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US Government Sets the Stage for a Broad Restructuring of Mortgage Finance by Placing Freddie Mac and Fannie Mae in Conservatorship

One of the most significant events in the history of US financial services occurred on September 7, 2008, when the Federal Housing Finance Agency ("FHFA") placed Freddie Mac and Fannie Mae ("Enterprises") into conservatorship. At the same time, the Department of the Treasury ("Treasury") announced a number of major initiatives, under its new authorities provided by the Housing and Economic Recovery Act of 2008 ("Recovery Act"), intended to ensure continued availability of mortgage financing.

These developments position the federal government squarely in the middle of the future of the Enterprises. Prior to yesterday's action, the Enterprises had to address the uneasy balance between meeting shareholder expectations and fulfilling social housing objectives. FHFA Director James Lockhart acknowledged the cooperation of the boards and management of the Enterprises, noting that these individuals "did not create the inherent conflict and flawed business model embedded in the Enterprises' structure." Treasury Secretary Henry Paulson similarly referred to the need to "resolve the systemic risk created by the inherent conflict in the GSE structure." This reaction, which may be distinguished from former cases of federal intervention in which directors and officers have not fared as well, emphasizes the sensitivity of this situation and the government's need to act in a measured and deliberative fashion.

Treasury has already weighed in on the debate that will ensue on the future of the Enterprises by requiring them to gradually and substantially reduce their portfolio holdings of mortgages and mortgage backed securities in exchange for financial support from Treasury. In the nearer term, it is likely that such a debate will take a back seat to the analysis by the FHFA and Treasury of the quality of the mortgage loans held or guaranteed by the Enterprises and the implications of that evaluation. Moreover, any major new initiatives in this area are likely to be the responsibility of the next administration.

Conservatorship is an inherently unstable and transitory status that should be the bridge to the development and implementation of longer-term business strategies. The reduction in the prestige and leadership of the Enterprises comes at a particularly difficult time for the mortgage market.

Actions and Impacts

As discussed in greater detail below, the Treasury is taking a series of actions that are intended to facilitate the Enterprises continuing to play a pivotal role in the mortgage finance industry.

The relative rights of, and winners and losers among, parties associated with the Enterprises will play out over a period of time. Based on what we see so far, the following emerges:

- Treasury is attempting to ensure that holders of debt (including subordinated debt) and mortgage backed securities of the Enterprises will continue to hold creditworthy instruments by virtue of an extraordinary commitment by the Treasury to recapitalize the Enterprises and purchase their mortgage backed securities. These actions are also intended to reinvigorate the country's mortgage markets.

- Holders of preferred stock and common stock of the Enterprises will find themselves in a much more difficult situation. On one hand, they are fortunate that the Enterprises were not placed in receivership. If that had occurred, it is likely that their interests would have been severely compromised or eventually wiped out. Instead, because the Treasury is committed to infusing equity to keep the Enterprises in a viable condition, it appears that private shareholders may have the opportunity to survive to see some form of a reprivatization of the Enterprises. On the other hand, common and preferred shareholders are likely to not receive dividends for many years, and the warrants that the government initially receives will give it an 80% interest in the common stock of the Enterprises.

- The federal bank regulatory agencies ("Agencies") have indicated that many institutions hold common or preferred stock of the Enterprises and that a limited number of smaller institutions have holdings that are significant compared to their capital. The Agencies indicated that they are prepared to work with such institutions to develop capital restoration plans. The Agencies have also noted that net unrealized losses on preferred or common stock with readily determinable fair value are deducted from regulatory capital.

- ISDA, an industry group of securities dealers and customers, has announced that it will launch a protocol to facilitate settlement of credit derivative trades involving the Enterprises. Securities dealers and customers are expected to work over the next few weeks to determine the terms of the protocol for the settlement of those swaps.

Details of the Government's Actions

A brief summary of the actions announced yesterday follows.

1. The Enterprises are Placed in Conservatorship

The boards of directors of the Enterprises consented to the appointment of the FHFA as conservator. Federal law provides that the directors are not liable to shareholders or creditors for consenting in good faith to the appointment of a conservator.

A conservatorship is very different from a receivership. The objective of a conservatorship is to take such action as is necessary to put a company into a safe and solvent condition. The conservator immediately succeeds to all the rights, powers and privileges of the Enterprise, its directors, officers and shareholders. Unlike a receivership, the appointment of a conservator does not trigger a claims process. The Enterprises will continue to conduct their business in the ordinary course. This is, however, subject to certain exceptions, the most prominent being the financial involvement and investment by Treasury.

The FHFA has announced that the dividends on the Enterprises' preferred and common stock are being eliminated. Their stock will continue to trade during the conservatorship. Subordinated debt interest and principal payments will continue. The conservator will have a general power to repudiate contracts subject to certain statutory provisions regarding damages for such repudiation.

2. Treasury Senior Preferred Stock Purchase Agreement

The Enterprises have debt and mortgage backed securities outstanding of about $5 trillion held by central banks and investors around the world. Treasury noted that investors purchased these securities, in part, because ambiguities in their congressional charters created a perception of government backing, which compels the US government to act in order to avert wide-scale systemic risk. Accordingly, exercising its authority under the Recovery Act, Treasury has entered into a senior preferred stock purchase agreement with both of the Enterprises to ensure that the Enterprises operate with positive net worth.

Under the agreements, which have an indefinite term, the Treasury will be authorized to purchase up to $100 billion in senior preferred stock from each Enterprise in order to maintain a positive net worth for the Enterprises. This amount was selected to demonstrate the government's commitment, rather than as a result of an analysis of their current financial condition. Treasury made an immediate $1 billion investment in senior preferred stock of each Enterprise.

Key elements of the stock purchase agreement include the following:

- The Treasury will receive warrants for the purchase of common stock of the Enterprises representing 79.9% of the common stock of each Enterprise on a fully diluted basis at a nominal price.
- Senior preferred stock will carry a 10% dividend rate per year. This rate will increase to 12% if in any quarter the dividends are not paid in cash until all accrued dividends are paid.

- Beginning in March 2010, the Enterprises will be required to pay a yet-to-be determined quarterly fee to Treasury to compensate Treasury for its financial support.

- Each Enterprise's retained mortgage and mortgage backed securities portfolio may not exceed $850 billion as of December 31, 2009, and must decline by 10% until it reaches $250 billion. Fannie Mae and Freddie Mac reported retained mortgage and mortgage backed securities holdings of approximately $740 billion and $760 billion, respectively, as of June 30, 2008.

- Each Enterprise will be subject to certain covenants restricting its activities and operations.

3. GSE Credit Facility

Treasury announced that it will make available a Government Sponsored Enterprise Credit Facility ("Facility") to provide secured funding on an as needed basis to the Enterprises and the Federal Home Loan Banks ("FHLBanks"). The Facility will be available until December 31, 2009.

Loans from the Facility must be collateralized by Freddie Mac or Fannie Mae guaranteed mortgage backed securities or, in the case of FHLBanks, by advances to members. Loan maturities are expected to range from one week to one month. The rate on the loans is expected to be LIBOR plus 50 basis points.

4. GSE Mortgage Backed Securities Purchase Program

Treasury also announced that in an effort to improve the availability of mortgage credit and to mitigate pressures on mortgage rates, it was beginning a new program to purchase mortgage backed securities guaranteed by the Enterprises. The purchases will be made under the authority granted to it in the Recovery Act, which remains in effect through December 31, 2009. Treasury indicated that it will begin these purchases later in the month, and that the purchased securities can be held through maturity.

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