

**September 7, 2008! Another Sunday Shocker, or Business as Usual?™**  
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**History Made: U.S. Takeover of the GSEs:** The Associated Press (AP) announced today, that President Bush acting to thwart the potential for major financial turmoil, that the federal government was taking control through a conservatorship of mortgage giants Fannie Mae (NYSE:FNM) and Freddie Mac.(NYSE:FRE). The AP reported that officials announced that the executives of both institutions had been replaced. Herb Allison, a former vice chairman of Merrill Lynch (NYSE:MER) (OTC:MERIZ) , was selected to head Fannie Mae, and David Moffett, a former vice chairman of US Bancorp (NYSE:USB) , was picked to head Freddie Mac. The GSE regulator, Jim Lockhart, (former Director of OFHEO, Office of Federal Housing Enterprise Oversight), is now the Director of the new independent regulator, the Federal Housing Finance Agency, FHFA.

**Another Sunday Shocker, or Business as Usual?** Today the GSEs were placed in the hands of the regulator, this time for real. As I reported last year, it was November 2007, New York City, where I had the pleasure of questioning industry and government leaders, including Director Lockhart regarding the mortgage crisis and the regulators' powers and limitations. That evening on the way to Mom's house on the Long Island Railroad, it was clear to me that a total restructuring of the regulators was in the cards, and that Director Lockhart was the likely leader. Today, September 7, 2008, I wake up to Mom's birthday, and same topic of conversation, but this time it's history.

At this SourceMedia Conference we had discussed the problems in the Shadow Banking System (www.shadowbanking.com), and of all the leaders, Director Lockhart clearly had a grip on its defects and solutions, at least as I perceived and presented them. I had to concede to Director Lockhart, that the limitations of the regulator over the GSEs at that time, was a serious problem. With the move by President Bush today, in taking over the GSEs, Director Lockhart now has the long needed authority and power to carry out his regulatory responsibilities.

Yes, this day marks a critical time in history. It's the first day of the rest of our new mortgage and financial banking system. The solutions start today.

When President Bush signed H.R. 3221 on July 30, 2008, (Housing and Economic Recovery Act of 2008, [www.procouncil.com/html/news.html](http://www.procouncil.com/html/news.html)), new powers were handed to the Treasury, the Federal Reserve and FHFA, including powers over the GSEs, Fannie Mae and Freddie Mac. The President had three critical objectives: "providing stability to financial markets, supporting the availability of mortgage finance, and protecting taxpayers – both by minimizing the near term costs to the taxpayer and by setting policymakers on a course to resolve the systemic risk created by the inherent conflict in the GSE structure."

Although, 3221 granted the power to the Treasury to make equity investments into the GSEs, the administration determined that such a move would not be sufficient in

recognition of the current economic situation of the markets and the GSEs. With a new regulator, with new and broad (banking type) powers, it was acknowledged that “the primary mission of these enterprises now will be to proactively work to increase the availability of mortgage finance, including by examining the guaranty fee structure with an eye toward mortgage affordability. To promote stability in the secondary mortgage market and lower the cost of funding, the GSEs will modestly increase their MBS portfolios through the end of 2009. Then, to address systemic risk, in 2010 their portfolios will begin to be gradually reduced at the rate of 10 percent per year, largely through natural run off, eventually stabilizing at a lower, less risky size.”

The U.S. Treasury Department Office of Public Affairs official statement went on to state, in select parts:

“Treasury has taken three additional steps to complement FHFA’s decision to place both enterprises in conservatorship. First, Treasury and FHFA have established Preferred Stock Purchase Agreements, contractual agreements between the Treasury and the conserved entities. Under these agreements, Treasury will ensure that each company maintains a positive net worth. These agreements support market stability by providing additional security and clarity to GSE debt holders – senior and subordinated – and support mortgage availability by providing additional confidence to investors in GSE mortgage backed securities. This commitment will eliminate any mandatory triggering of receivership and will ensure that the conserved entities have the ability to fulfill their financial obligations. It is more efficient than a one-time equity injection, because it will be used only as needed and on terms that Treasury has set. With this agreement, Treasury receives senior preferred equity shares and warrants that protect taxpayers. Additionally, under the terms of the agreement, common and preferred shareholders bear losses ahead of the new government senior preferred shares. These Preferred Stock Purchase Agreements were made necessary by the ambiguities in the GSE Congressional charters, which have been perceived to indicate government support for agency debt and guaranteed MBS. Our nation has tolerated these ambiguities for too long, and as a result GSE debt and MBS are held by central banks and investors throughout the United States and around the world who believe them to be virtually risk-free. Because the U.S. Government created these ambiguities, we have a responsibility to both avert and ultimately address the systemic risk now posed by the scale and breadth of the holdings of GSE debt and MBS. Market discipline is best served when shareholders bear both the risk and the reward of their investment. While conservatorship does not eliminate the common stock, it does place common shareholders last in terms of claims on the assets of the enterprise. Similarly, conservatorship does not eliminate the outstanding preferred stock, but does place preferred shareholders second, after the common shareholders, in absorbing losses. The federal banking agencies are assessing the exposures of banks and thrifts to Fannie Mae and Freddie Mac. The agencies believe that, while many institutions hold common or preferred shares of these two GSEs, only a limited number of smaller institutions have holdings that are significant compared to their

capital. The agencies encourage depository institutions to contact their primary federal regulator if they believe that losses on their holdings of Fannie Mae or Freddie Mac common or preferred shares, whether realized or unrealized, are likely to reduce their regulatory capital below "well capitalized." The banking agencies are prepared to work with the affected institutions to develop capital restoration plans consistent with the capital regulations. Preferred stock investors should recognize that the GSEs are unlike any other financial institutions and consequently GSE preferred stocks are not a good proxy for financial institution preferred stock more broadly. By stabilizing the GSEs so they can better perform their mission, today's action should accelerate stabilization in the housing market, ultimately benefiting financial institutions. The broader market for preferred stock issuance should continue to remain available for well-capitalized institutions. The second step Treasury is taking today is the establishment of a new secured lending credit facility which will be available to Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. Given the combination of actions we are taking, including the Preferred Share Purchase Agreements, we expect the GSEs to be in a stronger position to fund their regular business activities in the capital markets. This facility is intended to serve as an ultimate liquidity backstop, in essence, implementing the temporary liquidity backstop authority granted by Congress in July, and will be available until those authorities expire in December 2009. Finally, to further support the availability of mortgage financing for millions of Americans, Treasury is initiating a temporary program to purchase GSE MBS. During this ongoing housing correction, the GSE portfolios have been constrained, both by their own capital situation and by regulatory efforts to address systemic risk. As the GSEs have grappled with their difficulties, we've seen mortgage rate spreads to Treasuries widen, making mortgages less affordable for homebuyers. While the GSEs are expected to moderately increase the size of their portfolios over the next 15 months through prudent mortgage purchases, complementary government efforts can aid mortgage affordability. Treasury will begin this new program later this month, investing in new GSE MBS. Additional purchases will be made as deemed appropriate. Given that Treasury can hold these securities to maturity, the spreads between Treasury issuances and GSE MBS indicate that there is no reason to expect taxpayer losses from this program, and, in fact, it could produce gains. This program will also expire with the Treasury's temporary authorities in December 2009. At the end of next year, the Treasury temporary authorities will expire, the GSE portfolios will begin to gradually run off, and the GSEs will begin to pay the government a fee to compensate taxpayers for the on-going support provided by the Preferred Stock Purchase Agreements. Together, these factors should give momentum and urgency to the reform cause. Policymakers must view this next period as a "time out" where we have stabilized the GSEs while we decide their future role and structure. Because the GSEs are Congressionally-chartered, only Congress can address the inherent conflict of attempting to serve both shareholders and a public mission. The new Congress and the next Administration must decide what role government in general, and these entities in particular, should play in the housing market. There is a consensus today that these enterprises pose a systemic risk and

they cannot continue in their current form. Government support needs to be either explicit or non-existent, and structured to resolve the conflict between public and private purposes. And policymakers must address the issue of systemic risk. We make a grave error if we don't use this time out to permanently address the structural issues presented by the GSEs.”

To obtain and read a full copy of the three new and critical agreements, go to [www.procouncil.com](http://www.procouncil.com) and click on News ([www.procouncil.com/html/news.html](http://www.procouncil.com/html/news.html)).

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