Private Capital Now

An offer by post-crisis investors in Fannie and Freddie to purchase and operate their guarantee businesses immediately

Contents

I. PROPOSAL

Proposal

Post-crisis, private investors purchase and operate the guarantee businesses of Fannie and Freddie, immediately, with $52 billion of private capital and a business plan that is sustainable with or without a Federal reinsurance program

EIGHT STEPS

1. **CHARTER** State-regulated monoline insurance companies
2. **PURCHASE** operating assets necessary to write MBS bond insurance
3. **CAPITALIZE** insurers with approx. $52 billion, including $34.6 billion of restricted capital from conversion of existing preferred stock and $17.3 billion in new cash raised in a rights offering
4. **REPAY** Treasury promptly in full, with a substantial profit
5. **CATALYZE** reform, with or without legislation
6. **ENHANCE** stability and affordability during transition
7. **VALIDATE** fairness of outcome with restructuring tools
8. **RUN-OFF** old "Fannie" and "Freddie", after which they cease to exist

Step One: Charter State Insurers

State-regulated monoline insurance companies ("NewCos")

- Long history of oversight, stress-testing and standard-setting
- No conflicting affordable housing mandate
- Subject to State insurance resolution regime; not too big to fail

NewCos write bond insurance for mortgage-backed securities

- Conforming mortgages only
- Prime, with a limited amount of income-verified subprime
- Traditional bond insurance structure promotes stability (no forced sales of non-performing mortgages)

Private ownership

- Owned by holders of Fannie and Freddie preferred stock
- Private management and underwriting decisions
- Immediate new investment in technology, people and systems
- Managed to target AAA rating. Capitalized and stress-tested to withstand market downturn substantially greater than 2008

Step One: Charter State Insurers

(continued)

No Federal support

- No Federal charter
- No entity-level guarantees
- No political appointees
- No tax exemptions

New names: "Fannie" and "Freddie" gone forever

Robustly competitive marketplace

- NewCos compete with each other, and new entrants
- Common Securitization Platform opens front-end securitization infrastructure to all industry participants on fair terms

NewCos do not compete with US government

- US government programs left in place (FHA, FHLB, Ginnie Mae)

STEP TWO: **PURCHASE** OPERATING ASSETS

NEWCOS PURCHASE MORTGAGE GUARANTEE OPERATIONS OUT OF CONSERVATORSHIP

- Human capital
- IP, infrastructure and know-how
- Other operating assets

NEWCOS START BUSINESS FROM ZERO

- Underwrite new business and bear 100% of risk beginning on cut-off date (e.g., June 30, 2014)
- Acquire no interest in guarantees written prior to cut-off date
- Acquire no interest in retained investment portfolio

EXISTING FANNIE AND FREDDIE LEGAL ENTITIES ARE LEFT BEHIND ("RUN-OFF COMPANIES")

RUN-OFF COMPANIES RETAIN FEDERAL CHARTER TEMPORARILY FOR LIMITED PURPOSES OF WINDING DOWN HISTORICAL INVESTMENTS AND GUARANTEES

Step Three: Capitalize Insurers

~$52 Billion of Capital Raised from Fannie and Freddie Preferred Stockholders

- ~$34.6 billion of preferred stock exchanged for common equity of NewCos
- Corresponding assets transferred to NewCo as start-up capital
- ~$17.3 billion of new cash equity raised from preferred stockholders in a rights offering
- Rights are transferable and can be sold by community banks and other small stockholders who cannot or do not wish to invest

Converted Capital is Restricted for Five-Years

- Used to write new business and assure private capital remains in place
- No dividends or distributions to owners for five years, including from attributable profits

Very Strong Capital Ratios Result from Both Converting Existing Capital and Raising New Cash

- Target AAA rating
- Stress-tested to withstand market downturn substantially greater than 2008

NewCos Not Too Big to Fail

- NewCos sized to leave room for other competitors
- Significant participants, but do not dominate market

Step Four: Repay Treasury

Run-Off Companies monetize existing investments and income-producing guarantees, including guarantees written between now and closing

Wind down is reliably profitable

- Repays in 2014 all amounts invested by US Treasury and full dividends at a 10% rate
- Once Treasury repaid in full, yields additional distributions, shared 79.9% with Treasury and 20.1% with other common stockholders, unless an even greater share for Treasury is determined by Court
- Respects order of priorities under applicable law
- Consistent with legislative proposals
- Financial assumptions to be reviewed and verified prior to closing

NewCos available to assist Run-Off Companies

- Can offer asset management services at lower cost than third party asset manager, preserving employment of existing staff and utilizing expertise
- Can provide stalking horse bids in competitive auctions to repackage and insure seasoned MBS on books of Fannie and Freddie, significantly accelerating wind-down and de-risking US government

Step Five: Catalyze Reform

NewCos can start bearing risk of loss immediately without legislation

- FHFA has authority to sell relevant assets to the NewCos [*confirm*]
- NewCos business model does not require any specific legislation

Putting private capital to work will catalyze reform

- Provides test case for viability of new market
- Brings private discipline to development of origination, underwriting and servicing standards
- Funds investment in technology and infrastructure
- Speeds implementation of the Common Securitization Platform

NewCo success can be ensured by very strong initial capitalization

- Highest capital ratios in the marketplace, together with meaningful restrictions on dividends and distributions
- Once NewCo succeeds, others will follow

Fully consistent with reform agenda

- Creates many options for government to intervene in time of crisis or for macroeconomic policy objectives
- Preserves role for Federal issuers and guarantors in specific areas (affordable housing, veterans, multi-family)

Step Five: Catalyze Reform

(continued)

Although NewCo business plan does not require legislation, it is consistent with ALL reform proposals under discussion

- If there is a broad Federal guarantee or reinsurance program, NewCos would catalyze reform by underwriting to program guidelines and putting their private capital at risk ahead of the Federal government
- If there is a fully private market, NewCos would catalyze reform as cornerstone investor and foster competition
- In hybrid markets, NewCos would do both – the business model and value of private underwriting expertise does not change

> The nature of Federal support for the mortgage market is a question for Congress. All the NewCos require is equal treatment with other private market participants.

Step Six: Enhance Stability

NewCos are immediate partners for a stronger and more stable market

Existing securitization market improved by discipline of private capital

- For covered securitizations, the NewCos determine composition of pools, promulgate standards and actively oversee origination, purchase of private mortgage insurance, servicing and loss mitigation
- Securitization function becomes administrative, not discretionary. Interface with Common Securitization Platform is open to all competitors
- NewCo oversight of servicing and trustee practices can inform future regulation

No need to commit now to an untested market structure. Congress retains options

Level of Federal support can change over time

Federal support also can be provided by the Run-Off Companies on an interim basis without Congressional action

- An interim reinsurance program offered by Run-Off Companies could permit MBS buyers to continue to look to an effective Federal guarantee
- The program could avoid market disruption and earn extra revenue for the Run-Of Companies
- As with any permanent reinsurance program, NewCos would underwrite to program guidelines and bear first loss until their capital exhausted

Step Seven: Validate Process

Proposal establishes benchmark for fairness with a result that is consistent with a hypothetical Chapter 11 filing

Financial markets understand logic of converting preferred stock to common stock in the continuing businesses

- Experienced investors are willing to take ownership risk and sponsor emergence
- Already invested and understand company
- Have first claim on business after US Treasury senior preferred stock

No need to price existing investment book

- Left behind for benefit of US Treasury and common shareholders
- Respects order of priorities under applicable law

No dispute about unauthorized "nationalization"

- US Treasury maximizes return on senior preferred <u>and</u> common stock in a manner consistent with legislative authority

Sponsorship by investor with clean hands and no moral hazard risk

- Fairholme was not an investor in 2008
- Cannot be seen as benefiting from implied US government support pre-crisis

Step Eight: Run-Off

Run-Off Companies liquidate retained investment book and guarantees in an orderly manner

Run-Off Companies do not write new business in competition with private insurers

- Exceptions for agreed transitional activities

NewCos available to assist in prompt wind-down

- Transition services
- Insurance of retained securities

US government receives

- Return of full senior preferred stock investment, plus interest
- 79.9% of surplus equity proceeds from orderly wind-down, expected to be significant
- Fair fees for entity-level support and any interim reinsurance

At end of wind-down, Federal charters terminated and "Fannie" and "Freddie" cease to exist