DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

December 20, 2010

ACTION MEMORANDUM FOR SECRETARY GEITHNER

FROM: Jeffrey A. Goldstein
Under Secretary for Domestic Finance

SUBJECT: Periodic Commitment Fee for GSE Preferred Stock Purchase Agreements (PSPAs)

Recommendation

That you waive the Periodic Commitment Fee (PCF) for 2011 and reconsider next year.

TFG Approve ________ Disapprove ________ Let's Discuss

Background:

- The amended PSPA agreements between Treasury and GSEs specify that a Periodic Commitment Fee (PCF) be set by December 31, 2010.
- The date for setting the PCF was previously moved from December 31, 2009 to December 31, 2010 as part of the broader amendments to the PSPAs on December 24, 2009. Therefore, no PCF has been set or paid to date.
- Treasury may waive the PCF for one year at a time in its sole discretion based on adverse conditions in the mortgage market.
- The PCF is to be mutually agreed to by Treasury and FHFA, in consultation with the Federal Reserve. The PCF was designed to fully compensate Treasury for providing its ongoing financial commitment.

Considerations:

<u>Reasons to Waive the PCF for 2011</u>

Housing markets remain fragile

- Private capital has yet to return to the market
    - Fannie Mae, Freddie Mac, and FHA/GNMA currently account for over 95% of mortgage originations – the historic average is around 40%
    - The spread between prime jumbos and conforming mortgages is still elevated and is currently around 100 basis points – the historic average is closer to 20 basis points
    - Since September 2008, there has only been one private label new issue securitization to come to the market (Redwood Sequoia deal)
- Nearly 11 million borrowers are underwater on their mortgages
- Mortgage delinquency rates remain elevated (5.2% for prime, 36.5% for subprime, and 11.9% for FHA)
- Foreclosure starts and completions remain elevated

Given the size of current GSE draws, imposing a PCF would only lead to increased Treasury draws and not generate increased return for the taxpayer

- According to the FHFA stress tests in the base case, both GSEs are expected to require additional draws through the end of 2011 to cover net income losses and required dividend payments (although projected draws are < $1 billion for Freddie Mac in Q3 and Q4) (see appendix)

Other than timing, no real additional taxpayer value is created

- Even if the GSEs generated positive surplus of net income after dividends, that surplus can be used to offset potential draws in future quarters

Potentially confusing message to the market

- Last year we stated that the fragility of the housing market was one of the rationales for postponing setting the commitment fee; by setting the fee this year (at any level), we could be viewed as implicitly making an affirmative statement on the health of the housing market

Waiving the PCF for 2011 preserves full optionality to set the PCF next year if housing markets are more stable and if the GSEs are generating positive net income in excess of their dividend commitments

Reasons to Set the PCF

- Makes clear the Administration's commitment to ensure existing common equity holders will not have access to any positive earnings from the GSEs in the future
- Illustrates further commitment to recouping taxpayer support

If you decided to set the PCF, there are two potential options:
Option 1 – Set the PCF as a percentage of the liquidation preference of the outstanding preferred stock
Option 2 – Set the PCF equal to any generated positive net income (subject to further legal review)
These would have to be mutually agreed by FHFA in consultation with the Federal Reserve