ALSTON + BIRD LLP

Financial Services and Products ADVISORY

September 8, 2008

Fannie Mae and Freddie Mac Placed in Conservatorship

Yesterday, the Treasury Department and the Federal Housing Finance Agency (FHFA) placed Fannie Mae and Freddie Mac (collectively, GSEs) in conservatorship and took several other actions designed to shore up the financial condition of both GSEs. Common and preferred shareholders of the GSEs will lose a substantial portion — but not necessarily all — of their equity interests, but creditors will be protected. Treasury has not yet actually paid government funds to either GSE, but taxpayers ultimately could be at risk for as much as $200 billion.

We describe below the key legal elements of the actions, followed by a discussion of the financial impact on the GSEs, other participants in the secondary mortgage market and the federal government. The plan will be analyzed by economic historians for decades to come, but we offer a few broader, immediate conclusions as well.

The Actions

The actions of Treasury and the FHFA are based largely on powers granted to Treasury and the FHFA in the Housing and Economic Recovery Act of 2008 (HERA),[1] which was enacted just five weeks ago. At the time, Treasury stated that it did not intend to use its new financial assistance powers, but events — among them, indications that foreign central banks and other foreign entities could pull back from investments in GSE bonds— have superseded that view.

From a legal perspective, there are five elements to the agencies' actions:

- **Conservatorship.** The director of FHFA has appointed the FHFA itself as conservator of both GSEs. These conservatorships are similar to a conservatorship for a depository institution: The conservator succeeds to all the rights, titles, powers and privileges of the stockholders, officers and directors. FHFA has replaced the CEOs of both GSEs and exercises all voting power of the GSEs' stockholders. As conservator, the FHFA has authority to take all "necessary

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[1] Pub. L. No. 110-289. For additional information, see Alston & Bird's *Financial Services and Products Advisories* titled "President Signs Housing Bill; Significant Regulatory Decisions Must be Made in Coming Months," available at http://www.alston.com/files/Publication/8fb27e86-64dd-4308-aa59-dbf3e0bdad24/Presentation/PublicationAttachment/b0c221ed-2efa-4360-a162-e5c331df9665/Housing%20Reform%20Bill%20Advisory.pdf (July 30, 2008), and "House Passes Major Housing and GSE Reform Legislation," http://www.alston.com/files/Publication/08b1d3be-f488-449d-b5c9-a229d2f86ba5/Presentation/PublicationAttachment/73255d06-de7f-4b03-a512-a8c195ffa6f7/Housing%20Reform%20Bill%20Advisory.pdf (July 23, 2008).

and appropriate" actions to carry on the business of the GSEs and restore them to soundness and solvency.

As a technical matter, the conservatorship appears to be based on section 1369(a)(2) of the Financial Housing Enterprises Financial Safety and Soundness Act of 1992,[2] rather than on the more recent conservatorship and receivership powers contained in HERA that relate to specific capital levels. The FHFA has said that a receivership — a not uncommon consequence of a depository institution conservatorship — would, for either of the GSEs, require an Act of Congress, but the FHFA does have authority to appoint a receiver if a GSE becomes "critically undercapitalized."

- **Senior Preferred Stock and Other Securities.** Treasury entered into Senior Preferred Stock Purchase Agreements (the "Agreements") with both GSEs pursuant to which Treasury has committed to purchase up to $100 billion of senior preferred stock of the GSE. In exchange for entering into the Agreements and making these commitments, Treasury received $1 billion of senior preferred stock of each GSE and warrants to purchase up to 79.9 percent of the common stock of each, on a fully diluted basis. The exercise price for the warrants is one one-thousandth of a cent ($0.00001) per share. Treasury also obtained contractual commitments from the GSEs to reduce the sizes of their retained mortgage and mortgage-backed securities portfolios over time, as described below.

  Going forward, Treasury will ensure that each GSE maintains a positive net worth. If FHFA determines that either GSEs' liabilities exceed its assets, Treasury will contribute cash capital in an amount equal to the deficiency in exchange for additional senior preferred stock. Though subordinate to outstanding debt, the senior preferred stock is senior to "all other [outstanding] preferred stock, [outstanding] common stock or other capital stock to be issued by the GSE." The Agreements are indefinite in duration with a maximum capacity of $100 billion for each GSE.

  Because the Agreements and the senior preferred stock have the following features, they are deemed to protect taxpayers:

  – liquidation preference that is senior to all other preferred stock and all common stock;
  – upfront $1 billion issuance of senior preferred stock with a 10 percent dividend rate, payable quarterly in cash;
  – suspension of all dividends on other preferred and common stock;
  – warrants representing an ownership stake of 79.9 percent in each GSE;
  – certain operational and budgetary restrictions, such as consent for additional capital infusions and limitations on new borrowings; and

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2 See 12 U.S.C. § 4619(a)(2).

– a quarterly fee for support provided by Treasury under the Agreements beginning in March 2010, payable either in cash or in additional shares of senior preferred stock.

- **Secured Lending Facility.** Relying on its temporary authority under section 1117 of HERA to purchase obligations of the GSEs, Treasury will offer to the GSEs — and to the Federal Home Loan Banks — short-term loans (generally, one week to one month) from its general fund at the Federal Reserve Bank of New York. Any borrowings from the facility must be collateralized with GSE-issued MBS or with Federal Home Loan Bank advances. Over-collateralization appears to be a likely requirement, but the amount of over-collateralization will depend on a particular loan. The rate on such a loan ordinarily will be the daily LIBOR fix for a comparable duration, plus 50 basis points. By statute, the facility expires at the end of 2009.

- **Treasury Purchases of MBS.** Section 1117 of HERA also authorizes Treasury to purchase other obligations — including mortgage-backed securities — that are issued by the GSEs. The authority to purchase extends only until December 31, 2009, but Treasury is not required to divest MBS purchased before that date. Later this month, Treasury will begin to make such purchases in the open market, although it appears to have statutory authority to purchase directly from the GSEs as well.

  Section 1117 does not impose dollar limits on purchases of MBS, but it does require Treasury to take several factors into account, including a priority or preference for payments to the government, limits on maturities, the issuing GSE's plan for orderly resumption of private funding, restrictions on dividends and executive compensation payments, and the need to maintain the GSEs' status as private, shareholder-owned companies. Treasury also must report to several Senate and House committees on its MBS purchases. These considerations and reporting requirements also apply to loans under the Secured Lending Facility.

- **Limits on Portfolios of GSEs.** The mortgage loan portfolios of Fannie and Freddie currently are slightly above $750 billion and just under $800 billion, respectively. FHFA will allow the portfolios to grow slightly, to $850 billion each, by the end of 2009. (As a result of some of the other actions taken, this growth will not be constrained by capital considerations.) Beginning in 2010, the GSEs would be required to shrink their portfolios by 10 percent annually, until they reach $250 billion, a process that could take 12 years. Of all of the actions announced yesterday, the achievement of these portfolio goals seems the most doubtful. A new administration will be in place early next year and could easily change or lift the near-term or long-term caps.

Impact

The actions of Treasury and the FHFA will have important consequences for all participants in the secondary mortgage market, including investors, creditors, mortgage originators and borrowers, taxpayers, and even participants in the derivatives markets.

- **Stockholders.** The common and preferred shareholders of both GSEs have lost, at least temporarily, their voting rights (which the FHFA has assumed) and any dividends. They retain their equity rights in the GSEs, but they are subordinated to the senior preferred issued to Treasury, as well as to all creditors. If the GSEs recover, the shareholders could be significantly diluted, on the order of 20 percent, if Treasury exercises its warrants. As a result of these factors, the trading prices of the GSEs' common and preferred shares have fallen sharply.

  Banks or thrifts that currently hold material amounts of common or preferred stock of Fannie or Freddie should contact their federal regulator. While Treasury has determined that only a limited number of smaller institutions hold positions in either GSE that are "significant compared to their capital," the Federal Reserve, FDIC, OCC and OTS issued a joint press release on Sunday reminding institutions that unrealized losses on GSE stock must be deducted from regulatory capital, and announcing that they will work with institutions to prepare appropriate capital restoration plans if losses on GSE stock causes them to become less than well-capitalized.[3]

- **Bondholders.** The actions do not affect the legal rights of bondholders, but there is a very significant practical effect. Treasury and FHFA have now made explicit the longstanding implicit guarantee of the debt obligations of the GSEs. Treasury and the FHFA have committed to making payments of principal and interest on all debt obligations of the GSEs. Accordingly, these creditors are in a much stronger financial position than they were before the actions were announced.

- **Sellers to the GSEs.** The effects on mortgage originators will be a little harder to calibrate but should be somewhat favorable, at least in the near term. On the one hand, the assurances to the bondholders about repayment will reduce the GSEs' cost of funds, which in turn should cause mortgage rates to fall and create a somewhat greater supply of mortgage financing. On the other hand, the portfolio caps — whose permanence may be doubtful — may limit the ability of originators to sell conforming loans to Fannie and Freddie.

- **Mortgage Borrowers.** The effect on borrowers is likely to be a derivative of the effect on originators. Mortgage rates appear likely to decline, thus helping to bolster the housing market — one of the aims of Treasury. In light of the portfolio caps, however, the GSEs are not an open-ended source of cheaper mortgage financing.

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3 See Joint News Release, "The Federal Banking Agencies React to Takeover of Fannie Mae and Freddie Mac," http://www.fdic.gov/news/news/press/2008/pr08078.html (Sept. 7, 2008).

- **Derivatives Markets.** The conservatorships likely constitute a "credit event" under the numerous credit default swaps and other derivatives transactions referencing the GSEs' triggering settlement payments between the parties. The International Swaps and Derivatives Association (ISDA) has already begun the process of preparing settlement protocols.

- **Taxpayers.** At the moment, Treasury has not yet placed any taxpayer funds at risk. It is poised to do so, however. Treasury will fill whatever shortfall there is between assets and liabilities at each GSE, up to a maximum of $100 billion for each GSE. The Secured Lending Facility also exposes Treasury and the taxpayers to the GSEs' credit risk, although this should be ameliorated largely through collateral. In a more optimistic vein, Treasury's actions — the purchase of the senior preferred stock, the lending facility and the open market purchase of MBS — are all structured to offer the possibility of some gain to the taxpayers. Indeed, if the housing market recovers, there is a reasonable prospect taxpayers would not lose money.

A Few Observations

The actions of Treasury and the FHFA have three stated objectives, first articulated in section 1117 of HERA: providing stability to financial markets, supporting the availability of mortgage finance, and protecting taxpayers. In the first business day after the actions were announced, a measure of stability appears to have been achieved, at least insofar as the actions allay the fears of foreign central banks and foreign funds about the credit quality of the GSE's bonds. Whether either of the other two goals will or can be achieved is far more difficult to say. Mortgage rates on conforming loans seem likely to decline in the near term, but if the ultimate aim is for a private (rather than government-sponsored) secondary market, the actions of yesterday would not appear to enhance private activity. As for taxpayers, Treasury effectively is now making its own bet on the housing market. Unlike other investors in the housing and mortgage markets, Treasury is in a position to influence its own bet, but the taxpayer contribution to the financial crisis remains to be seen.

From a Washington point of view, the actions of yesterday have already drawn some fire from Democrats. Barring catastrophe, further meaningful government action is unlikely this year, but (regardless of the outcome of the Presidential race) Congressional hearings and additional proposals are likely next year.

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