeff to redo paragraph).**

Policy Option 3: Initiate an NPL disposition program and transfer legacy assets to a special purpose vehicle (SPV) or joint venture (JV) that manages loss mitigation activities

Concept: Have Fannie Mae and Freddie Mac form a joint venture to manage and streamline loss mitigation activities . Under this proposal, Fannie Mae and Freddie Mac would remain under the conservatorship of FHFA but jointly contribute NPLs and REO into a new special purpose vehicle or joint venture co-owned by the GSEs. In return, the Enterprises would receive a pro-rata share of the SPV/JV's equity.

The SPV would be responsible for all loss mitigation activities of the contributed assets and would be able to partner with private market participants to help reduce the operational and financial risks. The SPV would also be responsible for managing a REO and NPL disposition program to move legacy assets back to the private market via bulk sales and partner transactions (similar to the approach FHFA in consultation with Treasury is taking with the "REO to Rental" program). To avoid adverse effects in the broader housing market, the GSEs could also include certain covenants/restrictions in the sales documents that would restrict the usage of REO property sales for a period of time.

Key Benefits / Risks: This is a form of a "good bank/bad bank" strategy that would allow the GSEs to structurally partner with private market participants and separate their legacy assets from their post conservatorship business in a way that generates greater stability and maximizes operational expertise. It would also be an additional measure the Administration could point to in 2012 to show that the GSEs are being wound down.

Path to execution: The Enterprises would need to set up the SPV/JV structure because the Government Corporation Control Act prohibits Treasury from forming SPVs. Lawyers at the GSEs and FHFA would need to determine the legal basis under their respective charters that would authorize them to establish SPVs. An exercise of such authority would most likely require FHFA approval and direction, as conservator.[4]

Other potential solutions include creating a new Resolution Corporation (ResCo) owned or controlled by FHFA and Treasury (Appendix A discusses this option in more detail) or having the GSEs retain the troubled legacy assets, but having these assets marked to market and internally separated such as to create a "bad bank subsidiary". As with policy option 3, a ResCo would fully move troubled legacy assets off the GSEs' balance sheets. However, a ResCo approach would require congressional approval because of the Government Corporation Control Act. (The Government Corporation Control Act prohibits an agency from establishing or acquiring a corporation to act as an agent except when specifically authorized to do so by law.[5] If transferring assets off balance sheet is too operationally and legally complex to complete in the near term, the GSEs could take a less aggressive approach by transferring assets to a wholly owned resolution subsidiary and reclassifying NPLs from "held for investment" to "held for sale." This strategy would result in the assets being marked to market and could potentially ease operational and accounting barriers to a more accelerated disposition of troubled assets.

Regardless of whether the GSEs or FHFA create the entity, Treasury would recommend staffing and coordinating the effort with employees from the GSEs, FHFA, FDIC and Treasury. Fannie Mae would likely manage the venture's core operations given the size of its operations and percentage ownership of REO that would be contributed to the SPV/JV.

Costs / Capital Adequacy Considerations: The GSEs currently classify nearly all of their NPLs

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[4] GSE charter limitations, and the FHFA mandate of conservatorship, may also require that the legacy entities remain in place. Under their charter acts, Fannie Mae and Freddie Mac continue to exist and may only be dissolved by an act of Congress (12 USC 1717(a)(2)(B)). Even if FHFA places both GSEs into receivership, FHFA is prohibited by law from terminating the charters, and the limited-life regulated entities succeed to the charters by operation of law. There is also an implication in the wording of the receivership provisions of the law that FHFA may not establish one limited-life regulated entity for both GSEs, but only FHFA's interpretation of the wording of that statutory provision would be dispositive. Consequently, combining the assets from both GSEs into an SPV/JV and leaving the chartered GSEs behind could be viewed as a violation of the charter acts. More work with FHFA and the GSEs would be required to determine the feasibility of this option.

[5] Unlike the Emergency Economic Stabilization Act, which provided Treasury with such authority for purposes of the Troubled Asset Relief Program, the legislation that authorized the PSPAs – the Housing and Economic Recovery Act – did not provide Treasury with such authority.

as "held for investment" rather than "held for sale" on their balance sheets. Such asset sales and/or transfers would be subject to FHFA approval and, under the PSPAs, subject to Treasury approval.[6]

By contributing the NPLs to a SPV/JV and selling them at fair market value, the GSEs would be required to account for the valuation difference. If the entire portfolio of non-performing loans were contributed, for example, the GSEs may be required to draw up to $62 billion of capital in 2012. Further analysis and accounting work with FHFA and the GSEs would be required to fully analyze the impact of such a transfer and its cost. The economics of a more accelerated troubled asset disposition strategy are complex and widely debated. In summary, it is hard to evaluate the longer term economic impact associated with an accelerated restructuring and/or cleansing of troubled inventory versus continuing the current path of one off modification and/or sales. This analysis will need to be completed before any large scale program is started. If a large scale program is too challenging to move forward with in 2012, smaller transfers to a SPV/JV could be initiated at the inception of the program with further transfers made over time. Regardless of whether a small or large scale NPL/REO program is undertaken, combining this with a restructuring of the dividend as discussed in policy option 1 would help to further reduce concerns over capital adequacy due to the acceleration of losses into 2012.

Note: Based on the accounting practices currently applied and the estimated funding PSPA cycle time, GSE restructuring actions that results in a one-time funding requirement would likely need to be completed prior to 9/30/12. This will ensure any draws under the PSPAs occur prior to the establishment of the permanent funding caps. Treasury staff is currently assessing whether it is possible to account for any changes after 9/30/12 and still complete the modification before the funding levels are fixed at the end of 2012.

The table below shows the impact on draws and dividends paid to Treasury from such a change, assuming the full $62 billion is drawn. This is for illustrative purposes only and the actual amount would depend on a number of factors, including the amount of assets initially transferred and the accounting treatment for the entities, among other things. Net income at year-end 2012 would decrease relative to the base case because of the requisite charge from transferring the NPLs at fair market value; however, the GSEs would earn back roughly 70 percent of the accounting charge over time through higher net income (as only the expected loss portion of the FMV difference would be realized if the loans were held to maturity).

[6] More work is required to see whether transfers of such a substantial portion of a GSE's assets would violate any of the financial covenants in their debt indentures or charter requirements.

Base case with 10% dividend versus positive net worth sweep and NPL disposition program

	Base Case				Stress Case			
	Current 9/30/2011	**FY2012**	**FY2017**	**FY2022**	**Current 9/30/2011**	**FY2012**	**FY2017**	**FY2022**
Cumulative Gross Draw under 10% dividend	$172	$211	$240	$300	$172	$250	$347	$438
Cumulative Gross Draw under net worth sweep and NPL	$172	$260	$260	$260	$172	$300	$310	$310
Increase (Decrease)	*$0*	*$49*	*$20*	*($40)*	*$0*	*$49*	*($37)*	*($129)*
Cumulative Net Draw under 10% dividend	$140	$160	$76	$3	$140	$198	$141	$34
Cumulative Net Draw under net worth sweep and NPL	$140	$209	$100	$18	$140	$247	$165	$48
Increase (Decrease)	*$0*	*$49*	*$24*	*$15*	*$0*	*$49*	*$24*	*$15*
Remaining PSPA Capacity under 10% dividend	$275	$275	$245	$186	$275	$275	$179	$87
Remaining PSPA Capacity under net worth sweep and NPL	$275	$275	$275	$275	$275	$275	$265	$265
Increase (Decrease)	*$0*	*$0*	*$30*	*$89*	*$0*	*$0*	*$86*	*$178*

To the extent that NPLs are sold to third parties, a greater portion of the accounting charge would not be recovered. Note: there is no consideration given to the positive or negative effects on the housing market that may be realized by migrating legacy assets to the private sector or the benefits from joint ventures and other public/private partnerships.

Appendix A: Additional options which could be considered: (Jeff to slot in and delete appendix)

There are a number of other alternatives that could be considered to wind down GSEs.

Alternative 1: Pursue limited legislation to create a Resolution Corporation vehicle for legacy assets, allow Ginnie Mae (GNMA) to explicitly guarantee GSE MBS in exchange for a fee, and explicitly establish a transition path to reduce the direct credit risk exposure of the GSEs over time.

Concept: A limited legislative proposal could be pursued to support the transition of the GSEs from primary mortgage guarantors to more limited reinsurers/securitization utilities and the wind down of their legacy assets. Representatives Hensarling and Garrett and Senators Corker and Isakson have all proposed legislation which focuses on transition and wind down of the GSEs. The Administration could seek to find an interim transition solution which achieves our medium term objectives, but leaves the final end state debate open. However, it may be preferable to seek more comprehensive legislation that addresses a housing finance system end-state. In addition to generally executing on the policy options laid out above, a limited legislative proposal could include:

The creation of a new Resolution Corporation (ResCo), which would manage and resolve the troubled legacy assets of the GSEs. This entity would have explicit funding authority and be under the control of both FHFA and Treasury. This type of vehicle, similar to the Resolution Trust Corporation established by Congress to address the savings and loan crisis, would increase flexibility and effectiveness for the Government, as opposed to a SPV formed jointly by the GSEs.

Explicitly guaranteeing all GSE liabilities through a tender exchange for GNMA wrapped pools, in exchange for a fee. Despite the explicit capital support of the PSPAs, due to capital treatment of GSE liabilities under Basel III,[7] GSE mortgage backed securities (MBS) trade roughly two to three points lower than GNMA MBS. In exchange for full faith and credit wrap by GNMA, the government could charge GSE MBS investors a portion of this price difference and as a result receive a meaningful upfront value.

Alternative 2: Initiate receivership

Concept: Ask FHFA to exercise its discretion and place the Enterprises into receivership.

Benefits: If FHFA appoints itself as receiver of one or both Enterprises, then as in the case of conservatorship, FHFA immediately succeeds to all rights and powers of the Enterprise and of all the officers, directors, and stockholders of the Enterprise.[8] But unlike the case with conservatorship, the appointment of FHFA as receiver automatically *terminates* all rights and

[7] GSE MBS receive a 20 percent asset risk weighting and are currently expected to be treated as a level 2 asset under the liquidity coverage and net stable funding ratios.
[8] 12 U.S.C. § 4617(b)(2)(A).

claims that the stockholders and creditors may have against the assets or charter of the Enterprise, except for their right to payment, resolution, or other satisfaction of their claims as determined by FHFA as receiver.[9] Additionally, unlike the case with conservatorship, FHFA as receiver would be required to place the Enterprise in liquidation and proceed to realize upon the assets of the Enterprise by sale of the assets or transfer of the assets to a limited-life regulated entity established by FHFA.[10]

Considerations: First, in conservatorship the entities are treated as going concerns, and FHFA as conservator is required to preserve assets. In receivership, the entities would be in wind-down, and FHFA as receiver would be looking to sell the assets for as much money as it could. Additionally, while the definition of the deficiency amount used to calculate draws includes a paragraph about how the deficiency amount is to be calculated even when a GSE is in receivership, it is unclear whether Treasury's preferred stock would be wiped out in receivership.

[9] 12 U.S.C. § 4617(b)(2)(K).
[10] 12 U.S.C. § 4617(b)(2)(E).

Appendix B: Scenario Analysis

Stressed Base Case Scenario as described on page 4 of the memo

Stressed Base Case: Net Comprehensive Income (Loss)

$ in billions	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
Net Income (Loss)												
Fannie Mae	($49.0)	($8.8)	$12.9	$18.6	$9.3	$8.7	$8.2	$8.0	$8.7	$8.5	$8.2	$8.1
Freddie Mac	($7.8)	$6.6	$8.9	$6.1	$5.6	$5.6	$5.7	$5.4	$5.5	$5.4	$5.4	$5.4
Total	($56.8)	($2.2)	$21.8	$24.7	$14.9	$14.2	$13.9	$13.4	$14.1	$14.0	$13.6	$13.4

Stressed Base Case: Dividend Draws (Repayment)

$ in billions	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
Fannie Mae:												
Gross Draw	$58.1	$34.3	$11.3	$4.5	$18.6	$14.5	$16.5	$18.4	$19.9	$8.7	$0.0	$0.0
Dividend	($12.9)	($18.6)	($21.1)	($21.9)	($22.2)	($23.7)	($25.2)	($26.9)	($28.8)	($30.7)	($31.0)	($31.0)
Net Draw	$45.2	$15.7	($9.8)	($17.4)	($3.6)	($9.2)	($8.7)	($8.5)	($8.9)	($22.0)	($31.0)	($31.0)
Freddie Mac:												
Gross Draw	$20.7	$2.3	$0.5	$2.7	$3.6	$4.0	$4.4	$5.1	$5.5	$6.2	$6.8	$7.5
Dividend	($7.6)	($8.8)	($9.0)	($9.1)	($9.4)	($9.7)	($10.2)	($10.6)	($11.2)	($11.7)	($12.4)	($13.1)
Net Draw	$13.1	($6.5)	($8.4)	($6.4)	($5.8)	($5.7)	($5.8)	($5.5)	($5.7)	($5.5)	($5.6)	($5.6)
Combined:												
Gross Draw	$78.8	$36.6	$11.8	$7.2	$22.2	$18.5	$20.9	$23.5	$25.4	$14.9	$6.8	$7.5
Dividend	($20.5)	($27.4)	($30.1)	($30.9)	($31.6)	($33.4)	($35.4)	($37.6)	($40.0)	($42.4)	($43.3)	($44.0)
Net Draw	$58.4	$9.2	($18.2)	($23.7)	($9.4)	($14.9)	($14.5)	($14.1)	($14.6)	($27.5)	($36.5)	($36.5)
Beginning PSPA Stock	$171.6	$250.4	$287.0	$298.8	$306.0	$328.2	$346.7	$367.6	$391.1	$416.5	$431.4	$438.2
Total Gross Draw	$78.8	$36.6	$11.8	$7.2	$22.2	$18.5	$20.9	$23.5	$25.4	$14.9	$6.8	$7.5
Ending PSPA Stock	$250.4	$287.0	$298.8	$306.0	$328.2	$346.7	$367.6	$391.1	$416.5	$431.4	$438.2	$445.7
Implied Dividend Rate	*10%*	*10%*	*10%*	*10%*	*10%*	*10%*	*10%*	*10%*	*10%*	*10%*	*10%*	*10%*
Beg. Net PSPA Stock	$139.5	$197.9	$207.1	$188.8	$165.1	$155.7	$140.8	$126.3	$112.2	$97.6	$70.2	$33.6
Net Draw / Repayment	$58.4	$9.2	($18.2)	($23.7)	($9.4)	($14.9)	($14.5)	($14.1)	($14.6)	($27.5)	($36.5)	($36.5)
Cum. Net PSPA Draw	**$197.9**	**$207.1**	**$188.8**	**$165.1**	**$155.7**	**$140.8**	**$126.3**	**$112.2**	**$97.6**	**$70.2**	**$33.6**	**($2.9)**
Cum. Gross PSPA Draw	**$250.4**	**$287.0**	**$298.8**	**$306.0**	**$328.2**	**$346.7**	**$367.6**	**$391.1**	**$416.5**	**$431.4**	**$438.2**	**$445.7**
PSPA Capacity Left	**$275.0**	**$238.4**	**$226.6**	**$219.4**	**$197.2**	**$178.7**	**$157.8**	**$134.3**	**$108.9**	**$94.0**	**$87.2**	**$79.7**

Source: Grant Thorton

Appendix B: Scenario Analysis (Cont'd)

Base case forecast for change under Policy Option 1

Recommendation 1: Net comprehensive income (loss)

$ in billions	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
Combined:												
Net Income (Loss)	($6.4)	$14.9	$23.7	$19.5	$14.6	$14.0	$13.7	$13.2	$14.0	$13.8	$13.5	$13.4
NI Difference From Base Case	*$0.0*	*$0.0*	*$0.0*	*$0.0*	*$0.0*	*$0.0*	*$0.0*	*$0.0*	*$0.0*	*$0.0*	*$0.0*	*$0.0*

Recommendation 1: Restructure the PSPA agreements and move to a variable dividend payment

$ in billions	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
Combined:												
Base Case Gross Draw	*$39.2*	*$11.4*	*$2.9*	*$1.2*	*$7.0*	*$7.1*	*$8.2*	*$10.9*	*$12.3*	*$13.3*	*$15.1*	*$16.8*
Total Gross Draw	$39.2	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Dividend	($19.1)	($10.3)	($19.6)	($21.4)	($15.9)	($16.4)	($16.1)	($14.3)	($14.0)	($14.3)	($13.9)	($13.8)
Net Draw	$20.1	($10.3)	($19.6)	($21.4)	($15.9)	($16.4)	($16.1)	($14.3)	($14.0)	($14.3)	($13.9)	($13.8)
Beginning PSPA Stock	$171.6	$210.8	$210.8	$210.8	$210.8	$210.8	$210.8	$210.8	$210.8	$210.8	$210.8	$210.8
Total Gross Draw	$39.2	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Ending PSPA Stock	$210.8	$210.8	$210.8	$210.8	$210.8	$210.8	$210.8	$210.8	$210.8	$210.8	$210.8	$210.8
Implied Dividend Rate	*10.0%*	*4.9%*	*9.3%*	*10.2%*	*7.5%*	*7.8%*	*7.6%*	*6.8%*	*6.7%*	*6.8%*	*6.6%*	*6.5%*
Cum. Net PSPA Draw	**$159.6**	**$149.3**	**$129.7**	**$108.3**	**$92.4**	**$76.0**	**$59.9**	**$45.7**	**$31.6**	**$17.3**	**$3.4**	**($10.4)**
Cum. Gross PSPA Draw	**$210.8**	**$210.8**	**$210.8**	**$210.8**	**$210.8**	**$210.8**	**$210.8**	**$210.8**	**$210.8**	**$210.8**	**$210.8**	**$210.8**
PSPA Capacity Left	**$275.0**	**$275.0**	**$275.0**	**$275.0**	**$275.0**	**$275.0**	**$275.0**	**$275.0**	**$275.0**	**$275.0**	**$275.0**	**$275.0**

Source: Grant Thorton, U.S. Department of Treasury

Stress case forecast for change under Policy Option 1

Recommendation 1: Net comprehensive income (loss)

$ in billions	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
Combined:												
Net Income (Loss)	($56.8)	($2.2)	$21.8	$24.7	$14.9	$14.2	$13.9	$13.4	$14.1	$14.0	$13.6	$13.4
NI Dif. From Base Stress Case	*$0.0*	*$0.0*	*$0.0*	*$0.0*	*$0.0*	*$0.0*	*$0.0*	*$0.0*	*$0.0*	*$0.0*	*$0.0*	*$0.0*

Recommendation 1: Restructure the PSPA agreements and move to a variable dividend payment

$ in billions	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
Combined:												
Base Stress Case Gross Draw	*$78.8*	*$36.6*	*$11.8*	*$7.2*	*$22.2*	*$18.5*	*$20.9*	*$23.5*	*$25.4*	*$14.9*	*$6.8*	*$7.5*
Total Gross Draw	$78.8	$15.7	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Dividend	($20.5)	($6.5)	($18.2)	($23.7)	($9.4)	($14.9)	($14.5)	($14.1)	($14.6)	($27.5)	($36.5)	($36.5)
Net Draw	$58.4	$9.2	($18.2)	($23.7)	($9.4)	($14.9)	($14.5)	($14.1)	($14.6)	($27.5)	($36.5)	($36.5)
Beginning PSPA Stock	$171.6	$250.4	$266.1	$266.1	$266.1	$266.1	$266.1	$266.1	$266.1	$266.1	$266.1	$266.1
Total Gross Draw	$78.8	$15.7	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Ending PSPA Stock	$250.4	$266.1	$266.1	$266.1	$266.1	$266.1	$266.1	$266.1	$266.1	$266.1	$266.1	$266.1
Implied Dividend Rate	*9.7%*	*2.5%*	*6.8%*	*8.9%*	*3.5%*	*5.6%*	*5.4%*	*5.3%*	*5.5%*	*10.3%*	*13.7%*	*13.7%*
Cum. Net PSPA Draw	**$197.9**	**$207.1**	**$188.8**	**$165.1**	**$155.7**	**$140.8**	**$126.3**	**$112.2**	**$97.6**	**$70.2**	**$33.6**	**($2.9)**
Cum. Gross PSPA Draw	**$250.4**	**$266.1**	**$266.1**	**$266.1**	**$266.1**	**$266.1**	**$266.1**	**$266.1**	**$266.1**	**$266.1**	**$266.1**	**$266.1**
PSPA Capacity Left	**$275.0**	**$259.3**	**$259.3**	**$259.3**	**$259.3**	**$259.3**	**$259.3**	**$259.3**	**$259.3**	**$259.3**	**$259.3**	**$259.3**

Source: Grant Thorton, U.S. Department of Treasury

Appendix B: Scenario Analysis (Cont'd)

Base case forecast for change under Policy Option 1 and 3

Recommendation 3: Dividend Sweep and Pull NPL Forward

$ in billions	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
Combined:												
Net Income (Loss)	($55.8)	$22.1	$29.6	$24.4	$18.6	$17.3	$16.4	$15.4	$15.9	$15.4	$14.5	$13.4
NI Difference From Base Case	*($49.4)*	*$7.1*	*$5.9*	*$4.9*	*$4.0*	*$3.3*	*$2.7*	*$2.2*	*$1.9*	*$1.5*	*$1.0*	*$0.0*

Recommendation 3: Dividend Sweep and Pull NPL Forward

$ in billions	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
Combined:												
Base Case Gross Draw	*$39.2*	*$11.4*	*$2.9*	*$1.2*	*$7.0*	*$7.1*	*$8.2*	*$10.9*	*$12.3*	*$13.3*	*$15.1*	*$16.8*
Gross Draw	$88.6	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Dividend	($19.1)	($17.4)	($25.5)	($26.3)	($19.9)	($19.7)	($18.8)	($16.5)	($15.9)	($15.8)	($14.9)	($13.8)
Net Draw	$69.5	($17.4)	($25.5)	($26.3)	($19.9)	($19.7)	($18.8)	($16.5)	($15.9)	($15.8)	($14.9)	($13.8)
Beginning PSPA Stock	$171.6	$260.2	$260.2	$260.2	$260.2	$260.2	$260.2	$260.2	$260.2	$260.2	$260.2	$260.2
Gross Draw	$88.6	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Ending PSPA Stock	$260.2	$260.2	$260.2	$260.2	$260.2	$260.2	$260.2	$260.2	$260.2	$260.2	$260.2	$260.2
Implied Dividend Rate	*8.8%*	*6.7%*	*9.8%*	*10.1%*	*7.6%*	*7.6%*	*7.2%*	*6.4%*	*6.1%*	*6.1%*	*5.7%*	*5.3%*
Cum. Net PSPA Draw	**$209.0**	**$191.6**	**$166.1**	**$139.8**	**$120.0**	**$100.2**	**$81.4**	**$64.9**	**$49.0**	**$33.2**	**$18.2**	**$4.5**
Cum. Gross PSPA Draw	**$260.2**	**$260.2**	**$260.2**	**$260.2**	**$260.2**	**$260.2**	**$260.2**	**$260.2**	**$260.2**	**$260.2**	**$260.2**	**$260.2**
PSPA Capacity Left	**$275.0**	**$275.0**	**$275.0**	**$275.0**	**$275.0**	**$275.0**	**$275.0**	**$275.0**	**$275.0**	**$275.0**	**$275.0**	**$275.0**

Source: Grant Thorton, U.S. Department of Treasury

Stress case forecast for change under Policy Option 1 and 3

Recommendation 3: Dividend Sweep and Pull NPL Forward

$ in billions	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
Combined:												
Net Income (Loss)	($106.2)	$4.9	$27.7	$29.6	$18.9	$17.6	$16.6	$15.6	$16.0	$15.5	$14.6	$13.4
NI Difference From Base Stress Case	*($49.4)*	*$7.1*	*$5.9*	*$4.9*	*$4.0*	*$3.3*	*$2.7*	*$2.2*	*$1.9*	*$1.5*	*$1.0*	*$0.0*

Recommendation 3: Dividend Sweep and Pull NPL Forward

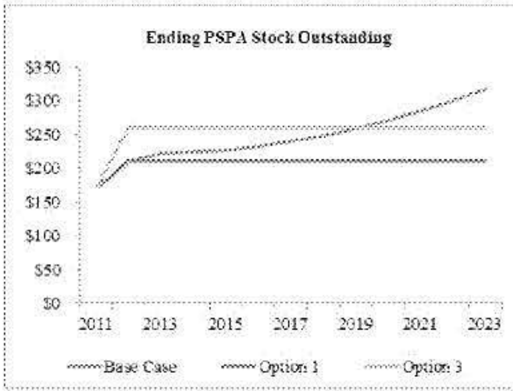
$ in billions	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
Combined:												
Base Stress Case Gross Draw	*$78.8*	*$36.6*	*$11.8*	*$7.2*	*$22.2*	*$18.5*	*$20.9*	*$23.5*	*$25.4*	*$14.9*	*$6.8*	*$7.5*
Gross Draw	$128.2	$9.9	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Dividend	($20.5)	($7.9)	($24.1)	($28.6)	($13.4)	($18.2)	($17.2)	($16.3)	($16.5)	($29.0)	($37.6)	($36.5)
Net Draw	$107.8	$2.0	($24.1)	($28.6)	($13.4)	($18.2)	($17.2)	($16.3)	($16.5)	($29.0)	($37.6)	($36.5)
Beginning PSPA Stock	$171.6	$299.8	$309.7	$309.7	$309.7	$309.7	$309.7	$309.7	$309.7	$309.7	$309.7	$309.7
Gross Draw	$128.2	$9.9	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Ending PSPA Stock	$299.8	$309.7	$309.7	$309.7	$309.7	$309.7	$309.7	$309.7	$309.7	$309.7	$309.7	$309.7
Implied Dividend Rate	*8.8%*	*6.7%*	*9.8%*	*10.1%*	*7.6%*	*7.6%*	*7.2%*	*6.4%*	*6.1%*	*6.1%*	*5.7%*	*5.3%*
Cum. Net PSPA Draw	**$247.3**	**$249.3**	**$225.2**	**$196.6**	**$183.2**	**$165.0**	**$147.8**	**$131.5**	**$115.0**	**$86.0**	**$48.4**	**$11.9**
Cum. Gross PSPA Draw	**$299.8**	**$309.7**	**$309.7**	**$309.7**	**$309.7**	**$309.7**	**$309.7**	**$309.7**	**$309.7**	**$309.7**	**$309.7**	**$309.7**
PSPA Capacity Left	**$275.0**	**$265.1**	**$265.1**	**$265.1**	**$265.1**	**$265.1**	**$265.1**	**$265.1**	**$265.1**	**$265.1**	**$265.1**	**$265.1**

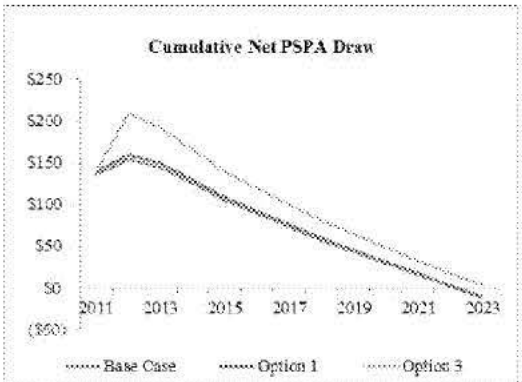
Source: Grant Thorton, U.S. Department of Treasury

Appendix C: Graphical Forecasts of Policy Actions

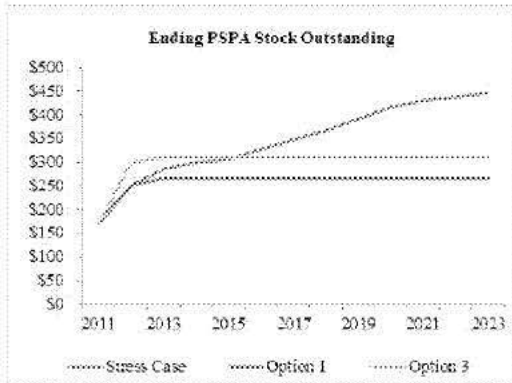
Gross and Net PSPA Draws

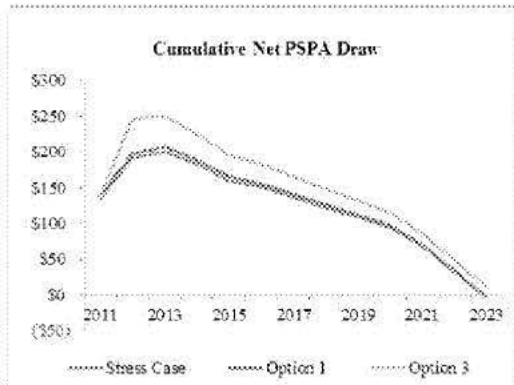
Base Case





Stress Case





Key for the charts above:

1) Base Case – base case forecast as provided by FHFA and Grant Thorton
2) Stress Case – stress case forecast as provided by FHFA and Grant Thorton
3) Option 1 – Restructure the PSPA agreements to a variable dividend payment
4) Option 2 – Not applicable
5) Option 3 – Initiate an NPL disposition program and contribute legacy assets into a special purpose vehicle (SPV) or joint venture (JV) that manages loss mitigation activities

Appendix D: GAAP and FMV Balance Sheet Reserves

				C-D					E+F+G	D+H	C-D-H		C-D-G	
A	B	C	D	J	K	E	F	G	H	I	L	M	N	O
							Fair Market Value					*Carrying Value*		
Total GSE	**Count**	**UPB**	**GAAP Allowance**	**GAAP Carry Value**	***% of UPB***	**Capital Costs**	**Market Discount**	**Expected Losses**	**Total FMV Allowance**	**Total Allowance**	**FMV Carry Value**	***% of UPB***	**FMV Ex-Capital/Mrkt**	***% of UPB***
Performing	27,051,977	$4,117.6	$33.5	$4,084.1	*99.2%*	$54.8	$5.7	$47.6	$108.0	$141.6	$3,976.1	*96.6%*	$4,036.6	*98.0%*
Sub-Performing	756,904	108.1	10.3	97.8	*90.4%*	3.6	5.9	3.3	12.8	23.1	85.0	*78.6%*	94.4	*87.4%*
Non-Performing	1,372,769	263.7	65.7	198.0	*75.1%*	7.8	37.7	16.3	61.8	127.4	136.3	*51.7%*	181.7	*68.9%*
Totals	29,181,650	4,489.4	109.5	4,379.9	*97.6%*	66.2	49.2	67.2	182.6	292.1	4,197.3	*93.5%*	4,312.7	*96.1%*
% of Total														
Performing	*92.7%*	*91.7%*	*30.6%*	*93.2%*		*82.8%*	*11.5%*	*70.8%*	*59.2%*	*48.5%*	*94.7%*		*93.6%*	
Sub-Performing	*2.6%*	*2.4%*	*9.4%*	*2.2%*		*5.4%*	*12.0%*	*5.0%*	*7.0%*	*7.9%*	*2.0%*		*2.2%*	
Non-Performing	*4.7%*	*5.9%*	*60.0%*	*4.5%*		*11.8%*	*76.5%*	*24.2%*	*33.8%*	*43.6%*	*3.2%*		*4.2%*	
Totals	*100.0%*	*100.0%*	*100.0%*	*100.0%*		*100.0%*	*100.0%*	*100.0%*	*100.0%*	*100.0%*	*100.0%*		*100.0%*	

Fannie Mae	**Count**	**UPB**	**GAAP Allowance**	**GAAP Carry Value**	***% of UPB***	**Capital Costs**	**Market Discount**	**Expected Losses**	**Total FMV Allowance**	**Total Allowance**	**FMV**	***% of UPB***	**FMV Ex-Capital/Mrkt**	***% of UPB***
Performing	16,064,713	$2,481.2	$25.9	$2,455.3	*99.0%*	$28.2	$0.0	$25.6	$53.8	$79.7	$2,401.5	*96.8%*	$2,429.7	*97.9%*
Sub-Performing	465,489	64.6	4.9	59.7	*92.4%*	2.1	4.1	3.8	9.9	14.8	49.8	*77.1%*	56.0	*86.6%*
Non-Performing	886,111	166.2	39.6	126.6	*76.2%*	5.6	30.4	13.6	49.7	89.3	77.0	*46.3%*	113.1	*68.0%*
Totals	17,416,313	2,712.1	70.4	2,641.7	*97.4%*	35.9	34.5	43.0	113.4	183.8	2,528.3	*93.2%*	2,598.7	*95.8%*
% of Fannie Mae														
Performing	*92.2%*	*91.5%*	*36.8%*	*92.9%*		*78.5%*	*0.0%*	*59.6%*	*47.4%*	*43.4%*	*95.0%*		*93.5%*	
Sub-Performing	*2.7%*	*2.4%*	*6.9%*	*2.3%*		*5.8%*	*11.8%*	*8.8%*	*8.8%*	*8.1%*	*2.0%*		*2.2%*	
Non-Performing	*5.1%*	*6.1%*	*56.2%*	*4.8%*		*15.7%*	*88.2%*	*31.6%*	*43.8%*	*48.6%*	*3.0%*		*4.4%*	
Totals	*100.0%*	*100.0%*	*100.0%*	*100.0%*		*100.0%*	*100.0%*	*100.0%*	*100.0%*	*100.0%*	*100.0%*		*100.0%*	

Freddie Mac	**Count**	**UPB**	**GAAP Allowance**	**GAAP Carry Value**	***% of UPB***	**Capital Costs**	**Market Discount**	**Expected Losses**	**Total FMV Allowance**	**Total Allowance**	**FMV**	***% of UPB***	**FMV Ex-Capital/Mrkt**	***% of UPB***
Performing	10,987,264	$1,636.5	$7.6	$1,628.9	*99.5%*	$26.6	$5.7	$22.0	$54.3	$61.9	$1,574.6	*96.2%*	$1,606.9	*98.2%*
Sub-Performing	291,415	43.5	5.4	38.0	*87.5%*	1.5	1.8	(0.4)	2.9	8.3	35.2	*80.9%*	38.5	*88.5%*
Non-Performing	486,658	97.5	26.1	71.4	*73.3%*	2.2	7.2	2.7	12.1	38.2	59.3	*60.9%*	68.7	*70.5%*
Totals	11,765,337	1,777.4	39.1	1,738.3	*97.8%*	30.3	14.7	24.2	69.2	108.3	1,669.1	*93.9%*	1,714.0	*96.4%*
% of Freddie Mac														
Performing	*93.4%*	*92.1%*	*19.4%*	*93.7%*		*88.0%*	*38.6%*	*90.7%*	*78.4%*	*57.1%*	*94.3%*		*93.7%*	
Sub-Performing	*2.5%*	*2.4%*	*13.9%*	*2.2%*		*4.9%*	*12.3%*	*(1.8%)*	*4.1%*	*7.7%*	*2.1%*		*2.2%*	
Non-Performing	*4.1%*	*5.5%*	*66.7%*	*4.1%*		*7.1%*	*49.1%*	*11.1%*	*17.5%*	*35.2%*	*3.6%*		*4.0%*	
Totals	*100.0%*	*100.0%*	*100.0%*	*100.0%*		*100.0%*	*100.0%*	*100.0%*	*100.0%*	*100.0%*	*100.0%*		*100.0%*	

DRAFT
Sensitive and Pre-Decisional

PSPA Amendment Q&A

GENERAL:

[Eric & Matt] What is the purpose, necessity and meaning of these changes?

- This proposed modification would have three primary benefits.
  - First, it would eliminate the circularity of Treasury funding the GSE's dividends payments to Treasury.
  - Second, it would capture all future positive earnings at the GSEs to help pay back taxpayers for their investment in those firms.
  - Finally, it would reduce future draws under the PSPAs so that such draws would only be made when needed to fund quarterly net losses.
- In making these changes, Treasury has sought to support three key objectives: (1) winding down Fannie Mae and Freddie Mac; (2) protecting taxpayer interests; and (3) ensuring the continued flow of mortgage credit during a responsible transition.
- Our commitment to ensuring Fannie Mae and Freddie Mac have sufficient capital to honor all guarantees issued now or in the future and meet all of their debt obligations remains unchanged.
- The Administration will not pursue policies or reforms in a way that would impair the ability of Fannie Mae and Freddie Mac to honor their obligations or diminish confidence in the solvency of Fannie Mae and Freddie Mac.

[Adam] What are the current terms of the Senior Preferred Stock Purchase Agreements (PSPAs)?

- The current capacity on Treasury's funding commitment under the PSPAs equals $200 billion plus the cumulative net worth deficits experienced during 2010, 2011, and 2012, less any surplus remaining as of December 31, 2012.
- At the end of 2012, the funding commitment capacity under the PSPAs will be fixed permanently, and the remaining PSPA capacity will be limited to approximately $149 billion for Freddie Mac and $125 billion for Fannie Mae. The remaining capacity is different for each GSE since it reflects the $200 billion commitment less the draws prior to 2010.
- Any subsequent draws whether to fund a net loss and/or dividend payments to Treasury would reduce the limited remaining PSPA capacity available to each GSE.

[Adam] What does this agreement change and why?

- *Replace the fixed 10 percent dividend with a net worth sweep dividend* - Quarterly dividend payments starting in 2013 will equal the positive net worth of the GSEs (i.e., GAAP assets less liabilities at quarter end), less a defined Applicable Capital Reserve Amount.

Comment [BR1]: I would stress: (1) stabilizing the housing market, (2) helping families to buy homes, (3) helping troubled borrowers, and (4) helping to bring back private capital to the mortgage finance market.

Comment [BR2]: This is really a mechanical means to broader policy objectives.

Comment [BR3]:

Raises the questions: What is time frame for wind-down? What happens after wind down? Maybe better to say "restore private mortgage financing" or "bring back private capital".

Doesn't reducing the retained portfolio encourage the GSE to resolve troubled loans more aggressively … which helps borrowers and stabilizes the housing market?

Comment [BR4]: Should be first Q.

- *Accelerate the wind-down of the retained investment portfolios* - The required reduction rate for the retained investment portfolios will be increased to 15 percent from 10 percent per annum beginning at year-end 2013 until such time that each GSE's portfolio reaches a target $250 billion balance ($250 billion was set in the original PSPA).
- *Require an annual risk management plan be delivered to Treasury* - On an annual basis, each GSE will submit to Treasury a plan that details the steps it will take to reduce the financial and operational risk profile associated with both their mortgage guarantee and retained investment portfolio businesses in order to help protect taxpayers from future losses.

[Adam] How does the full income sweep operate?

- Beginning with the financial results as of 1Q 2013, and each quarter thereafter, all positive net worth above the Applicable Capital Reserve Amount at each GSE will be transferred to Treasury in the form of a dividend.
  - Net worth is defined as net assets minus net liabilities (per GAAP)
  - No dividends are paid when there is a net worth deficit or a positive net worth below the Applicable Capital Reserve Amount
- Over time, this will result in all positive net income generated by the GSEs is paid to the government and will likely exceed the amount that would have been paid if the 10% was still in effect. Furthermore, this amendment eliminates the circularity of payments and preserves for the GSEs their respective PSPA draw capacity.

[Beth – need Peter to review]] What are the enforcement mechanisms to ensure the GSEs meet these new requirements?

- The PSPAs and their amendments constitute legally binding contracts between the GSEs and Treasury. Therefore, these amendments, like the rest of the agreements are a valid and legally binding obligation of the GSEs to fulfill.
- [If either party to the contract – the GSEs or Treasury – do not fulfill their obligations, they are enforceable in court.]
- There are laws of general applicability, such as bankruptcy and insolvency laws, that could supersede in court and limit enforceability. [However, these are limited in nature and typical of financial contracts between two parties.]

[Beth] How will this plan help families seeking mortgage credit, troubled homeowners, and the broader housing market?

- Although there are signs of housing market stabilization, there are many troubled borrowers who continue to face hardship. These amendments help support the continued flow of mortgage credit and bring greater stability to the housing market in several ways.

- It helps to ensure that mortgage credit remains available on reasonable terms. ~~because market participants will continue to have confidence in the GSEs ability to meet its guarantee obligations.~~ Until the private sector reemerges as a significant source of financing for the mortgage market, the GSEs will serve the critical role of providing mortgage credit to first time homebuyers as well as those borrowers looking to refinance into a lower rate loan. Market participants will continue to have confidence in the GSEs ability to meet its guarantee obligations, in part because changing the dividend to a net-asset sweep will preserve GSEs' borrowing capacity. The GSEs will no longer need to borrow from the Treasury merely to meet a 10 percent dividend requirement.
    - It is important that credit worthy first time homebuyers are able to access mortgage credit so that they can help reduce excess housing inventory in many communities.
    - Refinancing helps put more money in families' pockets so they can pay off debt or use for other expenses.
- [The risk management plan required of each GSE on an annual basis is expected to encourage activities that help troubled borrowers with loans guaranteed by Fannie Mae or Freddie Mac. This could include asset sales of troubled loans to specialty servicers, which are better equipped to assist borrowers with a mortgage modification or find other ways to keep families in their homes.]

Comment [BR5]: Or portfolio wind-down?

[Beth] How will these changes help bring private capital back to the mortgage market?

Comment [BR6]: Doesn't quite explain how these changes will bring private capital back.

- These changes, in combination with other commitments by FHFA, such as gradually increasing guarantee fees, will help bring pricing in line with private market participants so that they begin to again take mortgage credit risk.
- As part of these changes, Fannie Mae and Freddie Mac will be required to submit a risk management action plan each year that will provide clear goals and timetables for the GSEs to reduce the risk of the mortgages they guarantee as well as their mortgages they hold as investments in their retained portfolios.
- We expect these plans to include ways that private sector will begin to take on some of the GSEs' mortgage credit risk. ~~can be sold or moved to the private sector in order to better protect taxpayers as well as attract private investors back into the market.~~
- ~~These changes should also help attract private investors back into the mortgage market. They help ensure that private mortgage investors, whose purchases of Fannie and Freddie mortgage-backed securities (MBS) are an important source of funding in the housing finance market, will continue to have confidence in their guarantees.~~

Comment [BR7]: Maintaining investor confidence in USG backing for the GSEs is important, but it's quite different from getting the private market to take on credit risks the USG is now taking.

[Adam] When will these changes become effective?

- The amendment is effective immediately, and the dividend payment change will become effective starting with the first quarter 2013 earnings.

DRAFT
Sensitive and Pre-Decisional

[Adam] Without this amendment, do you think the Enterprises would become insolvent? If so, when?

- Today, we believe that the GSEs are fully able to meet all current obligations. However, the earnings outlook at the GSEs is difficult to forecast and is subject to speculation.

- ~~Given our intent to wind-down the GSEs over time, the existing 10 percent dividend structure could potentially become unsustainable. Therefore, we made the appropriate change to change dividend to full income sweep.~~

- ~~This~~ Changing the 10 percent dividend payment to a net worth sweep will help ensure financial stability of GSEs and that the taxpayer will be the beneficiary of the income. If their net earnings should be insufficient to pay the 10 percent dividend, the sweep will enable them to pay what they can without requiring additional borrowings from the Treasury that would constrain their overall borrowing capacity. If they should perform well enough to pay a dividend greater than 10 percent, taxpayers will recover their investment sooner.

- Since we intend to wind down the GSEs over time, the GSEs do not need to retain income in excess of amounts required to pay the 10 percent dividend.

[Ankur] What were the previous amendments to the PSPAs and why were those made?

- Over last several years Treasury has taken steps to ensure financial stability of GSEs and help the housing market most effectively.
- On September 6, 2008, FHFA, as regulator of the GSEs, placed both into conservatorship.
    - At that time, their combined guaranteed mortgage-backed securities (MBS) outstanding totaled more than $5.4 trillion and their share prices had fallen sharply.
    - The goals of conservatorship, as stated by FHFA, included helping to restore confidence in the GSEs, enhancing the GSEs capacity to fulfill their missions, and mitigating the systemic risk that had contributed directly to instability in the housing market.
- At the same time that FHFA placed the GSEs into conservatorship, Treasury provided capital support by entering into a Senior Preferred Stock Purchase Agreement (PSPA) with each GSE, acting through FHFA as their conservator. The PSPAs were intended to provide confidence to the market that the GSEs would remain solvent.
    - The initial Treasury funding commitment was $100 billion for each GSE.
    - In May 2009, Treasury increased the funding commitment caps to $200 billion for each GSE.
    - In December 2009, Treasury replaced the fixed $200 billion cap with a formulaic cap that increases the amount of capital support available through the PSPAs by the amount of draws between January 1, 2010 and December 31, 2012.

[Adam] What are the reasons Treasury and FHFA did not get this right in December 2009? Why must we revisit this issue again?

- Treasury believes the steps taken in 2009 were appropriate to best maintain the financial stability of the GSEs in order to best allow them to continue operating effectively.
- Given their improvement in operating performance and our intention to wind them down, we think the current steps being taken are appropriate.

[Ankur] Can Treasury make further amendments to the PSPAs? If so, until when?

- Treasury and FHFA have authority to make changes to legal agreements, except for the amount of funding that can be provided.
  - Funding authority was fixed in December of 2009 with the expiration of Treasury's authority under HERA.
- Treasury and FHFA do not anticipate additional changes at this time but the Administration will continue to monitor the situation and consider whether any additional changes to the PSPAs would be appropriate.

What power does Treasury actually have over Fannie Mae and Freddie Mac?

- Under the Conservatorship mandate, Treasury has the responsibility for approving transactions at the GSEs that fall outside the ordinary course of business; however, Treasury does not control Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac are under the conservatorship of their regulator, FHFA.
- As a member of the Federal Housing Finance Oversight Board (FHFOB), the Secretaries of Treasury and HUD provide policy guidance and recommendations to FHFA on a range of matters related to Fannie Mae and Freddie Mac.

<u>FINANCIAL / TAXPAYER IMPACT</u>

[Adam] How does this change impact taxpayers and the federal budget?

- The federal budget will continue to maintain the existing non-budgetary presentation for Fannie Mae and Freddie Mac, as it does for the other GSEs.
  - This is consistent with Governmental Accounting Standards that do not require consolidation if ownership control is temporary.
- All federal programs that provide direct support to Fannie Mae and Freddie Mac, including the Senior Preferred Stock Purchase Agreements (PSPAs), are shown on-budget.

Comment [BR8]: How can we argue that USG ownership control is temporary if we will be sweeping their net worth? Doesn't that ensure the GSEs will have no exit from conservatorship.

[Adam] How does OMB's estimate of Fannie Mae and Freddie Mac's deficit impact differ from CBO's approach?

- The 2013 Budget maintains the existing non-budgetary presentation for Fannie Mae and Freddie Mac.
    - This is consistent with Governmental Accounting Standards that do not require consolidation of an entity if ownership control is temporary, as it is for Fannie Mae and Freddie Mac during the period of their conservatorship.
    - However, all federal programs that provide direct support to Fannie Mae and Freddie Mac, including the Senior Preferred Stock Purchase Agreements (PSPAs), are shown on-budget.
- As we understand it, CBO's estimates of the deficit impact of Fannie Mae and Freddie Mac are considerably higher than the Administration's because CBO defines the budget impact as capturing what a private entity would require as compensation for assuming Fannie Mae and Freddie Mac's commitments.
- The compensation is represented in CBO's description as the difference in market value between Fannie Mae and Freddie Mac's assets and their liabilities on a "risk adjusted" basis.
- This "risk premium" assigned by CBO does not constitute a federal outlay, and is not comparable to the budgetary estimates of Fannie Mae and Freddie Mac's costs included in the President's Budget.
- The Administration presents the budget impact as the estimated amount attributable to transactions between Treasury and Fannie Mae and Freddie Mac under the PSPAs.

Comment [BR9]: See above

Comment [BR10]: Sounds like we are not sure we really understand.

[Adam] How much has the government's investment in Fannie Mae and Freddie Mac cost taxpayers to date? What is the expected lifetime cost?

- Through June 30, 2012, Fannie Mae has drawn $116.2 billion and Freddie Mac had drawn $71.3 billion, excluding the initial $1.0 billion liquidation preference for which the GSEs did not receive cash proceeds.
- Fannie Mae has paid $25.4 billion in dividends back to Treasury and Freddie Mac has paid $20.1 billion in dividends back to Treasury.
- As a result, the current net investment in the GSEs is $142.0 billion – $90.8 billion for Fannie Mae and $51.2 billion for Freddie.
- The overall expected lifetime costs are inherently uncertain. Treasury will continue to work with FHFA and the GSEs to ensure taxpayers are appropriately compensated for investments to date.
- The proposed modifications are not projected to result in the Government receiving less funds from Fannie Mae or Freddie Mac on a net basis over time.

[Adam] How much PSPA capacity is remaining for each GSE?

- After 2012, the funding commitment cap under the PSPAs will be fixed permanently, and the remaining PSPA capacity will be limited to approximately $149 billion for Freddie Mac and $125 billion for Fannie Mae.

[Beth] How does this change impact other preferred and common shareholders, including community banks? Does this mean their investments are worthless?

- The preferred and common stock holders of the GSEs do not have rights while the GSEs are in conservatorship. These amendments do not change that.
- Because all positive net worth will be swept to Treasury going forward, preferred and common shareholders should not expect to receive any dividends or economic gains while the PSPAs are in effect.
- Most community banks have previously written-down their preferred stock holdings and therefore these changes should not affect community banks financial positions. [Can we add a citation here to a third-party source???]

[Beth] Doesn't this change mean you could give the GSEs a bigger bailout by providing more headroom under the PSPAs?

- These changes do not change the maximum cap of PSPA support for either GSE. However, it preserves the remaining capacity for true business activity and other financial losses – its original intended use - rather than using the capacity in a circular fashion to pay Treasury the ~~10%~~ percent dividend.
- By sweeping the full income of the GSEs each quarter, Treasury will receive no less from the GSEs as we would have under the previous 10 percent dividend. Essentially, it will stop the GSEs from *drawing from* Treasury in order to *pay* Treasury the ~~10%~~ percent dividend.

[Ankur] Why are you providing the GSEs with a capital buffer under this agreement? How does the buffer work?

- The declining capital buffer, initially set to $3 billion, is provided to avoid extraneous quarterly draws on Treasury that would otherwise occur as a result of the volatility in earnings arising from the GSEs' normal course of business. The capital buffer will be declining each year going forward and reach zero by 2018. Thus, within six years, the entire capital buffer will be eliminated and paid to Treasury.

HOUSING FINANCE REFORM

[Beth] Will this change reduce the urgency for fundamental long-term housing finance reform? Moreover, now that the GSEs are profitable again, can they just continue operating indefinitely as a public utility?

- These changes are consistent with Treasury's policy to wind-down the GSEs. Sweeping the GSEs' positive net worth helps ensure that the GSEs will not be able to rebuild capital as they are wound down.
- Furthermore, these changes provide a framework for the GSEs to transition to a future housing finance system that is more reliant on private capital. This agreement sets out clear targets by requiring the GSEs to reducing the size of the mortgage holdings in their retained portfolios by 15 percent per year – faster pace than before. And it forces the management of the GSEs to set concrete goals and timetables to reduce the operational and financial risk of the enterprises by requiring an annual risk management action plan. In other words, this effectively operationalizes our commitment to wind down the GSEs.

Comment [BR11]: Doesn't really explain how this brings back private risk-taking

- However, we also recognize the housing market is still fragile and private capital has not yet returned in a robust manner. These changes strike an important balance. They will allow the GSEs to continue to play a critical role supporting the housing market in the near-term, but provide a road map for how they will be wound down going forward.
- Along with other commitments by FHFA to increase guarantee fees, these changes should encourage the return private capital to the housing financing market and reduce the GSEs' market share.

[Beth] How long is a reasonable transition?

- Treasury supports a transition to a long-term housing finance system as soon as practicable. We look forward to working with Congress to determine what that end-state should look like and the steps needed to get there.

[Beth] What information will be included in the "Annual Report on Taxpayer Protection" that Fannie Mae and Freddie Mac submit to Treasury? What is the purpose of the report? Does it have any enforcement or accountability mechanisms?

- The annual report will contain steps that Fannie Mae and Freddie Mac plan to take in order to reduce the risk profiles of both the mortgages they guarantee businesses as well as those they hold as investments in their retained portfolios. They will have to lay out, in reasonable detail, specific goals, targets and timetables so both management and the conservator has a clear understanding of the wind-down strategy. We expect that these plans will change over time, but would include steps to reduce their risk profile.
    - For their Credit Guarantee businesses, the plan could include sales of mortgage credit risk to private investors so that taxpayers bear less of the burden.
    - For the GSEs retained portfolios, we expect the plans to indicate aggressive managing down their legacy assets in order to reduce risk of non-performing loans, complex securities, and other hard to manage assets to reduce the portfolio's risk over time.

- FHFA, as the GSEs' regulator and conservator, will oversee the implementation of the steps outlined in the report. In addition, each GSE will be required to assess the progress it has made in meeting the goals and timetables in the plans set forth in the previous year. [These reports will be made available to the public.]

[Eric & Matt] When is the Obama Administration going to submit a long-term housing finance reform plan?

- As Secretary Geithner has stated, we're continuing to work to identify a bi-partisan path forward on housing finance reform.
- At the same time, we'll continue to put in place measures right now – including today's announcement -- that help ensure continued access to mortgage credit for American families, promote a responsible transition, and protect taxpayer interests

[Adam] What is the current status of the other housing finance initiatives Treasury and FHFA are working on, including REO-to-Rental, NPL sales, credit risk syndication, and others.

- Treasury remains committed to our broader efforts that will restart the private mortgage market, shrink the government's footprint in housing finance, and protect the long-term interests of taxpayers.
- Treasury continues to help FHFA and the GSEs think through the important challenges and questions raised by these efforts.

<u>HOMEOWNER IMPACT</u>

[Beth] How will these changes affect the cost and availability of mortgage credit?

- These changes will help to ensure that mortgage credit remains available and on reasonable terms because private investors will continue to have confidence that Fannie Mae and Freddie Mac obligations – including their credit guarantees on their MBS – will be fulfilled.

[Ankur] Will these changes in the PSPAs make it easier for families to buy a home by lowering the average FICO scores or high downpayment requirements currently required by lenders?

- We believe that the agreements should give mortgage market participants continued confidence that the GSEs will fulfill their future obligations as they are wound down. That should enable them to continue to play a critical role supplying mortgage credit to families in the near term until more private capital returns to the market. However, access to mortgage credit remains tempered by still-fragile housing market and an economic recovery that is not as fast as anyone would like.

- We are very attuned to the challenge faced by many families seeking to refinance or obtain a mortgage, especially first time ~~lower income~~ and ~~first time~~ lower-wealth homebuyers. And we are exploring ways to ease the situation.
- That is also why we are seeking to balance our desire to wind-down the GSEs as soon as practicable with the need for a responsible transition to a mortgage market that is more reliant on private capital. Any changes to the system should be taken with great sensitivity to both of these concerns.

Comment [BR12]: Elsewhere we call this a long-term goal. Sounds confusing.

[Adam] FHFA recently announced it plans to raise GSE mortgage guarantee fees by the end of the year. Why is it necessary to raise the cost of mortgage loans when the market is still struggling to recover?

- The GSEs are gradually raising guarantee fees to help restart the private mortgage market, shrink the government's footprint in housing finance, and protect the long-term interests of taxpayers.
- We will work to ensure, however, that the increases occur at a measured pace, allowing borrowers to adjust to the new market, preserving widespread access to affordable mortgages for creditworthy borrowers including lower-income Americans, and supporting, rather than threatening, the health of our nation's economic recovery.

Comment [BR13]: Do we want to endorse G-fees at this time? I thought we wanted to maintain distance?

IMPACT ON THE HOUSING MARKET AND THE GSES

[Adam] How will the net worth sweep reassure investors in GSE debt and help maintain investor confidence?

- Treasury anticipates the financial markets will scrutinize the GSEs' expected losses and dividend payments relative to the level of available PSPA funding that remains.
- Since the existing 10 percent dividend structure could become unsustainable, we made the appropriate change to the dividend with the positive net worth sweep.
- This will help ensure financial stability of GSEs and that the taxpayer will be the beneficiary of the income.
- The GSEs continue to generate the bulk of their profits not in the single-family segments but in the investment portfolio segments which generate interest income on securities and whole loans financed by debt.
    - In 2Q 2012, the portfolio segment for Freddie Mac generated a net income of $2.5bn (versus $0.2bn for the single-family segment). For Fannie Mae the investment portfolio generated $1.5bn (versus what would have been $1.3bn in the single-family business if the reduction in reserves was not recorded as income).

[Beth] Why are you giving up your leverage by agreeing to make this change without further concessions? Shouldn't you have used this as leverage to get the GSEs to do more to help homeowners (e.g. principal reduction and/or greater opportunities to refinance)?

- Treasury continues to remain actively engaged with FHFA in exploring ways to help troubled homeowners.
  - For example, FHFA and Treasury have seen tremendous success with HARP changes, with a significant pickup in HARP refinancing activity since Treasury worked with FHFA to improve the program in the Fall of 2011.
- ~~At this point in time,~~ Although ~~Treasury remains disappointed with FHFA's decision to not have the GSEs participate in the HAMP PRA program. However, as~~FHFA is an independent regulator and conservator of the two GSEs, and~~FHFA~~ is solely responsible for the ultimate decision whether the GSEs can participate or not. Treasury has asked FHFA to reconsider its decision to not have the GSEs participate in the HAMP PRA program.

[Ankur] What does this change mean for employees at the GSEs? When you say "wind down," what do you mean by that if the GSEs can still keep their systems, still retain people and still have a capital reserve?

- We believe that employees of the GSEs should not be affected by the latest PSPA amendment. Treasury has consistently stated its intention to wind down the GSEs, and the latest PSPA amendment merely formalizes one aspect of the process by which that long-standing goal can be achieved.
- Winding down the GSEs is not inconsistent with allowing them to retain the basic infrastructure required to conduct their day-to-day operations, as this will allow the GSEs to effectively conduct business and completely repay the funds it has received from Treasury/the taxpayer.

[Adam] Will accelerating the wind down of GSEs' retained portfolio adversely impact those firms' operations or the housing market?

- We do not believe this modification will adversely impact the GSEs or the broader housing market. However, we anticipate that the GSEs will have lower earnings from their retained portfolios due to the lower allowable annual balance.

[Adam] Will these changes trigger any accounting revisions at the GSEs?

- Treasury does not believe this change will trigger any accounting revisions at the GSEs.

[Adam] Will any of the changes affect Freddie Mac differently from Fannie Mae, and if so, why, and is this good or problematic?

- Both GSEs will be required to implement these changes.

DRAFT
Sensitive and Pre-Decisional

TIMING / STRATEGY

[Adam] How long will it take to wind down Fannie Mae and Freddie Mac? Why not unwind Fannie Mae and Freddie Mac at a faster pace? Why did you not come out with a specific proposal for pace of unwind?

- The pace will depend on market conditions.
- We cannot forget that while we have made important progress stabilizing the housing market, this critical sector of the economy remains fragile.
- Private capital has not yet fully returned to the market, and the government continues to play an outsized – though unfortunately necessary role – in ensuring the availability of mortgage credit.
- Proposals that prematurely constrain Fannie Mae and Freddie Mac's ability to guarantee loans could limit the availability of mortgage credit, shock the economy, and expose taxpayers to greater losses on the loans already guaranteed by Fannie Mae and Freddie Mac.

[Adam] Why make this change now, particularly after the GSEs had such a profitable quarter?

- Given our intent to wind-down the GSEs over time, the existing 10 percent dividend structure could potentially become unsustainable. Therefore, we made the appropriate dividend change from 10% to a positive net worth sweep.
- This will help ensure financial stability of GSEs and that the taxpayer will be the beneficiary of the income.

Comment [BR14]: How/why?

[Ankur] Who had to sign off on this change? When did that happen?

- The latest PSPA amendment was signed by the Secretary of the Treasury, Timothy Geithner, and as the Conservator for each GSE, the Acting Director of FHFA, Edward DeMarco.
- While the formal document execution occurred on [Friday, August 17], the amendment had been jointly drafted and reviewed by Treasury and FHFA.

[Beth] How is your working relationship with FHFA? Did the negotiations over principal reduction complicate this agreement on the PSPAs?

- Treasury and FHFA are currently working on many different issues in a productive manner. These include credit risk syndication, REO-to-rental initiatives, federal short sale programs, as well as other steps to reduce taxpayer risk and bring back private capital.
- Both Treasury and FHFA were required to consent to this transaction.

[Beth] Why does this agreement exclude any requirement for principal reduction at the GSEs?

- Treasury already pursued a course of action to encourage principal reduction by the GSEs as part of their loan modification programs. Because the PSPAs are contracts between Treasury and the GSEs (through FHFA as their conservator), all changes to the PSPAs needed to receive support and agreement from all parties.

[Adam] Can Treasury dictate terms of PSPA amendments? What is role of each GSE and what is the role of FHFA?

- The Housing and Economic Recovery Act of 2008 amended the charter acts of the GSEs to give Treasury the authority to purchase obligations and other securities issued by the GSEs, and to exercise, at any time, rights received in connection with such purchases.
- The PSPAs are the contracts under which Treasury purchased the senior preferred stock certificates issued by Fannie Mae and Freddie Mac.
- In the PSPAs, Treasury received the right to amend the PSPAs, with the GSEs' agreement.
- The terms of the senior preferred stock certificates authorize the GSEs, with the consent of two-thirds of the holders of the senior preferred stock (i.e., Treasury), to amend the terms of the senior preferred stock certificates.

[Adam] Why are GSEs allowed to keep portfolios of $250 billion each in 2018 if they are to be wound down?

- The GSEs provide important services to the mortgage market, in particular small lenders through their cash window and other warehousing. The GSEs also need to use their investment portfolios to fund delinquent loans bought out of trusts.
- Given this fact pattern, we maintained the $250 billion level as the maximum retained portfolio size.
- Until such time there is a decision on the ultimate resolution of the GSE's we think this is an appropriate figure.

[Adam] When did Treasury first think about these changes? When did we approach FHFA? What was their reaction?

- Within the context of the Administration's goal of winding down the GSEs, we began exploring alternatives to the 10 percent dividend, knowing that the 10 percent dividend was likely to be unstable as the businesses were reduced.
- We have been evaluating the GSEs financial profile since conservatorship. It has remained an ongoing focus for us to help make sure that the GSEs have sufficient capital support.
- We don't comment on discussions between Treasury and independent regulators.

Comment [BR15]: Doesn't hold water. Their business won't reduce in the immediate future.