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GSEs Reform: 5th Circuit Court Of Appeals Trumps Biased Media Reports

September 13, 2019

Friday, September 6, Fannie and Freddie common and preferred got pummeled, down 10 to 12% in an otherwise strong market, based on biased and inaccurate media accounts, including Bloomberg.

Around 5 p.m., the 5th Circuit Court of Appeals reversed a district court and ruled 9 to 7 in favor of shareholders. On Monday, September 9, common shares were up 42%, and preferred up 12%.

Tuesday September 10, the Senate Banking, Housing, and Urban Affairs committees heard Treasury Secretary Mnuchin, HUD Secretary Carson, and FHFA Director Mark Calabria. Common shares were down 12%, with preferred mostly unchanged.

I bought on Friday and Monday. I did not sell Tuesday. To understand what's next, here are quotes from the 5th Circuit Court: Sixteen hard-core judges in plain English.

Bottom line: A double is the key word. And sooner than later is the adjective.

This September 6 Bloomberg article, published at the closing bell, is a perfect example of biased news, which, unfortunately for the shorts, was too widely echoed. That said, the title does capture their gist:

Fannie-Freddie Fall as Trump Plan Shows Quick Windfall Unlikely.

Trump plan... windfall.

The first sentence:

...hedge funds minting riches on their investments giants.

Hedge funds.

Finally:

There might not be a windfall unless President Donald Trump wins re-election in 2020.

Trump's re-election.

In a nutshell: The president is in cahoots, this time with the bad hedge fund guys, to the detriment of We The People.

Of course, nothing of the sort transpires from the plan; to the contrary. This is simply a biased and unsubstantiated opinion. Actually, not *that* unsubstantiated; the authors do cite their source: Jim Parrott, "a former housing official during the Obama Administration." Unfortunately, the same Jim Parrott is cited on page 41 of the 5th Circuit Court of Appeals opinion, and plays an important role in the decision to reverse the district court, and favor the shareholders -- all

shareholders, not just the hedge funds -- and the public at large -- not just President Trump or his administration. You will find the synopsis below, but this one is worth citing twice:

A federal official commented privately that the Third Amendment was designed to prevent *Fannie and Freddie from recapitalizing." (page 12).[…] National Economic Council advisor Jim Parrott*, who worked with Treasury in developing the net worth sweep, allegedly wrote: *"[W]e've closed off [the] possibility that [Fannie and Freddie] ever[] go (pretend) private again.*" Similarly, when Bloomberg published a comment that "[w]hat the Treasury Department seems to be doing here, and I think it's a really good idea, is to *deprive [Fannie and Freddie] of all their capital so that [they can not go private again]," Parrott emailed the source: "Good comment in Bloomberg*—you are exactly right on substance and intent." *The emails reinforce that the Third Amendment "deprive[d]" the GSEs of their capital, keeping them in a permanent state of suspension, which is not authorized by statutory conservator powers.* The pleadings in Jacobs v. Federal Housing Finance Agency208 and Perry Capital LLC v. Mnuchin209 appear to lack similar allegations. *That factual difference distinguishes them."* (page 41)

And, to boot:

The net worth sweep transferred a fortune from Fannie and Freddie to Treasury. When this suit was filed, the GSEs had paid $195 billion in dividends under the net worth sweep. Under the Agreements more broadly, *Treasury had disbursed $187 billion and recouped $250 billion,* thanks largely to the net worth sweep." (page 13).[…] *"But bumping large profits to Treasury instead of restoring the GSEs' capital structure is an injury in fact."* (page 44)

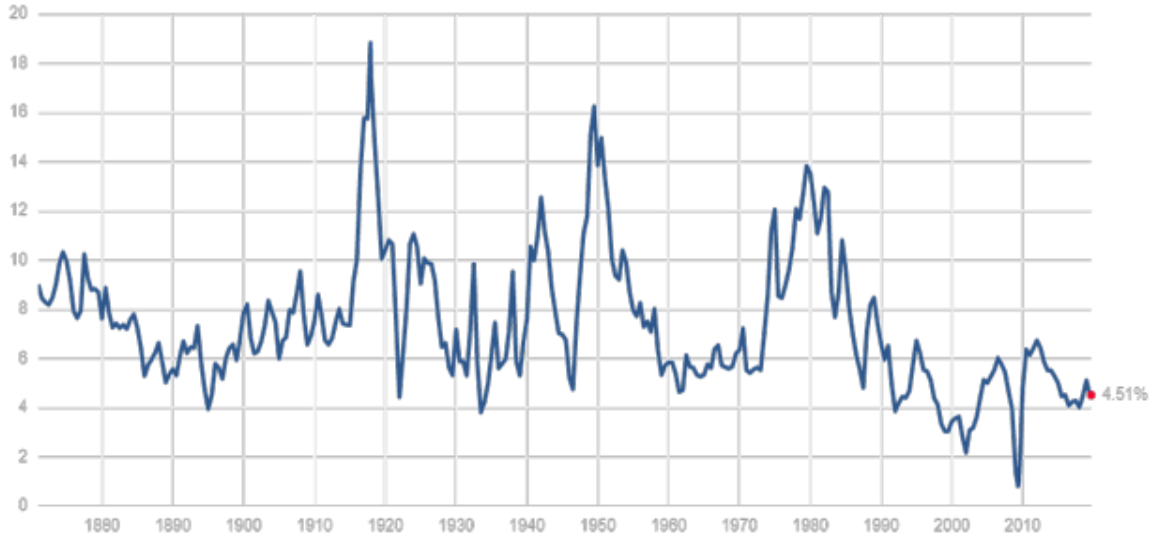
So, enough of Bloomberg and Parrott. Suffice it to say, whomever is coming to a conclusion without reading the Treasury Housing Reform Plan and the 5th Circuit Court of Appeals opinion is doing so at his/her own risk. The plan is only 45 pages long, makes for an easy read, and you can find it here. As for the Court's opinion, it is much longer and denser, at 123 pages. I have highlighted below what I think are the salient points.

The bottom line is this. On Housing Reform, the Chairman of the Senate Committee, Michael Crapo, was clear: FHFA should start the reforms to nudge Congress into a bipartisan deal, key words being *nudge, more leverage than before* the crisis, and *even bigger to fail* than before. Marc Calabria simply added this was *keeping him up at night*. Add Friday's judgment, and expect the recapitalization to start in earnest now.

Whether Congress decides to make the guarantee explicit, as in Ginnie Mae's case, it only matters as to valuation -- the greater the guarantee, the lower the risk, the lower the Earnings Yield, the lower the dilution, the higher the valuation. But *FHFA is calling the bluff -- they will reform, guarantee or not.*

However, the Reform also seeks a lower footprint for the GSEs, through more competition and less "implicit guarantee subsidy gap". How does this play into valuation is an open question, left for long term thinkers in my opinion. I encourage you to follow SA Contributor Glen Bradford on this saga, he has long had an excellent perspective.

And since I will be referring to the Earnings Yield (EY), here is the S&P EY chart you need to have in mind:



Sources: Standard & Poor's; multpl.com.

In essence, in the 2008 aftermath, the GSEs borrowed money from the Treasury, $185 billion. They repaid it, and then some. $250 billion. This is called the Net Worth Sweep – since 2012, every dollar the GSEs make goes to the Treasury.

What the 5th Circuit Court opined is simple. You can't do that. Which means Treasury will have to give that excess money back to the GSEs, hence to its shareholders – who will claim it plus damages. In this analysis, I am only looking at Fannie Mae, which I own.

My largest holding is the T non-cumulative preferred, 8.25% yield when issued at $25 in 2008 (OTCQB:FNMAT). Now selling at $13, for a 15.5% yield. When all is said in done, either preferred will be called, or the yield will come down to…? *In either case, this one is an easy double, in my opinion which includes all the disclaimers you can think of...*

As for FNMA common, using the back-of-the envelope previously issued guidelines, a 3% risk capital means $100 billion. Easy. Fannie earned $16 billion in 2018. Maybe we are down to $14 billion in 2019. This would still mean an Earnings Yield of 14%, about three times the current S&P 500 EY. Bearing in mind that the GSEs currently have an implicit government guarantee, and may end up with an explicit one, Congress willing, I could easily argue that a recapitalized Fannie could support an EY lower than the overall market risk asset. Add to this the Court's ruling which puts the burden on Treasury to pay the Preferred, and the $60 billion cash on Fannie's books, and take away a lower profitability stemming from the competition FHFA is asking for, this still leaves plenty of room for price appreciation. *My best guess at this point is a double, order of magnitude.* Push me, it's a triple, with a 4% EY.

To help you understand how this plays out, here is the summary of the Court's opinion – I have rearranged some of the pages so you won't need to go back and forth. Note that *Mark Calabria, director of FHFA and a Defendant in the case, is himself cited by the Court in support of its decision:*

Michael Krimminger & Marc [sic] A. Calabria, "the Conservatorships of Fannie Mae and Freddie Mac: Actions Violate HERA and Established Insolvency Principles," Cato Institute, Working Paper No. 26, 2015, cited as footnote on page 16 and 36.

Judge Willett, who led the majority opinion, also cited him *on the last page in the last sentence of the opinion.* "Venenum in cauda es" said Cicero, "the poison is in the [scorpio's] tail." In other words, the FHFA, Defendant, argues in favor of the Plaintiff. Makes it easy for the opinion to be enforced…

In case you missed it, this is important. In Tuesday's Senate hearing, one of the opening questions Chairman Crapo asked was about Congress' need to act. Ben Carson answered at 2:29 in this video that "anything that we do is going to be questioned as biased so, yes, working with Congress is going to be the best way to do it." *The Court's decision gets the bias out of the equation and gives a free hand to the Administration.* With that said, here is the "synopsis."

In *2008*, the President signed *HERA* into law to protect the national economy from further losses. HERA established *FHFA* as an "independent agency of the Federal Government" and classified *Fannie and Freddie as "regulated entit[ies]"* under FHFA." (page 6).

FHFA has discretion to appoint itself *conservator or receiver* in some cases, and receivership is mandatory in other critical insolvency situations. Conservatorship and receivership are *mutually exclusive* […]"(page 7). "In September 2008, *FHFA appointed itself a conservator* for the GSEs." (page 11).

As conservator, the agency may take actions "(I) necessary to put the regulated entity in a *sound and solvent* condition; and (II) appropriate to carry on the business of the regulated entity and *preserve and conserve the assets and property* of the regulated entity." (page 3).

As of August 2012, the GSEs had drawn approximately $187 billion […] But they lacked the cash to pay 10% dividends. So […] FHFA and Treasury adopted the *Third Amendment* which […] replaced the quarterly 10% dividend with variable *dividends equal to the GSEs' entire net worth* except a capital reserve. The Shareholders call this arrangement the "*net worth sweep*." The capital reserve buffer started at $3 billion. It decreased annually until it reached zero in 2018.[…] *Treasury announced* that the Third Amendment would ensure *that the GSEs "will be wound down* and will not be allowed to retain profits, rebuild capital, and return to the market in their prior form." *A federal official commented* privately that the Third Amendment was designed to prevent *Fannie and Freddie from recapitalizing." (page 12).[…] National Economic Council advisor Jim Parrott*, who worked with Treasury in developing the net worth sweep, allegedly wrote: *"[W]e've closed off [the] possibility that [Fannie and Freddie] ever[] go (pretend) private again*." Similarly, when Bloomberg published a comment that "[w]hat the Treasury Department seems to be doing here, and I think it's a really good idea, is to *deprive [Fannie and Freddie] of all their capital so that [they can not go private again]," Parrott emailed the source: "Good comment in Bloomberg*—you are exactly right on substance and intent." *The emails reinforce that the Third Amendment "deprive[d]" the GSEs of their capital, keeping them in a permanent state of suspension, which is not authorized by statutory conservator powers.* The pleadings in Jacobs v. Federal Housing Finance Agency208 and Perry Capital LLC v. Mnuchin 209 appear to lack similar allegations. *That factual difference distinguishes them."* (page 41)

The net worth sweep transferred a fortune from Fannie and Freddie to Treasury. When this suit was filed, the GSEs had paid $195 billion in dividends under the net worth sweep. Under the Agreements more broadly, *Treasury had disbursed $187 billion and recouped $250 billion*,

thanks largely to the net worth sweep." (page 13).[…] "But *bumping large profits to Treasury instead of restoring the GSEs' capital structure is an injury in fact.*" (page 44).

The Shareholders seek a declaration that the net worth sweep violates HERA and is arbitrary and capricious; a declaration that *FHFA's structure violates the separation of powers [Count IV]; an injunction against Treasury to return net-worth sweep dividends (or treat them as paying down the liquidation preference);* vacatur of the net worth sweep; and *an injunction against further implementation of the net worth sweep."* (page 14). […] "The Shareholders seek, among other things, *vacatur of the net worth sweep. That would redress their injury. The Shareholders have standing.*" (page 45).

HERA's anti-injunction provision limits court action against FHFA's conservator or receiver powers. […] The anti-injunction provision deflects claims about how the conservator used its powers, not claims it exceeded the powers granted. It distinguishes *improperly exercising a power (not restrainable) from exercising one that was never authorized (restrainable).* […] Congress borrowed much of HERA's text from the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).[…] If FIRREA is HERA's parent, FISA [1966] is a grandparent." (pages 16-17)[…] It follows that whether the anti-injunction provision bars relief on Counts I–III depends entirely on *whether the net worth sweep exceeded FHFA's statutory conservatorship powers." (page 21). […] "In adopting the net worth sweep, the Agencies abandoned rehabilitation in favor of "winding down" the GSEs.*[…] As a textual matter, the net worth sweep actively undermined pursuit of a "sound and solvent condition," and it did not "preserve and conserve" the GSEs' assets." (page 38). […] "*HERA […] did not authorize a conservator to "wind down" the ward's affairs or perpetually drain its earnings*." (page 40).

The Shareholders plausibly allege that *the Third Amendment exceeded FHFA's conservator powers* by transferring Fannie and Freddie's future value to a single shareholder, Treasury. In Parts I–VI of this opinion, *a majority of the en banc court holds that this claim survives dismissal* under Federal Rule of Civil Procedure 12(B)(6)."(page 4).[…] *Transferring substantially all capital to Treasury, without limitation, exceeds FHFA's powers* to put the GSEs in a "sound and solvent condition," "carry on the[ir] business," and "preserve and conserve [their] assets and property." *We ground this holding in statutory interpretation, not business judgment.*" (page 38).

In Parts VII–VIII of this opinion, a majority of the en banc court holds that the *Director's "for cause" removal protection [of the FHFA] is unconstitutiona***l**." (page 4).

Count I, to the extent it has merit, is a direct claim. *The Shareholders suffered injury in fact—they were excluded from the GSEs' profits.*" (page 24). […] "We now consider Count I's substantive allegation that the net worth sweep exceeded FHFA's conservator powers." (page 27).

Counts II and III, however, are *not* within the asserted statutes' zone of interests." (page 26).

The Shareholders are entitled to judgment on Count IV." (Page 46).

We REVERSE the judgment dismissing Count I and REMAND that claim for further proceedings. […]The court REVERSES the judgment as to Count IV and REMANDS that claim for entry of judgment that the "for cause" removal limitation in 12 U.S.C. § 4512(B)(2) is unconstitutional." (page 4) *(NOTE: despite Judge Haynes' 9 to 7 opinion that Shareholders can*

only obtain a declaration that the FHFA's structure is unconstitutional, meaning blowing the whole FHFA off).

The majority opinion, led by Judge Willett, ends on page 53. Dissenting opinions start on page 54 and, while they make for extremely interesting reading if you are into this, I did not want to TMI. Enough as it is. Plus, they are not relevant for purposes of this article. For example, one opinion is that the FHFA was always under the control of the President and the Treasury, regardless of the "for cause" removal restriction. As such, the FHFA could not be declared unconstitutional, and neither the Net Worth Sweep nor the whole Preferred Stock Purchase Agreements could be invalidated. Instead, the removal restriction should simply be severed as if it never existed (page 60).

Another one, by two of the judges who joined with the majority decision in holding the FHFA unconstitutional, concludes that the remedy is not to vacate the Net Worth Sweep, but to sever the removal restriction as well (page 61 to 63).

Yet another two judges who joined with the majority decision expand on the unconstitutionality of the FHFA (page 64 to 91).

And a minority opinion of six judges conclude that FHFA did not abuse of its statutory powers by adopting the Net Worth Sweep (page 92 to 96).

Lastly, four judges consider that the FHFA is indeed constitutionally structured…(page 97 to 117).

In closing, the same majority Judge Willett, with another six judges, concludes that the proper remedy for the FHFA unconstitutionality is not a prospective remedy, but the simple vacation, i.e. cancellation of the Net Worth Sweep (page 118 to 123). This one is particularly important, in that Judge Willett remands the district court:

The Third Amendment is the smallest independent agreement that caused the Shareholders' injury, so that *is what to rescind*. When a contract is rescinded, restitution is generally in order, and the plaintiff may also need to return benefits it received. *I would recognize the district court's authority, on remand, to decide the parties' rights and duties to restore their rightful position.* […] In light of recent developments, I would remand Count IV to the district court for *entry of a judgment consistent with this opinion.*" (page 123).

The recent developments the judge is referring to are footnoted in #32:

FHFA's newly appointed Director has publicly indicated he is considering renegotiating FHFA's agreements with Treasury. Andrew Ackerman & Ben Eisen, Push to Overhaul Fannie, Freddie Nudges Up Mortgage Costs, WALL STREET J. (June 25, 2019).

With that, I will leave you with one thought. The pendulum is swinging. Taxpayers and investors lent the GSEs money when they needed it. Time for the GSEs to pay them back. With interest. That's for the Appellate Court decision.

As for the plan, it is good for about every one - shareholders, public at large, and the overall financial community. Increased competition, lower risk of too-big-to-fail, lower mortgage rates. It will be tough to be partisan on this one. Unless you are "a former housing official during the Obama Administration..." BTW, footnote: While Senator Chris Dodd was the top recipient of

Fannie Mae donations in the 2008 cycle, Senator Obama was close second... And if you still think this has nothing to do with politics, this was the situation in 2018.