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November 15, 2018

Alfred M. Pollard, General Counsel
Attention: Comments/RIN 2590–AA95
Federal Housing Finance Agency
400 Seventh Street SW, Eighth Floor
Washington, DC 20219

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

Dear Mr. Pollard,

We appreciate the opportunity to comment on FHFA's Proposed Rule on Enterprise Capital Requirements (the "Proposed Rule"). Pershing Square's current investment in Fannie Mae and Freddie Mac ("Fannie" and "Freddie," respectively, and collectively the "GSEs" or the "Enterprises") began in the fall of 2013. Since that time, we have been one of the largest private common stockholders of each of the GSEs, aligned with the United States Treasury, which continues to hold warrants for 79.9% of the common stock of both companies. While most of our investment in the GSEs is in the form of common stock, we are also a sizeable investor in the junior preferred stock of each Enterprise. We are pleased that FHFA is soliciting feedback from market participants regarding adequate capital levels for the Enterprises, which have been near zero since conservatorship began over a decade ago.

Necessary Conditions to Raise Capital

Implicit in the Proposed Rule and to meet all interested parties' shared goal of preventing another episode of government intervention, the GSEs must raise capital. If, for example, the GSEs are required to maintain capital at 2.5% of total assets for their single-family guarantee business, they would need to raise approximately $120 billion to support this business alone, through a combination of retained earnings and new capital raised in the public markets. This would require one of the largest issuances of common and preferred equity in history.

In order for such an unprecedented capital raise to be feasible, we believe that current investors in Fannie and Freddie must be treated fairly, as new investors will be highly skeptical as to how they will be treated if the ultimate outcome is poor for legacy shareholders of the GSEs. New investors must also have visibility into the long-term earnings power of Fannie and Freddie so that they can reasonably estimate the valuation of each Enterprise. To maximize such visibility, required capital ratios should be fixed rather than dynamic, and should balance the objective of a fortress balance sheet with the need to deliver market returns to investors and affordable

mortgage rates to consumers. There are also several aspects of the Proposed Rule that must be eliminated if new capital is to be raised, including procyclicality and excessive conservatism.

Fair Treatment

In order for the Enterprises to successfully raise the new private capital contemplated by the Proposed Rule, we believe that legacy investors in Fannie and Freddie must be treated fairly. No new investor will invest in Fannie and Freddie unless historic investors are protected from, and compensated for, the expropriation of profits from the two companies that took place with the Net Worth Sweep that has extracted more than $237 billion of profits from the Enterprises since it took effect on January 1, 2013.(1) This amount represents a return to Treasury greater than the bargained for 10% interest rate on its Senior Preferred Stock investment, including complete repayment of the $191 billion invested by Treasury in the Enterprises.(2)

Wall Street's memory of injecting tens of billions of dollars into Fannie and Freddie just prior to their conservatorship ($24.6 billion of new junior preferred and common equity capital was raised in 2007 and 2008), and the expropriation of both companies' profits forever, just as they began to turn profitable, is still fresh. Completing the largest capital raise in history in a newly restructured Fannie and Freddie will not be achievable unless and until investors in the companies are treated fairly and receive commitments that the extra-legal action of the past will be reversed and not recur. Moreover, there is likely to be considerable overlap between the current and historic shareholder base of the Enterprises and the group of institutions that is willing and able to invest in a new capital raise.

Visibility and Transparency

If new capital is to be raised, private market investors will require and must have visibility into the long-term earnings power of Fannie and Freddie so that they can reasonably estimate the valuation of each Enterprise. This visibility decreases as complexity increases around key assumptions such as required capital levels, making the feasibility and cost of a recapitalization more challenging. To that end, we recommend that required capital ratios be fixed rather than dynamic, and would advocate abandoning the Risk-Based Capital ("RBC") framework entirely, and requiring the Enterprises to solely meet the Minimum Leverage Capital Requirement ("MLC"). We do not believe that investors will be able to estimate long-term earnings power under the RBC framework, as the dynamic nature of the RBC calculation makes future required capital levels impossible to predict. The RBC is procyclical, as discussed further below, and would cause the Enterprises to hold less capital as the housing market improves and approaches a peak, and more capital as the housing market declines and approaches a trough. The RBC is also overly complex in general, requiring 49 pages and 28 tables in the Proposed Rule. The MLC, by contrast, is inherently simple and would require the Enterprises to always hold a reasonably conservative ratio of capital.

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(1) Includes $6.6 billion of dividends that are expected to be paid to Treasury by December 31, 2018. Total cash dividends paid to Treasury since conservatorship began in 2008 including the December 2018 payments are $292 billion, while cumulative cash invested in the Enterprises by Treasury is $191 billion.

(2) Includes $187 billion invested prior to the Net Worth Sweep and $4 billion invested in December 2017 in conjunction with corporate tax reform.

We view as reasonable both (i) MLC Alternative 1 of a flat 2.5% of total assets and off-balance sheet guarantees and (ii) MLC Alternative 2 of 1.5% for trust assets and 4% for non-trust assets. Since we first publicly shared our views on this issue in May 2014, we have advocated a required capital ratio for Fannie and Freddie in-line with MLC Alternative 1. MLC Alternative 1 is both simpler and more conservative since the amount of non-trust assets vastly exceeds the amount of trust assets, while MLC Alternative 2 has the advantage of incentivizing the Enterprises to minimize their holdings of non-trust assets. Equity capital of 2.5% would amount to approximately 2.6 times the cumulative losses in the GSEs' single-family guarantee business during the Global Financial Crisis ("GFC").[(3)] If one adjusts historical results to exclude credit losses from subprime and Alt-A mortgage-backed securities ("MBS"), which the GSEs no longer issue, required capital of 2.5% would amount to nearly 4.5 times cumulative GFC losses. The GSEs' historical required capital levels of 45 basis points would have been nearly sufficient during the GFC absent over-provisioning and the issuance of MBS backed by subprime and Alt-A loans. MLC Alternative 1 is over five times this amount.

Claims Paying Resources

While required capital of 2.5% would create a fortress balance sheet on its own, equity capital is not the only source of funds that the Enterprises will have to meet future claims. The total claims-paying ability of the Enterprises, which we refer to as Claims Paying Resources ("CPR") is derived from equity capital plus the tens of billions of dollars of recurring cash flows that the GSEs will collect on their existing book of business, as well as the Enterprises' ability to write new business at higher market shares and credit quality during and after a crisis or downturn.

Although it is a stated objective of the Proposed Rule to not count future Enterprise revenue as capital, we believe it is imprudent to ignore the future revenue that Fannie and Freddie will earn when thinking about whether the GSEs will be able to continue operating in a crisis. Fannie and Freddie's combined single-family guarantee portfolio generated net guarantee fees[(4)] of $18.4 billion in 2017, over three times the administrative costs incurred to operate this business. This guarantee fee income should continue to grow at a mid-single-digit rate over the next several years as guarantee fees on newly issued MBS are higher than those on older MBS, and as the size of their guarantee portfolios increases along with the total amount of residential mortgage debt outstanding. The Enterprises are contractually entitled to collect this guarantee fee revenue on their existing book of business until the underlying mortgages are fully repaid. We estimate that future revenues from the existing book are worth approximately $50-$75 billion on a present-value basis, equating to ~130 basis points of the existing single-family guarantee portfolio at the midpoint.[(5)]

While credit quality of the existing book of business often worsens during a crisis, this is partially offset by superior volumes and economics on new business. Typical dynamics during and after a housing crisis include falling home prices and interest rates, tighter underwriting

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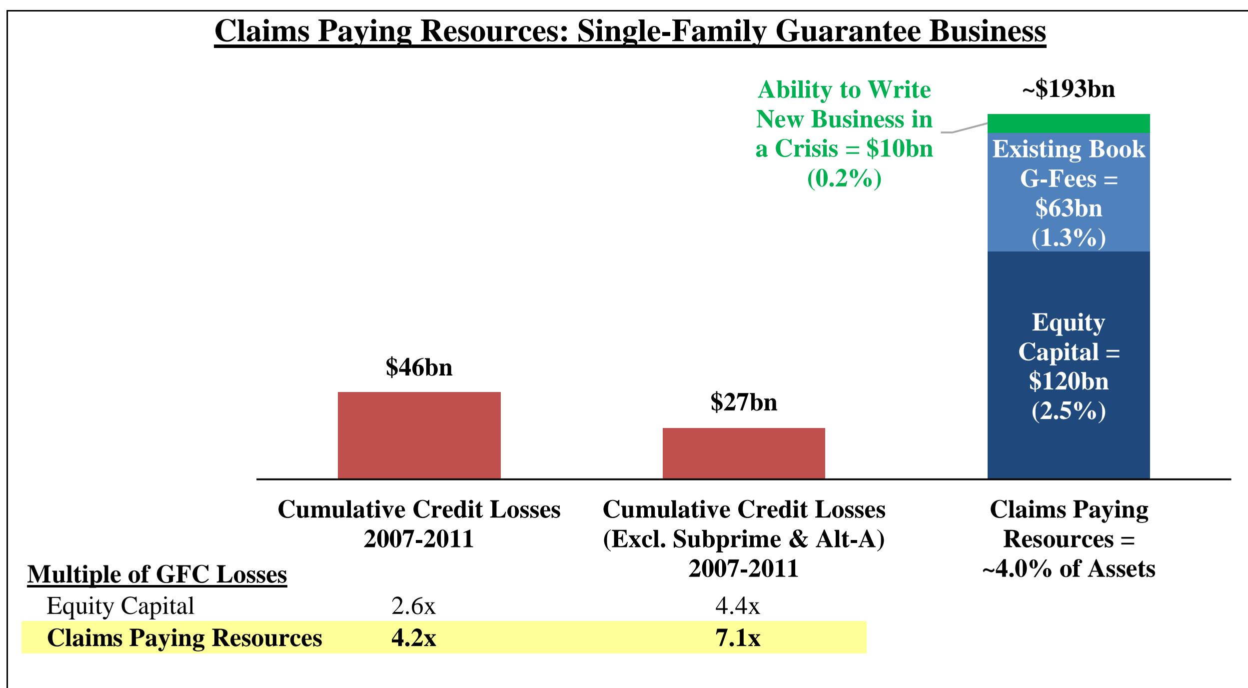
[(3)] Data is based on actual credit losses incurred and excludes provisions of $92 billion that were subsequently reversed.
[(4)] Net of the 10 basis point pass-through guarantee fees remitted to Treasury under the Temporary Payroll Tax Cut Continuation Act of 2011.
[(5)] Based on a 2018 estimated combined average single-family guarantee portfolio of $4.8 trillion, net guarantee fees equal to the 2018 estimated averages for each Enterprise, a discount rate equal to current MBS yields, and average portfolio turnover between 11%-17%.

standards, and higher market shares for Fannie and Freddie. During the GFC, Fannie and Freddie were a critical source of funding for the housing market as other institutions reduced their roles or exited the market, with the combined share of residential mortgage originations held or guaranteed by the Enterprises increasing from 27% in 2006 to 70% in 2009. Their market shares increased during the years when credit quality was highest – Fannie's cumulative default rate for conventional single-family loans guaranteed in 2006 is over 13.5%, while the cumulative default rate for the 2009 vintage is less than 1%. Much like a well-capitalized insurance company that can weather a hundred-year storm, a crisis causes losses on existing holdings for Fannie and Freddie, but provides them with bountiful amounts of new business at higher levels of profitability. While difficult to quantify precisely, we estimate that this unique ability to write new business during a crisis enhances the CPR of the Enterprises by approximately $10 billion, or 20 basis points of the existing single-family guarantee portfolio.[6]



When accounting for all components of Claims Paying Resources, the Enterprises would have capital and future revenues worth over $190 billion, or 4.0% of assets and guarantees, to meet claims and continue operating during a downturn if they adopt MLC Alternative 1 as their capital standard. This equates to over *seven times* the losses that the Enterprises incurred in their single-family guarantee business during the GFC excluding subprime and Alt-A loans. We believe this would be a truly fortress balance sheet in any economic environment. The RBC is an unnecessary addition to the capital framework for the Enterprises and would be problematic for several reasons, most importantly procyclicality.

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[6] Assumes a 23% increase in the size of the combined single-family guarantee portfolio due to market share gains, similar to what occurred during the GFC, net guarantee fees of 50 basis points, average portfolio turnover of 14%, and a discount rate of 8%.

Procyclicality
The Risk-Based Capital ("RBC") requirements in the Proposed Rule are procyclical in that they require the GSEs to hold a decreasing amount of capital as home prices increase and, conversely, an increasing amount of capital when home prices are falling. This rule would disincentivize the Enterprises from raising capital in good times when it is likely to be cheapest and least dilutive to existing owners, and would likely force them to raise large and increasing amounts of capital at unattractive prices and on unattractive terms during downturns, terms far worse than would have been available during a more stable or improving housing market. In a sudden or extreme downturn, the GSEs might be unable – temporarily – to raise the capital needed under the RBC, thereby precipitating a needless crisis in the entire mortgage market and likely the broader economy. Just when the GSEs should be providing stability, their obligations under the RBC could force them to take actions which would amplify the deterioration in the housing and mortgage markets.

The primary cause of this procyclicality is that the RBC requirements use dynamic, current loan-to-value ratios when calculating credit risk, rather than the fixed, original loan-to-value ratios ("OLTVs") that have been used since the RBC standards were last revised in 1992. OLTVs are by far the superior input as they (i) do not exhibit the procyclicality inherent in current loan-to-value ratios, (ii) allow the Enterprises to price their guarantee fees efficiently since the capital that they must hold over time to account for credit risk is a known quantity, and (iii) become increasingly *more* conservative over the long-term as the underlying loan pools season since mortgage balances decrease as principal is repaid and home prices appreciate. We urge FHFA to allow the Enterprises to continue using OLTVs and to eliminate any other factor in the RBC framework that causes the capital required for credit risk to increase as home prices fall, and vice-versa. If this element of the Proposed Rule is not remedied, we believe it will be virtually impossible to raise the private capital necessary to emerge, as no rational investor would take the risk of being wiped out by a massively dilutive equity issuance during a downturn. Even if the initial recapitalization is achieved, we believe that in a housing downturn or crisis, the RBC would cause the GSEs' required capital to ratchet up to a level that private investors will refuse to fund, necessitating another taxpayer bailout.

The treatment of credit risk transfers ("CRT") is another element of the Proposed Rule that is a source of procyclicality. While we believe some degree of capital relief for CRT is appropriate if the Enterprises continue to be mandated to engage in these transactions, CRT will never be an effective substitute for equity capital. The two major disadvantages of CRT are (i) procyclicality as CRT investors participate only on an "at will" basis and, during a housing downturn, are likely to either demand exorbitant pricing for new business or leave the market entirely, and (ii) the various tranches of CRT are not cross-collateralized. If there are losses on a single pool of loans that exceed the protection offered by the CRT tied to that pool, CRT issued on other, more creditworthy pools cannot be used to offset those losses. By comparison, equity capital is by its nature fully cross-collateralized. We are also cautious about reliance on CRT in general as it is a relatively recent innovation that has never been tested in a crisis.

Whether the RBC, MLC, or both rules are ultimately adopted, it is imperative that the Enterprises not be forced to raise capital at extremely dilutive prices during a downturn. As housing downturns are typically short-lived and the GSEs are highly cash-generative businesses

with billions of dollars of in-place recurring cash flow, the Enterprises should be allowed to suspend dividends and rebuild capital through retained earnings should capital fall below required levels.

Excessive Conservatism

While we agree that Fannie and Freddie should have fortress balance sheets, we believe this objective must be balanced with the need to deliver affordable mortgage rates to consumers and market returns to investors once the Enterprises exit conservatorship. To that end, we believe that adding the going-concern buffer of 75 basis points as well as the operational risk capital requirement of 8 basis points in calculating required capital under the RBC framework is overly burdensome. The stated objective of the going-concern buffer, the more material of the two charges, is to provide "the Enterprises with sufficient capital to continue operating for one to two years after a stress event without external capital support."(7) We do not believe an infusion of capital for this purpose will ever be necessary due to the enormous Claims Paying Resources of the Enterprises, which would equate to roughly 4.0% of assets and guarantees under MLC Alternative 1. The additional value provided by future revenues on the existing book of business as well as the ability to write new business in a crisis equates to approximately 1.5% of assets and guarantees, nearly double the 83 basis-point combined charge for the going-concern buffer and operational risk under the RBC. These redundant charges should be eliminated from the RBC if it is ultimately part of the final rule. As we, however, have explained previously, we would strongly advocate abandoning the RBC framework in favor of the MLC.

Additional Necessary Measures

While development of the Proposed Rule is a good first step, we urge that the following actions be taken immediately to ensure that taxpayers are not in a first-loss position in the next housing downturn:

(i) FHFA should direct the GSEs to submit Capital Restoration Plans, as authorized by the Housing and Economic Recovery Act of 2008; and

(ii) Treasury and FHFA must terminate the Net Worth Sweep so that Fannie and Freddie can begin to rebuild capital beyond the current $3 billion limit for each Enterprise, which is woefully inadequate in light of their more than $5 trillion of outstanding guarantees and other liabilities.

Sincerely,

William A. Ackman

(7) Page 10 of FHFA slide deck describing the Proposed Rule, June 19, 2018.