BANKING & FINANCE

Government Control of Fannie and Freddie in Historical Perspective

Are we on the right path with ongoing reforms or is government oversight of these mortgage giants a lost cause?

BY VERN McKINLEY

Just after Labor Day 2019, the Treasury Department released a report on reforming Fannie Mae and Freddie Mac, the government-sponsored enterprises (GSEs) that purchase mortgages in the secondary market. The report gets into the details of an issue that has been at the forefront of housing policy for the past 30 years, since the two mortgage behemoths began their massive growth during the 1990s. The issue has taken on greater importance in the last 12 years, as the GSEs have been under direct government control after they began to melt down as part of the 2007–2008 financial crisis.

Before we can wade into the report, we must appreciate the confounding history of the issues and the involved policymakers. Much of the coverage in the media has glossed over this complex history, leaving readers with many questions about how the pieces of this puzzle came together and what will change under proposed policy reforms.

To understand where the GSEs have been and where they will go in the future requires focus on a few core issues. Some of these can be addressed administratively under current law, such as what level of capital the GSEs require, how much longer Fannie and Freddie will remain as wards of the state, and how to make transparent to the public the last decade-plus of government authorities' decision-making over the GSEs. Changing the duopoly presence in their market will likely require legislation, although in the short run administrative measures can be used to shrink their asset base.

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A DOZEN YEARS AND COUNTING FOR GOVERNMENT CONTROL

In early July of 2008, James Lockhart, then-director of the Office of Federal Housing Enterprise Oversight, which was Fannie and Freddie's supervisor at the time, gave assurances on the financial network CNBC that the GSEs were "adequately capitalized" according to the most up-to-date data from Fannie and Freddie. (Capital is used as a buffer against losses during difficult operational times.) Then-treasury secretary Henry Paulson echoed Lockhart's comments in testimony to Congress a week later, with then-Federal Reserve Board chairman Ben Bernanke backing him up.

In response to the early phases of the mortgage crisis, Paulson had shepherded the Housing and Economic Recovery Act (HERA) through Congress, granting new powers to Fannie and Freddie's supervisor to be used during times of market stress. HERA was

WIKICOMMONS (FANNIE MAE), KEN HOWARD IMAGES /ALAMY (FREDDIE MAC) signed on July 30, 2008, many weeks before anyone had even heard of the acronym "TARP," the moniker for the centerpiece bailout legislation during the crisis.

In his memoir, Paulson explained how he organized an effort in August 2008 to ascertain "the true financial condition of Fannie and Freddie." It was a volatile time for the GSEs as they struggled with the reality of the financial crisis and its effect on their mortgage holdings. As the situation deteriorated that month, he assembled a team made up of examiners from the Federal Reserve and the Office of the Comptroller of the Currency. He also brought in advisers from Morgan Stanley who worked for Treasury "for free" to undertake a full financial review. Their assessment was bleak, with both Fannie and Freddie having "true economic capital holes amounting to tens of billions of dollars." Required government capital injections were estimated at over $100 billion. This meant that Paulson and Bernanke would have to do an about-face on their earlier very public and sunny comments on the GSEs' capital position.

The next step after getting the details from the examiners and Morgan Stanley seemed logical to Paulson: intervene. In early September 2008, he and Lockhart—whose agency, by then, had been rechristened the Federal Housing Finance Agency (FHFA)—did just that, placing Fannie and Freddie in conservatorship, a legal procedure designed for the FHFA to manage them to health. A joint Treasury and FHFA announcement laid out the new narrative on capital: "Their statutory capital requirements are thin and poorly defined as compared to other institutions." The Treasury Department would stand ready to fund the operations of the GSEs, which was one of the largest of the 2008 bailouts in terms of upfront financial commitments. The announcement also made mention eight times of the "systemic risk" that the two GSEs posed to the financial system and in particular noted a need for policymakers to "resolve the systemic risk" created by the GSE structure.

The ensuing bailout / The terms of Fannie and Freddie's bailout were codified in separate senior preferred stock purchase agreements between the Treasury Department and the individual GSEs signed in late September 2008. In executing the agreements, the FHFA acted on behalf of the GSEs in its new role as conservator. Each of the agreements committed the Treasury to purchase up to $100 billion in senior preferred shares. Warrants were issued to the Treasury permitting it to purchase up to 79.9% of the GSEs' common stock. This structure would allow Fannie and Freddie's creditors to avoid suffering any losses.

Matters of restructuring financial institutions on the brink of failure should be straightforward. There are two paths: recovery and resolution. Recovery means troubled institutions fully address their problems and exit to more normal operations. Resolution means problem areas cannot be so easily addressed and there is an exit strategy to put the institutions out of business, generally through a receivership, which is a different legal vehicle than conservatorship.

Fannie and Freddie could have been placed directly into receivership, but Paulson chose to put the pair into conservatorship for what he called "a time out." Conservatorship should be used (ideally for one to two years) to assess a troubled institution and determine which path to take. But somehow, for over a decade, the ever-changing team of leaders and staff at the Treasury Department and FHFA managed to avoid making a decision about whether they had a recovery or a resolution on their hands. Analogous to the U.S. military intervention in Afghanistan (now going on 19 years), Treasury and the FHFA figured out a way to intervene but they never developed an exit strategy. The FHFA has refused to release information regarding the reasons for the choice of conservatorship over receivership, even though there are documents that would reveal in detail their chosen preference.

FHFA director / The FHFA director has significant discretion in applying the provisions of the agency's enabling statute. For example, the appointment of a conservator or receiver is "at the discretion of the director" provided the grounds set out in the statute are met. The office of director is a rather high-impact and powerful position, as Washington agencies go. This is one reason why there have been constitutional challenges to the director's authority, similar to those challenges to the authority of the director of the Consumer Financial Protection Bureau.

Unlike other federal financial authorities (e.g., Federal Reserve Board, Federal Deposit Insurance Corporation), the FHFA does not work under the auspices of a board, but has a single director who comprises the governance structure. The removal provisions for the FHFA director are more stringent than those for the comptroller of the currency, whose agency regulates national banks and operates within the Treasury Department.

After Lockhart left the FHFA in 2009, Edward DeMarco assumed the role of director in an acting capacity through 2014. Before landing at FHFA and its predecessor, DeMarco spent his career in government at the General Accounting Office, U.S. Treasury, and Social Security Administration. Much of his time as FHFA acting director was occupied with a controversy over whether the FHFA should provide principal forgiveness to homeowners whose mortgages were underwater. Despite a great deal of public pressure, he stood firm against that potentially costly relief. He was also occupied with getting the conservatorships for the GSEs operationalized and placing the two GSEs under the firm control of the FHFA. What he did not operationalize during his five years at the helm of the FHFA was a path out of conservatorship.

Melvin Watt, director of the FHFA from 2014 to 2019, was appointed by President Barack Obama and confirmed by the Senate. Watt had a very different background from DeMarco, having spent 20 years as a member of the U.S. House of Representatives, sitting on the Committee on Financial Services. He served on the committee throughout the financial crisis and was a member of a subcommittee focused on housing.

Like DeMarco, Watt neglected to assemble a path for an exit from conservatorship, preferring instead to stay with the status quo. Watt wanted the GSEs to continue in their familiar role as an off-budget means to impose housing mandates on Fannie and Freddie. Watt saw little reason to rock the boat by invoking his administrative powers to make any significant changes to the structure or operations of the GSEs.

Near the end of his tenure, he did oversee the release of a proposed capital rule to clarify the level of a required capital buffer for the GSEs. At the Obama Treasury Department, although there was a sense of urgency post-crisis to pass banking reform, there never seemed to be much urgency to come to a long-term legislative solution to the GSE conundrum as rationalized by Obama treasury secretary Timothy Geithner: "There was no immediate rush; we knew Fannie and Freddie would be in conservatorship for a while, and that private mortgage lending was too deeply damaged to come back soon."

During the Obama years, the Treasury and FHFA approved amendments to the 2008 stock purchase agreements that imposed a net worth or profit sweep in 2012. The sweep essentially drew all the profits from Fannie and Freddie and put them in government coffers, leaving the GSEs with almost no capital. None of the other large financial institutions that approached failure during the crisis were subjected to such an extreme measure. That sweep transformed the GSEs into a cash cow for the federal budget, which provided a funding source for non-GSE purposes.

Not surprisingly, this move triggered litigation on behalf of Fannie and Freddie shareholders. As part of the shareholder litigation, the FHFA and Treasury have also fought efforts at transparency regarding the justification for the sweep, invoking executive privilege to shield critical internal documents.

CHANGING THE STATUS QUO

The status quo has been jeopardized by the newly appointed director of FHFA, who succeeded Watt in 2019: Mark Calabria. A few weeks after the 2016 election, as the then-director of financial regulation studies at the Cato Institute, Calabria penned an op-ed for *The Hill* in which he set out an agenda for the Trump administration's nominee for treasury secretary, Stephen Mnuchin:

> There is perhaps no bigger unresolved issue from the financial crisis than Fannie Mae and Freddie Mac. These two have been trapped in the limbo of government conservatorship for over eight years. By contrast, the longest bank conservatorship was 18 months.

Calabria was also highly critical of the undercapitalized state of Fannie and Freddie:

> The current situation is neither sustainable nor what Congress intended, and having worked on that legislation, I can say it's worked nowhere near as intended. With essentially no capital, the taxpayer stands directly behind these entities, exposed to trillions of dollars of risk.

Calabria soon thereafter took a position on Vice President Mike Pence's staff as chief economist, and then was appointed director of the FHFA.

Calabria's reference to legislation was to his work on HERA while he was on the senior staff of the Senate Banking, Housing, and Urban Affairs Committee. Prior to that, he was a deputy assistant secretary at the Department of Housing and Urban Development and also had stints at Harvard University's Joint Center for Housing Studies, the National Association of Home Builders, and the National Association of Realtors. This range of work experience gave him a grasp on the policy issues underlying Fannie Mae and Freddie Mac's business model and the Treasury/FHFA intervention in the GSEs' operations. At the same time, he developed a paper trail on government policy options for Fannie and Freddie.

As evidenced by his paper trail, Calabria was a vocal critic of the never-ending Fannie and Freddie conservatorship. He coauthored a 2015 analysis with former FDIC general counsel Michael Krimminger arguing that the ongoing approach of Treasury and the FHFA in leaving Fannie and Freddie in conservatorship was a clear violation of HERA. The FHFA's approach was also entirely inconsistent with the long history of the FDIC's application of the conservatorship and receivership powers upon which HERA was based. Calabria and Krimminger stated that regarding the then seven years of conservatorship, if Fannie Mae and Freddie Mac "cannot be returned to a 'sound and solvent' condition, then they must be placed into receivership."

AN EXIT STRATEGY AT LAST?

The September 2019 Treasury report offers a number of elements of serious reform, at least as compared to the prior decade of intransigence. However, the specifics for follow-through on certain administrative actions were not precisely detailed as to full operational form or timing. Still, these elements are worth noting:

- *Amend the agreements to allow the GSEs to retain and build capital*. This would involve a multipronged effort to raise capital through public or private offerings to a level to meet increased GSE regulatory capital requirements. No timeline was set for the effort to build capital.
- *Bring the conservatorships to an end.* This is a complex set of preconditions that include setting capital requirements, approving individualized capital plans for Fannie and Freddie, and amending the 2008 agreements to facilitate an exit. The report also mentions the option of placing Fannie and Freddie in receivership in order to facilitate a capital restructuring. No timeline was set for the exit from conservatorship, including potential placement into receivership.
- *Review by the Financial Stability Oversight Council (FSOC) of GSE systemic risk.* The FHFA will consult with the members of the FSOC, which is a body created under the 2010 Dodd–Frank Act to conduct systemic risk assessments. No timeline was set for this review.

Raising needed capital / In the months since the Treasury report was delivered, some of its informational gaps have been filled in, primarily in testimony and speeches by Mnuchin and Calabria. The FHFA director has emphasized that progress will be slow; in his words, it will be "process driven" and not "calendar driven." As he explained, that process will primarily come down to the strength of the GSEs' "ability to raise capital" to provide a buffer for them to avoid failure in the next financial crisis.

Step one in the process of raising this capital is to administratively allow Fannie and Freddie to retain profits. Last September, a few weeks after the release of the Treasury report, the Treasury and FHFA came to agreement to allow Fannie Mae to accumulate capital reserves of up to \$25 billion and Freddie Mac to accumulate up to \$20 billion. (Previously this was set at \$3 billion for each.) This is a modest step toward the two GSEs drawing closer to what they need in capital to support their operations, but it falls far short of what will ultimately be needed to exit conservatorship. Under the best of circumstances it would likely take a decade or more for Fannie and Freddie to retain enough of their profits to reach sufficient capitalization and exit conservatorship.

The precise level of capital needed by Fannie and Freddie has not been determined and will not be determined until an administrative capital rule has been approved. Although Watt did issue a proposed rule when he headed the FHFA, Calabria has decided to re-propose the regulation given the changes in policy since 2018. This decision is not the equivalent of starting from scratch on the rule, but it does mean continued uncertainty as to where the endgame is for GSE capital. Absent an actual capital rule to reference, most estimates of the total capital needs for Fannie and Freddie fall in the range of \$100–200 billion. The remaining capital needs will likely be met by a secondary public offering, which would possibly be the largest offering in U.S. history. The FHFA is now initiating some of the required early-stage prerequisites for such an offering, including hiring a financial adviser, but it will likely be 2021 or 2022 before that offering happens.

These additional bits of information can help sketch out a clearer timeline than could be assembled from the Treasury report alone. If the economy avoids a severe recession in the next few years, Fannie and Freddie sustain their profitability, and a public or private offering raises the necessary remaining funds to meet their capital requirements, an exit from conservatorship via the recovery route is foreseeable for one or both of the GSEs in the late years of Calabria's term, which ends in 2024. If one or more of those pieces do not fall into place, then it might be difficult to get everything done before 2024.

As noted, there is ongoing litigation over the constitutionality of the FHFA director position, and that casts a pall over Calabria's efforts. If the litigation is successful, the 2024 time frame may be shortened. The ongoing Fannie and Freddie shareholder litigation may also affect timing, depending on if and how funds are allocated to the plaintiffs. Additionally, if the GSEs' capital mandate cannot be met, this could provide an opportunity to place Fannie and Freddie into receivership. Under HERA, mandatory receivership requires either a state of insolvency or nonpayment of debts, but there is also a discretionary receivership provision, which if the grounds are met could lead to appointment of a receiver. Foremost among those grounds are unsafe or unsound condition and undercapitalization.

FANNIE AND FREDDIE STILL PRESENT A SYSTEMIC RISK

The Treasury report does not set out a credible plan for shrinking the GSEs from their dominating \$5 trillion in asset holdings in their market. They will remain a systemic risk to the financial system, notwithstanding any modest operational changes at the margins.

Although the 2008 joint announcement by Paulson and Lockhart of placement into conservatorship mentioned the phrase "systemic risk" eight times, nothing has been done to materially shrink the footprint of the GSEs. Fannie has remained at over \$3 trillion in assets and Freddie has remained at about \$2 trillion for much of the past decade. Over the last four to five years, both GSEs grew based on asset size, albeit at a modest pace.

The Treasury report does make reference to capping or otherwise limiting multifamily activity as one means to shrink the GSEs' market share, and Calabria has voiced this idea publicly. But multifamily is just a small part of Fannie and Freddie's operations as compared to single-family activity. The Treasury report does recommend that the FHFA be given the power to license competitors to Fannie Mae and Freddie Mac, but this would require legislation that would likely not be approved for many years, if ever. Even then, given their dominating position in the market and the built-in advantages of that market power, the two GSEs will likely continue to be a dominating force for decades to come.

The next housing crisis / As recounted at the beginning of this analysis, the Treasury Department and its advisers determined in 2008 that Fannie and Freddie were careening toward failure and a swift bailout of the GSEs was needed to maintain the stability of the mortgage market. The proximate cause of that near failure was federal housing policy, as best characterized by a 2003 quote from then-congressman Barney Frank during a hearing on Fannie and Freddie in the runup to the financial crisis: "I want to roll the dice a little bit more in this situation toward subsidized housing."

The policy response since the 2008 intervention and nationalizing of the GSEs has meandered between the status quo, the perpetual conservatorship method implemented by FHFA directors DeMarco and Watt, and the "under development" approach of Calabria. The last has been characterized by a focus on avoiding a future bailout by bolstering the capital buffer for Fannie and

Freddie and by putting some limits on the GSEs' risk appetite. As we have also recounted, there are a variety of potential outcomes for this strategy, which is in the early stages of implementation.

How events will unfold during the next housing crisis will depend on when another crisis happens and the policy approach du jour. There is no certainty that Calabria's recapitalization and the proposed operational changes will come to fruition. Even if they do, in some cases they will be vulnerable to administrative reversal after his departure, especially with regard to the GSEs' risk appetite. There is no certainty that future FHFA leadership or a future Congress will not return to a "roll the dice" strategy; in fact, that seems likely given the incentives of those who advocate for an interventionist housing policy.

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HAS REAL PROGRESS BEEN MADE?

When Paulson started off this odyssey of government intervention a dozen years ago, Robert Scully, one of his advisers from Morgan Stanley, was looking for some direction about the underlying rationale for the intervention. His simple question at the time was, "Do you want to kick the can down the road?" Paulson's response was equally simple: "No. I want to address the issue. I don't want to leave the problem unsolved."

Paulson outlined what the underlying problems were in his joint announcement with Lockhart. He spoke of how large the GSEs were, the fact that they were interwoven into the financial system, and the necessity of reducing Fannie and Freddie to a less risky size. He spoke of the fact that Fannie and Freddie could not continue in their current form, the need to address the systemic risk created by the inherent conflict between the GSEs' private shareholders and their public mission, and the flawed business model embedded in the GSE structure. No existing proposal is poised to permanently solve those problems.

Absent any clear solution to these very deep flaws in the structure of Fannie Mae and Freddie Mac, I have been an advocate for putting both in receivership—and I've advocated this since the initial choice between conservatorship and receivership was laid out. My belief in this is buttressed by the FHFA and Treasury's lack of transparency regarding their decision-making at that time and over the subsequent decade-plus. Merely boosting capital mandates to approach the level of bank-like capital standards is not enough, as evidenced by the cycles of bank failures we have seen over the past century. Even the Obama administration, not one to regularly advocate policy moves to shrink the footprint of government influence, issued a report in early 2011 that spoke repeatedly of "winding down" Fannie and Freddie.

Preserving the 30-year mortgage / Thomas Stanton is a long-time observer of Fannie and Freddie who questioned the financial stability implications of the legal and operational framework for the GSEs in his 1991 book *A State of Risk: Will Government Sponsored Enterprises Be the Next Financial Crisis?* Since 2008, Stanton has been an advocate of placing the GSEs in receivership. In 2012 he spoke at a Cato Institute book forum about one of his more recent books focused on the management cultures of failing financial institutions, including Fannie and Freddie. (The moderator of that forum was none other than Calabria.) Stanton told a story about a question he received many years before the crisis on how to "get rid of" Fannie and Freddie and his response was, "Once they fail, I am sure you can do anything you want with them." Stanton admitted that, as it turns out, he was wrong and he attributed this to his "hopeless optimism."

Stanton went on to explain that the role of Fannie and Freddie in the mortgage market has now come down to a question of "what the political process thinks about the 30-year fixed-rate mortgage." Based on that test, it appears that the political process continues to look upon the mortgage favorably, and this is being used as a rationalization for leaving Fannie and Freddie in place. During his confirmation hearings to head the FHFA, Calabria touted his own 30-year fixed mortgage, notwithstanding some of his earlier work for the Cato Institute, which included an article entitled "Housing Market Will Be Fine Without 30-Year Fixed Loans."

This focus on the efficacy of the 30-year fixed-rate mortgage as a basis for keeping the GSEs intact is misplaced. The debate needs to return to the overwhelming flaws with the Fannie and Freddie GSE model as a necessary conduit to deliver that mortgage. R

READINGS

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