Fannie Mae: Here's what plaintiffs want in the GSE court cases

Feb. 10, 2020 Update: In a note today, bank analyst Dick Bove provided details of two events Odeon Capital Group held last week to discuss Fannie Mae and Freddie Mac. Based on conversations with one of the lawyers for the plaintiffs in the cases against the government-sponsored enterprises and an industry consultant, Bove said the plaintiffs want several things if they win all the major court cases.

For example, they want the Senior Preferred stock issue to be eliminated. They also want the courts to rule that the dividend requirements pertaining to the Senior Preferred shares have been met and no more payments are required. They also want to keep Fannie Mae and Freddie Mac from having to pay commitment fees that were suspended. Additionally, they want a $30 billion fee to be paid to the two GSEs over time by eliminating taxes up to that amount or eliminating future fees up to that amount.

Bove noted that litigants are not demanding any payments be made to shareholders. The view is that if the

Senior Preferred shares are gone, Fannie and Freddie will be able to produce significant earnings. From those earnings, the GSEs can then pay dividends and hold a new initial public offering.

IPO upcoming?

He expects the Federal Housing Finance Agency to produce a new capital rule soon. He also looks for a consent agreement to allow Fannie Mae and Freddie Mac to return to the public market outside their conservatorships. The agreement should also allow them to operate without the required capital until the desired level is achieved.

Bove notes that advisors close to the Treasury secretary are being put in place, and the GSEs themselves must make plans for their own initial public offerings. He doesn't expect anything to be rushed through before the election. Recapitalization and release from conservatorship still seem to be two years away.

Feb. 7, 2020 Update: The Federal Housing Finance Agency awarded a contract to Houlihan Lokey Capital to help figure out a timeline for the privatization of Fannie Mae and Freddie Mac. The move signals the agency's plan to keep moving forward despite the cases that are pending in the nation's court systems.

Privatizing Fannie Mae

Appointing an investment bank to work on a plan is just the first step of many required to recapitalize and release the GSEs from conservatorship. **The Wall Street Journal** notes that one key next step will be to propose and then approve new capital guidelines. The guidelines will dictate how much capital Fannie Mae and Freddie Mac will have to maintain when they become independent.

In 2019, the Treasury Department started allowing the GSEs to retain some of their earnings. However, the size of their balance sheets means they will need more capital than just what is being retained from their earnings.

Other important questions that must be answered relate to how the federal government will remain involved in Fannie Mae and Freddie Mac after they are released from conservatorship. Anyone who invests in the companies after they are recapitalized will want clarity on how the government will back the mortgages they supply. One possibility is that the GSEs will have to pay some kind of fee in exchange for the government's commitment to backing their mortgages. However, such a fee would impact the flow of earnings to investors, so it will be a key issue.

Court case

Jan. 28, 2020 Update: Bank analyst Dick Bove published details on a presentation given by home finance expert Ed Pinto about the status of the mortgage industry and details about Fannie Mae's and Freddie Mac's business. Pinto's views highlight the challenges both government-sponsored entities will face if or when they finally exit conservatorship. The big concern for investors is how Fannie and Freddie will survive in a difficult business.

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Pinto believes the housing industry is stressed due to supply side issues related to finance and building practices. He also said Fannie Mae and Freddie Mac are currently being stripped of the products that have generated more than 75% of their business. If the GSEs were placed in the private market, he believes they would lose market share in a troubled industry.

If ignoring the housing issues and focusing on the investment cases for Fannie Mae and Freddie Mac, Bove feels that Pinto’s argument is much different from the view held by most investors. He doesn’t believe the senior preferred shares in the GSEs have been paid off, and he sees problems if the net worth sweep is eliminated, but the senior preferred shares are not.

“While this view is almost violently disputed by investors, it should be noted that every Treasury Secretary in the past 11 years agrees with Mr. Pinto,” Bove wrote. “The current Secretary has publicly stated that Fannie and Freddie have an obligation to the United States government.”

Bove suggested that one solution to the problem facing Fannie and Freddie is to leave all investors with common shares, whose value would be tied to the outlook for the housing industry and their positions in housing finance. He warned that neither of these outlooks suggests the stocks would be worth very much.

Jan. 14, 2020 Update: It sounds like the Supreme Court might refuse to hear the case involving Fannie Mae and Freddie Mac. The court didn’t take any action on the Collins case this past Friday, either positive or negative. Another conference is set for Friday, so it’s possible it will still agree to hear the case. However, bank analyst Dick Bove of Odeon Capital decided to take up the issue as if the Supreme Court chooses not to hear the case.

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In a note this week, he said the Collins case focuses on two main issues. The first is whether the position of the Federal Housing Finance Agency's director is constitutional. Even the constitutionality of the agency could be called into question. The second issue is whether the net worth sweep, which diverts almost all of Fannie Mae's and Freddie Mac's earnings to dividends paid to the U.S. Treasury, is valid.

According to Bove, if the Supreme Court ignores the Colins case, it is generally assumed that it will be because it wants to hear arguments on the constitutionality of the FHFA and the position of its director. Arguments on that issue are scheduled for March in the Seila case, which involves the Consumer Financial Protection Agency.

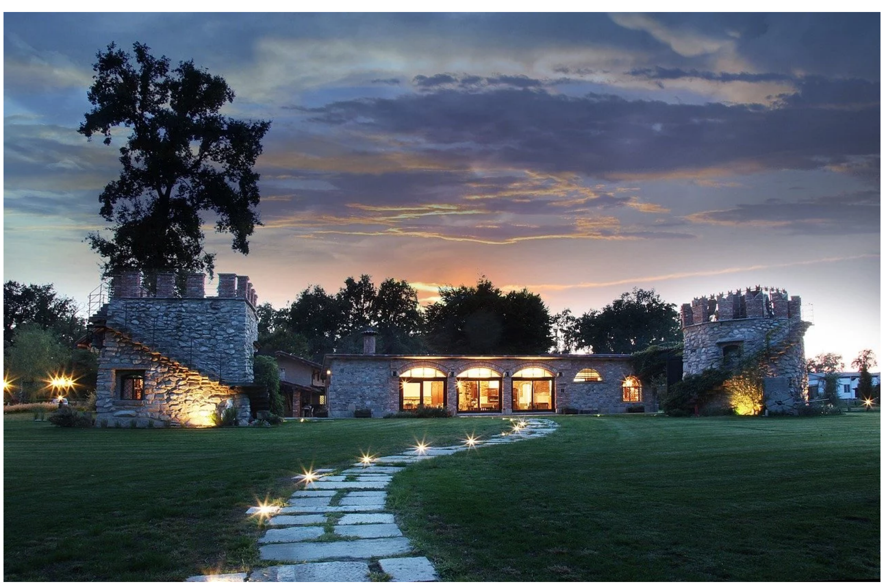
A lower court already ruled that the agency and its director are unconstitutional because they violate the separation of powers called for in the U.S. constitution. If the court upholds that ruling, it will impact the FHFA because the Fifth Circuit Appeals Court ruled in another case that the FHFA and its director are also unconstitutional. A ruling on that matter is expected in June, and after that, the Supreme Court may be able to decide on the net worth sweep.

Fannie Mae and federal court

The Collins case was already returned to the Houston Federal District Court, where the judge is being asked to review it a second time after initially dismissing it and siding with the government. If she changes her mind and sides with the plaintiffs, it will return to the Fifth Circuit, where the plaintiffs are expected to prevail over the net worth sweep.

Two other cases involving Fannie Mae and Freddie Mac are before the Federal Court in Washington D.C. and the Federal Claims Court. The trial in front of the D.C. Federal Court has been pushed back to March 2021, and the judge requested 70,000 documents to review. In the Federal Claims Court case, both sides are expected to set the terms of the debate and trial by Jan. 20, but it will likely take at least a year to review the discovery documents and arguments, so no ruling in the GSEs' cases is expected for quite some time, barring a decision from the Supreme Court soon.

Jan. 10, 2020 Update: Although Fannie Mae and Freddie Mac remain in conservatorship for the foreseeable future, that isn't keeping investors from thinking about what must happen for the GSEs to start offering public shares. Bank analyst Dick Bove published a list of several barriers they must overcome for their stock offering to be successful when they exit conservatorship.



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Settle the lawsuits

Perhaps the most obvious barrier is all the lawsuits that were filed over the GSEs' preferred shares. There are currently three major lawsuits pertaining to Fannie Mae, Freddie Mac, the Treasury Department and the Federal Housing Finance Agency. There are also many other cases that aren't as important.

The GSEs could owe tens of billions of dollars in penalties, fees and repayments, but it's too early to know what the courts will decide. New investors certainly aren't going to invest new funds without knowing how much money they will owe. However, Bove maintains that the plaintiffs will win the lawsuits over the preferred shares, so he wants to buy and hold those preferred shares of Fannie Mae and Freddie Mac.

The Fifth Circuit Appeals Court has already ruled that the FHFA director position is unconstitutional. The one thing that remains up in the air as far as the lawsuits go is the net worth sweep, which also must be settled before new capital will be invested. If the net worth sweep is ruled to be illegal, the government will probably appeal the ruling. A series of appeals means it could take years to settle just one of the lawsuits.

Bove believes the judge in the case in front of the Federal Claims Court has already ruled that the plaintiffs can sue the Treasury on behalf of Fannie and Freddie to recover the dividend payments that were made under the net worth sweep. However, the judge continues to try to force the government to hand over discovery documents, although those that have been turned over appear to suggest the **government lied to the federal courts**.

Documents made available in the Federal District Court also seem to suggest the government lied, so things do look good for the plaintiffs in the cases involving Fannie Mae and Freddie Mac. The Supreme Court has been asked to submit an opinion on the matter, and Bove believes it will also find in favor of the plaintiffs if it decides to review the case.

Get rid of the net worth sweep

Bove explained that many believe the net worth sweep has already been **eliminated** by the Fifth Circuit Court, but that's not true. Fannie Mae and Freddie Mac are still paying almost all their profits to the government, although they are supposedly allowed to rebuild their capital. The problem is that it's unclear how they can rebuild their capital if they continue to pay all of their earnings in dividends. It's hoped that the lawsuits will force the end of the net worth sweep, but for now, it remains in play.

Bove also believes the GSEs must get rid of their senior preferred stock without having to make a large payment. If they don't get rid of it, they will continue having to make large payments to the Treasury and won't be able to earn enough money to be good investments.

Other issues include creating a capital rule that allows the GSEs to grow and defining their business model. Bove also believes they must straight out their balance sheets, which he describes as "**fraudulent**," and obtain a consent decree allowing them to operate without the required amount of capital. He thinks they also require Congressional approval to allow for government backing on certain products, must eliminate special program payments to the Treasury, and must raise a lot of money.

Jan. 8, 2020 Update: When it comes to investing in Fannie Mae and Freddie Mac, much of the attention has been on the junior preferred shares, especially as the related lawsuits make their way through the court system. However, looking at the government-sponsored enterprises' as businesses through the lens of the mortgage market is less encouraging than the probable outcomes of the lawsuits filed over their preferred shares.

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Bank analyst Dick Bove released a report this week about the mortgage origination forecasts for this year, which were released in December. He cited numbers from *Inside Mortgage Finance*.

Forecasts do expect mortgage rates to rise over the next two years, so homeowners will not be incentivized to refinance. It's predicted that mortgage refinancing activities could fall by much more than 20% this year and next.

The view of home purchase mortgages is better than the refinancing outlook, but it still isn't great. Experts expect home purchase mortgages to grow 4% this year and 5% next year due to demographics.

Banks not selling their loans

Another problem for Fannie Mae and Freddie Mac is the fact that the nation's biggest banks with over $100 billion in assets aren't selling the mortgages they originate. Instead, they're holding onto them. Additionally, the Federal Housing Finance Agency is restricting the loans the GSEs can buy, which further reduces their potential market share. Bove calls this combination "a relatively doleful take for investing in the GSEs based on fundamentals."

Dec. 30, 2019 Update – A new year is dawning, and the future of Fannie Mae and Freddie Mac remains undecided. However, 2020 brings a number of important events that will have an impact on what happens to the GSEs. Bank analyst Dick Bove complied a list of key events that will impact Fannie and Freddie in 2020.

Image source **from and with permission** of Fannie Mae

Affected parties

Those who have been watching what happens to the GSEs will be especially paying attention to what the courts have to say about them. In the middle of January, the Supreme Court is expected to rule on whether it is willing to hear the important cases related to Fannie Mae and Freddie Mac. If the Supreme Court refuses to hear the cases, their shares will likely decline quite a bit. However, Bove expects the court to agree to hear them.

It will be a while before any major developments come from the Federal Claims Court. However, many will be watching the case there as arguments could begin in January. Washington's Federal District Court probably won't have any results until October.

Congress isn't expected to make any meaningful movements on the GSEs in 2020 either. However, Bove said the Democrats could continue pushing for the status quo to be continued rather than bringing Fannie Mae and Freddie Mac out of conservatorship.

It's expected that impeachment activities will overshadow major developments in the GSEs except for trade news. Much of the attention will be focused on the Federal Housing Finance Agency (FHFA) as it works on amending the capital rule.

The main event

Perhaps the most important event surrounding Fannie Mae and Freddie Mac during the first quarter will be the release of the new capital rule. Bove explained that the two main issues to be determined in regard to the capital rule are what constitutes assets and what constitutes capital.

According to him, "The **FHFA** has already indicated that it is willing to play fast and loose with those definitions. For example, its willingness to accept, as retained earnings, a dividend obligation of both companies leads one to believe that whatever the capital rule produced it is likely to extend, beyond credibility, generally accepted accounting principles."

Bove also said other important things to note include whether assets should be assessed in bulk or according to the mortgage category they fall into and whether market considerations should be part of the computation. He also noted that the rule should indicate whether the capital that's held should be procyclical or as a reserve.

It should also state whether the actual capital ratio should be variable or fixed and whether it should be set at levels consistent with the traditional banking industry, the mortgage industry or hypothetical stress tests.

The capital rule should also indicate whether other operational considerations should be factored in and if the ultimate ratio assumes government backing of the companies' debt or guarantees.

The ultimate ratio

Addressing these issues in the capital rule will determine just how profitable Fannie Mae and Freddie Mac will be. They will also influence the three biggest variables as the GSEs look to exit conservatorship. The variables include whether they will be able to offer value to investors, whether investors will be willing to put up the extra funds that are needed, and whether the build-up of retained earnings will meet the needs of the companies.

Bove emphasized once again that for those who care only about the preferred shares of Fannie Mae and Freddie Mac, only the outcomes of the court cases matter. However, those who want to profit off the common shares will care more about the outcome of the capital rule issue.

Dec. 19, 2019 Update: The future of Fannie Mae and Freddie Mac continues to hang in the balance amid debate over what should happen next.

Investors who hold the government-sponsored enterprises' junior preferred shares are depending on the court system to uphold their rights and eliminate the net worth sweep. However, Democratic lawmakers want everything to remain the way it is.

Democrats scrutinize Fannie Mae, Freddie Mac plan

A number of Democratic senators sent letters to the Federal Housing Finance Agency and the Treasury Department about the GSEs. The letters reveal that the senators don't want anything to change with Fannie's and Freddie's status in conservatorship. Bank analyst Dick Bove offered insight into the senators concerns in a note this week.

For example, they expressed concern that the secondary mortgage market will shrink under the current plan for Fannie Mae and Freddie Mac, and Bove believes it will. They are also worried about there being less funding for affordable housing, and Bove also believes there will be.

The senators were also concerned about a lack of clarity about whether the debt issuances and guarantees provided by the GSEs will be continued. They also wanted to know what Fannie's and Freddie's capital requirements will be and whether they will be released from conservatorship before they achieve those capital levels. Bove expects the requirement to be 2.5% of designated assets and that both GSEs will be released before they reach that level under a consent decree.

The senators also wanted to know whether the net worth sweep would be maintained, but Bove believes that is unlikely if they are released from conservatorship.

Depending on the courts

Because the Democratic senators want Fannie Mae's and Freddie Mac's status to be maintained, Bove believes it will depend on the courts to move forward the issue on when they will be released from their conservatorship. He added that despite "a great deal of brave talk" from the FHFA, he doesn't believe the GSEs will be released and recapitalization without several requirements.

He said the courts will have to take care of the lawsuits that are pending over the issue and get rid of the net worth sweep. Additionally, he also believes the courts will have to eliminate the senior preferred shares, which are owned solely by the government. Bove believes the 30-year fixed mortgage must also have a guarantee backed by the government and that "the atrociously improper account standards" put in place must be eliminated.

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"These letters to the Treasury and the FHFA are clear indications that the Democrats will resist the elimination of any of the above," Bove wrote. "Thus, as we have argued, the only place where one will find a solution to the current deadlock is in the court system."

He continues to expect the courts to eliminate the net worth sweep, which will begin negotiations anew. Investors who hold junior preferred shares have already seen signs of progress on their behalf as one of the courts declared the net worth sweep illegal. However, Bove has made much of what he calls the "accounting chicanery" going on at Fannie Mae and Freddie Mac, as both GSEs have had to pay the net worth sweep in the form of new shares to the government while stating on their financial reports that no dividends were paid.

Previously: There has been plenty of talk about Fannie Mae and Freddie Mac and the government's proposal to recapitalize them and release them from **conservatofrship**. However, not everyone may be familiar with the history of these two government-sponsored enterprises (GSEs) and the issues that face them. Bank analyst Dick Bove of Odeon Capital released a primer on Fannie and Freddie this week to help investors understand them and everything that's happening with them.

Fannie Mae and Freddie Mac: the basics

According to Bove, Fannie Mae has 1.158 billion outstanding common shares owned by the public, and another 131 million shares could be issued related to a convertible **preferred stock**, which also trades publicly. He estimates that 4.6 billion additional shares could be issued if the U.S. government converts the warrants it holds. The warrants do not trade because they are owned only by the federal government.

Freddie Mac has 650 million outstanding common shares. He estimates that another 2.6 billion shares could be issued if the government converts the warrants it holds.

Fannie has 16 outstanding preferred issues. The government owns the senior preferred shares, which do not trade. Ten of the junior **preferred shares** have rates between 4.75% and 8.375%. The Preferred S shares yield 8.375% and trade more than all of the other preferreds put together. The Preferred S shares have ranged in price from $5.23 to $14.30 per share over the last 52 weeks. Four of Fannie's preferred shares are variable rate, while one is a convertible preferred. Par value for nine of the junior preferreds is $50, while five have a par value of $25. The par value of the Preferred S shares is $25.

Freddie has 26 outstanding preferred issues, including a non-trading senior preferred issue owned only by the federal government. Twenty of Freddie's junior preferred issues have rates between 5% and 8.375%. Like Fannie's 8.375% issue, Freddie's also trades more than all the other preferred issues put together. The 8.375% issue has been trading between $5.23 and $14.30 per share over the last 52 weeks. Five junior preferred issues are variable rate. The par value of six of Freddie's junior preferreds is $25, while 18 of them have par values of $50 per share. There is no available data on one of the junior preferred issues, and the 8.375% issue has a $25 par value.

The U.S. Treasury's role in Fannie Mae and Freddie Mac

Bove said Fannie Mae borrowed $119.8 billion from the Treasury and has paid $181.4 billion in dividends. The GSE has a $113.9 billion open line of credit with the Treasury. Freddie Mac has borrowed $75.6 billion and paid $119.7 billion in dividends. Freddie's open credit line with the Treasury is $140.2 billion.

Both Fannie and Freddie guarantee mortgages originated by other firms. They both own mortgages, some of which are secured by the government, and they both own investment securities. Fannie reported $4.321 billion in pretax earnings for the second quarter, while Freddie reported $1.898 billion.

Treasury proposals

The U.S. Treasury recently **released a list of its proposals** to bring both GSEs out of conservatorship. The proposals include ending the collection of the current dividend based on sweeping earnings and establishing a plan to recapitalize and release them. The plan also includes guarantees on debt service payments on mortgage-backed securities they issue and some type of ETguarantee on payments for the 30-year fixed rate mortgages. The Treasury must also receive payment for the services it provided.

The Federal Housing Finance Agency agreed to end the profit sweep into the Treasury and wants to establish capital requirements for the GSEs which are well above current levels. The agency also wants to authorize more firms like Fannie Mae and Freddie Mac.

Congress could become involved at some point, but for now, the House of Representatives has no pending bills.

While the Senate does have one outline for recapitalizing and releasing the GSEs, it doesn't have any legislation in the works.

Court rulings on the GSEs

Complicating everything with the GSEs is some court cases filed over the net worth sweep of Fannie's and Freddie's profits into the Treasury. The Fifth Circuit Court in New Orleans ordered a lower court to reconfigure the basis of the Treasury dividends and declared the FHFA to be unconstitutional. The Supreme Court may step into this case.

The Federal District Court in Washington, D. C. has requested 70,000 documents from the government to be used in discovery. The court also requires a new trial on whether the FHFA and Treasury acted illegally by commandeering the GSEs' profits. If so, then penalties should be established in this case.

The Federal Claims Court has scheduled a hearing for Nov. 19 to hear the case about the government taking private property without just compensation.

Bove has said in other reports that he recommends buying Fannie's and Freddie's junior preferred shares because he believes the courts will side with shareholders. Because of his expectations, he believes buying the preferred shares now will be like getting a discount on common shares because they will likely be converted as part of the recapitalization process. Several hedge funds have benefitted from the steady increase in Fannie's and/or Freddie's preferred shares, including the **top-performing hedge fund of last week**.

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