

## Implications of U.S. Government's Takeover of Fannie Mae and Freddie Mac

September 9, 2008

In light of Sunday's announcement that the U.S. government is taking over (the Takeover) the operations of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), money managers, fund companies, pension funds, and other institutional investors need to evaluate the implications for their portfolio holdings, including both cash instruments and derivatives.<sup>1</sup> Although industry participants have begun to discuss the implications, particularly with respect to credit default swaps, there are still many open questions regarding the impact of this unprecedented event.

### Credit Default Swaps

The most obvious effect of the Takeover relates to credit default swaps (CDS), contracts under which a "Buyer" of credit protection contracts with a "Seller" for a negotiated payment with respect to reference debt in the event of a "credit event" trigger. The International Swaps and Derivatives Association, Inc. (ISDA) convened a call yesterday and reported to the membership that participating dealers have uniformly determined that the Takeover constitutes a "Credit Event" for purposes of the Credit Derivatives Definitions used in connection with CDS. The consensus is apparently based on the fact that a "Conservatorship" is a specified Credit Event under the standard agreements. ISDA also published uniform settlement agreements that counterparties to CDS may elect to use in settling outstanding swaps relating to Fannie Mae and Freddie Mac debt. These agreements provide that the parties waive notice requirements for declaration of the Credit Event. ISDA indicated that it is in the process of creating a settlement protocol that includes a process to set the value of CDS in an auction to simplify settlement.

Although the implications of the occurrence of a Credit Event will depend upon the terms of the particular CDS contract, the typical contract provides for settlement upon a Credit Event either (i) by delivery by the Buyer to the Seller of a specified quantity of debt of the reference issuer against a payment by the Seller of the par value (referred to as "physical settlement") or, (ii) less commonly, by delivery from the Seller to the Buyer of the difference between the par value of the specified quantity of reference debt and the market price, typically as determined by auction pricing (referred to as a "cash settlement"). Investors should review their contracts to determine their delivery obligations (or obligations to accept delivery, if they are Sellers) upon settlement and the settlement payment due.

### CDS Index Derivatives

In addition to single-reference-name CDS, investors should check on their exposure to Fannie Mae and Freddie Mac through their holdings in CDS indices as well as in customized or bespoke portfolios. Fannie Mae and Freddie Mac are not referenced in the LCDX index. Dow Jones is currently quoting the CDX both with and without the names.<sup>2</sup> Derivatives transactions that reference either a standardized index, such as the CDX, or a bespoke

1. The Takeover was effected as a conservatorship according to the provisions of the Federal Housing Finance Regulatory Reform Act of 2008 (Public Law 110-289) and the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4501, et seq., as amended).
2. For information regarding CDS indices affected by the Takeover, investors may want to look at the following website published by Markit Partners: <http://markit.com/information/products/category/indices/cdx.html>.

index may be affected in a number of ways depending upon the contractual terms. The derivative may provide for settlement upon the first to default of one of the specified reference entities. Other transactions may not lead to a settlement, for example, if the contract requires there to be a Credit Event with respect to more than one or two of the referenced debt obligations. Investors should review their contracts and discuss the terms with their counterparties.

### **Credit-Linked Notes**

Beyond reviewing the terms of swaps, options, and other over-the-counter derivatives (such as swaptions), investors should check on whether they hold index-linked notes or single-reference notes that reference debt of Freddie Mac or Fannie Mac. Credit-linked notes may be structured in a variety of ways, some of which may be impacted by the Takeover (i.e., depending upon how the Takeover is interpreted under the trigger events defined in the particular instrument) and others that will not be.

### **Equity Swaps and Options**

According to communications from ISDA, the Takeover may also be viewed as a triggering event under equity derivatives transactions relying on the ISDA Equity Definitions. If the Takeover is a "Nationalization," an "Insolvency," or an "Insolvency Filing," depending on the election of the parties to the transaction, the transaction may be subject to termination. An initial call among ISDA members was held during which there was a consensus view that the Takeover constituted neither a "Nationalization" nor an "Insolvency" but might constitute an "Insolvency Filing."

### **Repurchase Transactions and Stock Lending**

For investors holding Fannie Mae or Freddie Mac debt under a Master Repurchase Agreement, it is not clear that the Takeover would have any effect other than, potentially, with respect to the value of the collateral. If investors have sold Fannie Mae or Freddie Mac debt through a repurchase arrangement or lent out such securities, they may want to review their agreements to determine their recall rights, particularly if they will have an obligation to make physical settlement under a CDS using these securities.

### **Notes and Other Debt Obligations**

Regular payments on debt instruments of Fannie Mae and Freddie Mac should continue unchanged. According to the FAQs published by the U.S. Department of the Treasury, obligations under the instruments will be paid in the normal course of business during the Conservatorship and the Treasury Department has enhanced the ability of the issuers to make their obligations through a secured lending credit facility and a senior preferred stock purchase agreement. The FAQs also indicated that the Conservator does not anticipate that there will be any disruption in the pattern of payments or ongoing business operations.

### **Use of Fannie Mae or Freddie Mac Debt as Collateral**

The Credit Support Annexes of many ISDA Master Agreements permit securities issued or guaranteed by Fannie Mae or Freddie Mac to be posted as collateral. To the extent that investors are no longer comfortable receiving such collateral, or are no longer comfortable with the valuation percentage being used in their Credit Support Annex, they should consider a modification of their Credit Support Annex.

### **Preferred and Common Stock**

For holders of preferred stock or common equity of Fannie Mae or Freddie Mac, the Takeover poses serious issues regarding the need to write down or write off the value of the holdings. Under the Treasury announcements, the U.S. Government will take over 79% of any remaining equity value of the agencies. Accordingly, the stock price will be significantly impacted. As the FAQs make clear, during the Conservatorship, the stock will continue to trade. However, by statute, the powers of the stockholders are suspended until the Conservatorship is terminated.

For general information regarding the Takeover, companies may want to review questions and answers posted by the U.S. Treasury Department on its website: <http://treasury.gov/news/index1.html>.

We will continue to monitor the situation as it evolves. Meanwhile, we are ready to help with contract reviews and to answer questions regarding proposed settlements, protocols, and any other questions that you may have regarding the implications of the Takeover.

If you have any questions concerning these important legal developments, please contact any of the following Morgan Lewis attorneys:

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