

Note 9. Investments in Government-Sponsored Enterprises

Investments in GSEs as of September 30, 2020			
(In billions of dollars)	Gross Investments	Cumulative Valuation Gain/(Loss)	Fair Value
Fannie Mae senior preferred stock	137.8	(79.5)	58.3
Freddie Mac senior preferred stock	83.9	(46.0)	37.9
Fannie Mae warrants common stock	3.1	5.2	8.3
Freddie Mac warrants common stock	2.3	2.1	4.4
Total investments in GSEs	<u>227.1</u>	<u>(118.2)</u>	<u>108.9</u>

Investments in GSEs as of September 30, 2019			
(In billions of dollars)	Gross Investments	Cumulative Valuation Gain/(Loss)	Fair Value
Fannie Mae senior preferred stock	127.0	(78.3)	48.7
Freddie Mac senior preferred stock	77.3	(38.5)	38.8
Fannie Mae warrants common stock	3.1	12.9	16.0
Freddie Mac warrants common stock	2.3	6.3	8.6
Total investments in GSEs	<u>209.7</u>	<u>(97.6)</u>	<u>112.1</u>

Congress established Fannie Mae and Freddie Mac as GSEs to provide stability and increase liquidity in the secondary mortgage market and to promote access to mortgage credit throughout the nation. A key function of the GSEs is to purchase mortgages, package those mortgages into securities, which are subsequently sold to investors, and guarantee the timely payment of principal and interest on these securities.

Leading up to the financial crisis, increasingly difficult conditions in the housing market challenged the soundness and profitability of the GSEs, thereby threatening to undermine the entire housing market. In response Congress passed the *Housing and Economic Recovery Act of 2008* (P.L.110-289) in July 2008. This act created FHFA, with enhanced regulatory authority over the GSEs, and provided the Secretary of the Treasury with certain authorities intended to ensure the financial stability of the GSEs, if necessary. In September 2008, FHFA placed the GSEs under conservatorship and Treasury invested in the GSEs by entering into a SPSPA with each GSE. These actions were taken to preserve the GSEs' assets, ensure a sound and solvent financial condition, and mitigate systemic risks that contributed to market instability.

The purpose of such actions is to maintain the solvency of the GSEs so they can continue to fulfill their vital roles in the mortgage market while the Administration and Congress determine what structural changes should be made to the housing finance system. Draws under the SPSPAs result in an increased investment in the GSEs as further discussed below. Under SFFAS No. 47, *Reporting Entity* criteria, Fannie Mae and Freddie Mac were owned or controlled by the federal government only as a result of (a) regulatory actions (such as organizations in receivership or conservatorship) or (b) other federal government intervention actions. Under the regulatory or other intervention actions, the relationship with the federal government was and is not expected to be permanent. These entities are classified as disclosure entities based on their characteristics as a whole. Accordingly, these entities are not consolidated into the U.S. government's consolidated financial statements; however, the value of the investments in these entities, changes in value, and related activity with these entities

are included in the U.S. government's consolidated financial statements. See Note 29—Subsequent Events for additional information.

Senior Preferred Stock Purchase Agreements

Under the SPSPAs, Treasury initially received from each GSE: 1) 1,000,000 shares of non-voting variable liquidation preference senior preferred stock with a liquidation preference value of \$1,000 per share; and 2) a non-transferable warrant for the purchase, at a nominal cost, of 79.9 percent of common stock on a fully-diluted basis. The warrants expire on September 7, 2028. Under the amended SPSPAs, the quarterly dividend payment changed from a 10.0 percent per annum fixed rate dividend on the total liquidation preference (as discussed below) to an amount equivalent to the GSE's positive net worth above a capital reserve amount. The capital reserve amount, which was initially set at \$3.0 billion for calendar year 2013, declined by \$600 million at the beginning of each calendar year thereafter, and was scheduled to reach zero by calendar year 2018. On December 21, 2017, Treasury and FHFA modified the SPSPAs between Treasury and the GSEs to increase the capital reserve amount for each GSE back to \$3 billion, effective with the December 2017 dividend payment. In exchange for the increase in the capital reserve, Treasury's liquidation preference in each GSE increased by \$3 billion on December 31, 2017. On September 27, 2019, Treasury and FHFA agreed to increase the capital reserve amounts of Fannie Mae and Freddie Mac to \$25 billion and \$20 billion, representing an increase of \$22 billion and \$17 billion, respectively, over the prior reserve amount of \$3 billion each. In exchange, Treasury's liquidation preference in each GSE will gradually increase up to the adjusted capital reserve amounts based on the quarterly earnings of each GSE. For the fiscal year ended September 30, 2020, Treasury's liquidation preference in Fannie Mae and Freddie Mac increased by \$10.8 billion and \$6.6 billion, respectively. As of September 30, 2019, Treasury's liquidation preference in Fannie Mae and Freddie Mac increased by \$3.4 billion and \$1.8 billion, respectively. The GSEs will not pay a quarterly dividend if their positive net worth is below the required capital reserve threshold. Treasury received no cash dividends for the fiscal year ended September 30, 2020 as the positive net worth was below the capital reserve amounts. Treasury did receive cash dividends of \$15.3 billion during fiscal year ended September 30, 2019.

The SPSPAs, which have no expiration date, require that Treasury will disburse funds to either GSE if at the end of any quarter, the FHFA determines that the liabilities of either GSE exceed its assets. Draws from Treasury under the SPSPAs are designed to ensure that the GSEs maintain positive net worth, with a fixed maximum amount available to each GSE under this agreement established as of December 31, 2012 (refer to the "Contingent Liability to GSEs" section below and Note 20—Contingencies). Draws against the funding commitment of the SPSPAs do not result in the issuance of additional shares of senior preferred stock; instead, it increases the liquidation preference of the initial 1,000,000 shares by the amount of the draw. The combined cumulative liquidation preference totaled \$222 billion and \$204 billion as of September 30, 2020 and 2019, respectively. There were no payments to the GSEs for the fiscal years ended September 30, 2020 and 2019. See Note 29—Subsequent Events for additional information.

Senior Preferred Stock and Warrants for Common Stock

In determining the fair value of the senior preferred stock and warrants for common stock, Treasury relied on the GSEs' public filings and press releases concerning their financial statements, as well as non-public, long-term financial forecasts, monthly summaries, quarterly credit supplements, independent research regarding preferred stock trading, independent research regarding the GSEs' common stock trading on the OTC Bulletin Board, discussions with each of the GSEs and FHFA, and other information pertinent to the valuations. Because the instruments are not publicly traded, there is no comparable trading information available. The fair valuations rely on significant unobservable inputs that reflect assumptions about the expectations that market participants would use in pricing.

The fair value of the senior preferred stock considers the amount of forecasted cash flows to equity. The fair valuations assume that a hypothetical buyer would acquire the discounted dividend stream as of the transaction date. The fair value of the senior preferred stock-as measured by unobservable inputs-increased as of September 30, 2020 when compared to September 30, 2019. Fannie Mae's senior preferred stock drove this increase primarily due to higher projected cash flows and a decrease in the market value of Fannie Mae's other equity securities that comprise its total equity, partially offset by a higher discount rate.

Factors impacting the fair value of the warrants include the nominal exercise price and the large number of potential exercise shares, the market trading of the common stock that underlies the warrants as of September 30, the principal market, and the market participants. Other factors impacting the fair value include, among other things, the holding period risk related directly to the assumption of the amount of time that it will take to sell the exercised shares without depressing the market. The fair value of the warrants-as measured by observable inputs-decreased at the end of FY 2020, when compared to 2019, primarily due to decreases in the Level 1 fair value measurement of the market price of the underlying common stock of each GSE.

Estimation Factors

Treasury's forecasts concerning the GSEs may differ from actual experience. Estimated senior preferred values and future draw amounts will depend on numerous factors that are difficult to predict including, but not limited to, changes in government policy with respect to the GSEs, the business cycle, inflation, home prices, unemployment rates, interest rates, changes in housing preferences, home financing alternatives, availability of debt financing, market rates of guarantee fees, outcomes of loan refinancings and modifications, new housing programs, and other applicable factors.

Contingent Liability to GSEs

As part of the annual process undertaken by Treasury, a series of long-term financial forecasts are prepared to assess, as of September 30, the likelihood and magnitude of future draws to be required by the GSEs under the SPSPAs within the forecast time horizon. Treasury used 25-year financial forecasts prepared through years 2045 and 2044 in assessing if a contingent liability was required as of September 30, 2020 and 2019, respectively. If future payments under the SPSPAs are deemed to be probable within the forecast horizon, and Treasury can reasonably estimate such payment, Treasury will accrue a contingent liability to the GSEs to reflect the forecasted equity deficits of the GSEs. This accrued contingent liability will be undiscounted and will not take into account any of the offsetting dividends that could be received, as the dividends, if any, would be owed directly to the General Fund. Treasury will adjust such recorded accruals in subsequent years as new information develops or circumstances change. If future payments are reasonably possible, they are disclosed but not recorded as an accrued contingent liability.

Based on the annual forecasts as of September 30, 2020 and 2019, Treasury estimated there was no probable future funding draws. As of September 30, 2020, it is reasonably possible that a period of sustained economic and housing market volatility could potentially cause the GSEs to generate quarterly losses, and therefore, result in future funding draws against the funding commitment. Due to challenges quantifying future market volatility or the timing, magnitude, and likelihood of such events, the total amount of this reasonably possible future funding liability could not be estimated as of September 30, 2020 and 2019. There were no payments to the GSEs for fiscal year ended September 30, 2020 and 2019. At September 30, 2020 and 2019, the maximum remaining funding commitment to the GSEs for the remaining life of the SPSPAs was \$254.1 billion. Subsequent funding draws will reduce the remaining commitments. Refer to Note 19—Commitments for a full description of other commitments and risks.

In assessing the need for an estimated contingent liability, Treasury relied on the GSEs' public filings and press releases concerning their financial statements, monthly business summaries, and quarterly credit supplements, as well as non-public, long-term financial forecasts, the FHFA House Price Index, discussions with each of the GSEs and FHFA, and other information pertinent to the liability estimates. The forecasts prepared in assessing the need for an estimated contingent liability as of September 30, 2020 include four potential wind-down scenarios, with varying assumptions regarding the continuation of the GSEs new business activities, including purchasing mortgage loans and issuing new guaranteed MBS. The forecasts as of September 30, 2020, also assumed the maintenance of the GSEs' retained mortgage portfolios below the \$250 billion maximum permitted under the amended SPSPAs.

Regulatory Environment

To date, Congress has not passed legislation nor has FHFA taken action to end the GSEs' conservatorships. The GSEs continue to operate under the direction of their conservator, the FHFA. On March 27, 2019, the President issued a Memorandum that directed the Secretary of the Treasury to develop a plan for administrative and legislative reforms to achieve the following housing finance reform goals: 1) ending the conservatorships of the GSEs upon completion of specified reforms; 2) facilitating competition in the housing finance market; 3) establishing regulation of the GSEs that safeguards their safety and soundness and minimizes the risks they pose to the financial stability of the U.S.; and 4) providing that the federal government is properly compensated for any explicit or implicit support it provides to the GSEs or the secondary housing finance market. On September 5, 2019, Treasury released their Housing Reform Plan, which included recommended legislative and administrative reforms to achieve each of these goals.

The *Temporary Payroll Tax Cut Continuation Act of 2011* (P.L. 112-78) was funded by an increase of ten basis points in the GSEs' guarantee fees (referred to as "the incremental fees") which began in April 2012 and is effective through September 30, 2021. The incremental fees are remitted to Treasury and not retained by the GSEs and, thus, do not affect the profitability of the GSEs. For FYs 2020 and 2019, the GSEs remitted to Treasury the incremental fees totaling \$4.2 billion and \$3.9 billion, respectively.