

CONSERVING CONSERVATORSHIP

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In early 2008, responding to a rash of unhealthy behaviors, Britney Spears' father swept into action, placing the former Mouseketeer into conservatorship. Later that year, responding to a global financial crisis, Richard Lockhart III, the Director of the Federal Housing Finance Agency, took similar action, placing into conservatorship the government-sponsored enterprises, or GSEs, known colloquially as Fannie Mae and Freddie Mac.

Twelve years later, the "Free Britney" movement staged protests outside government buildings, hoping to garner support for ending her conservatorship. And in the weeks between the November 2020 election and the inauguration of President Biden, a drama likewise unfolded within Washington's corridors of power, as Mark Calabria, the current Director of FHFA, similarly sought to end to the conservatorships of Fannie Mae and Freddie Mac.¹

Yet despite the extensive public theater, both conservatorships survive to this day. If 2008 was the Year of Conservatorship, 2020 was the Year of Conserving Conservatorship.

The GSEs' conservatorships, along with the entire housing finance infrastructure, were built, and occasionally refurbished, during times of profound economic and social turmoil. Since its inception with the Great Depression, the nation's housing finance system has been asked to accomplish many goals, among them:

- Increase home ownership, especially among underserved communities.
- Help Americans build wealth through home ownership.
- Keep financial markets stable and liquid.
- Keep mortgages affordable.
- Support home price growth.
- Contribute to geographic and social mobility by keeping the mortgage market liquid.
- Keep 30-year-fixed rate mortgages available as the predominant mortgage choice for homeowners.
- Price securities backed by residential mortgages to reflect their underlying risks.
- Don't price securities backed by residential mortgages to reflect their underlying risks.

- Promote competition in the market for home mortgages.
- Protect home owners from predatory lenders in the home mortgage market.

No housing policy could realistically accommodate all of these goals, yet because home ownership occupies an almost sacred space in the American imagination, those policymakers entrusted with minding the housing finance apparatus cannot entirely ignore these issues and policy drivers. A national housing finance system must balance the interests of the citizenry with the exigencies of the market.

It should not be surprising, given all the misery unleashed into the world in 2020, that policymakers would avoid radically transforming a conservatorship that was, more or less, addressing the issues it was designed to address.

THE HISTORY OF HOUSING FINANCE

During the Great Depression, in an effort to stimulate the economy through home construction, the federal government initiated its support for homeownership by creating the entities that form the foundation of our current housing finance apparatus: Fannie Mae, the Federal Home Loan Bank system, and the Federal Housing Administration, or FHA.²

In 1938, Fannie Mae was chartered as a government corporation with the purpose of operating a secondary market to purchase loans guaranteed by FHA. That mission was broadened after the Second World War with the creation of the Department of Veterans Affairs, when Fannie Mae was further authorized to purchase VA-guaranteed mortgage loans.

In 1968, as part of the war on poverty and the implementation of President Lyndon Johnson's "Great Society" programs, the Department of Housing and Urban Development was created, splitting Fannie Mae into two entities: Fannie Mae, which continued its secondary market operations, and the Government National Mortgage Association, or Ginnie Mae, which assumed the administration of the portfolio of mortgage loans expressly insured by the federal government.

In 1970, Fannie Mae transitioned to a shareholder-owned corporation with a government charter, becoming authorized to acquire mortgage loans that were not insured by the federal government. This was

¹ Fannie Mae's formal name is the Federal National Mortgage Association, and Freddie Mac's is the Federal Home Loan Mortgage Corporation.

² Much of this section is summarized from the U.S. Department of the Treasury Housing Reform Plan, Pursuant to the Presidential Memorandum Issued March 27, 2019, September 2019, pp. 4-5, <https://home.treasury.gov/system/files/136/Treasury-Housing-Finance-Reform-Plan.pdf> (accessed January 30, 2021).

also the year Congress established Freddie Mac in order to provide competition to Fannie Mae.

At that time, most mortgage loans were made by financial institutions and other private sector entities, which bore the risk of loan defaults. By the mid-1980s, the portion of mortgage debt guaranteed by the GSEs and other federal guarantors began to increase as a share of outstanding mortgage debt. In 2018, mortgages guaranteed in one form or another by the federal government, whether through the GSEs, FHA, the VA, or Ginnie Mae, accounted for about 63 percent of total mortgage debt outstanding, according to data from the Federal Reserve (see graph, p.33).

THE SUBPRIME DISASTER

Most observers blame the proliferation of subprime mortgages for the 2008 financial crisis. As chartered, the GSEs were required to avoid subprime mortgages, with limited exceptions that were meant to support initiatives intended to expand homeownership to certain specified underserved communities. FHA and Ginnie Mae hold the primary responsibility of providing support for low- and moderate-income families whose mortgages cannot be supported through traditional underwriting.

Partly in response to changes in the tax code, partly in response to reforms following the savings and loan crisis of the 1980s, and partly as investors sought more sophisticated methods to manage risk, securitization of residential mortgage debt swelled in the 1990s.

The GSEs faced increasing competition from private financial institutions entering the securitization market because of the increased demand for mortgages, the primary “raw material” of the residential mortgage-backed securitization “factory.”

Meanwhile, banking laws and regulations issued under the Basel II Accord provided recommendations to strengthen the level and quality of capital that banks were required to hold, given the financial and operational risks they faced. Capital buffer requirements dictated the types of securities that would fulfill the tiered requirements for capital adequacy. Although the U.S. government did not expressly guarantee the GSEs’ mortgage-backed securities, the new international banking rules treated them as if they were of the same quality as that of U.S. Treasury securities. This perceived guarantee created almost unlimited demand for GSE MBS as banks across the globe sought to bolster their balance sheets with the GSEs’ MBS.

Because the GSEs had a ready market to sell virtually any security they created, this had the consequence of expanding the demand for subprime mortgages as the competition for mortgages between the GSEs and private label securitizers intensified.

For years, the GSEs’ regulator, then known as the Office of Federal Housing Enterprise Oversight, warned Congress of the GSEs’ unsafe behavior, but the GSEs’ lobbying machines usually were able to fend off calls for increased regulation by wrapping themselves in the flag of home and hearth. It was extremely difficult to find any legislators willing to attach their names to something that its opponents would inevitably call the “Destroying the American Dream Act.”



Perhaps not entirely coincidentally, expanded securitization had the added benefit of increasing the bonus pool for the GSEs’ management teams, making many of them multi-millionaires, lending credibility to critics who argued that the GSEs were able to reap the benefits during the good times, while forcing taxpayers to pick up the tab for the losses once the party ended.

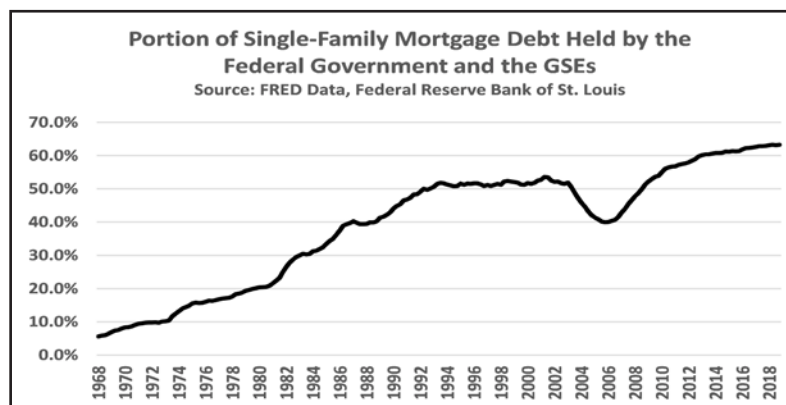
In 2007, panic in the financial markets set in as subprime lenders began filing for bankruptcy and an increasing number of homeowners grew delinquent on their mortgage payments, threatening the ability of the MBS to deliver the returns their investors required.

By the summer of 2008, it was like a global game of chicken, with investors holding GSE MBS – many of them the world’s largest financial institutions – practically daring the U.S. government not to guarantee them. Ultimately, rather than allow the destruction of America’s credit-worthiness, Treasury Secretary Henry Paulson swerved first, averring that well, yes, while they’re not *officially* guaranteed, we will, um, right, you know, make sure that the GSEs’ MBS are fully supported by *essentially* the full faith and credit of the U.S. government.

CONSERVATORSHIP

In late July 2008, Congress passed the Housing and Economic Recovery Act of 2008, establishing FHFA as a more robust regulator for the GSEs, and within a few weeks, FHFA Director Lockhart placed Fannie Mae and Freddie Mac into conservatorship.

The GSEs’ conservatorships are governed by the terms of the Senior Preferred Stock Purchase Agreement, or PSPA, under which the Treasury Department promised to provide the GSEs an amount of up to \$100 billion each, following any quarter in which they reported a deficit in their balance sheets. While this amount may



seem a trifle now that we are accustomed to economic stimulus packages denominated in the trillions, at the time, \$100 billion seemed like a number that just might be sufficient to restore calm to the global financial markets.

It is important to recognize that the PSPAs were structured not as loans, but as preferred equity. In exchange for the capital infusions Treasury offered under the PSPAs, the GSEs were required to make quarterly dividend payments on an annual basis of 10 percent (12 percent if not paid in cash), meaning that a PSPA draw of \$10 billion would require annual cash dividends of \$1 billion. And while there was a mechanism within the PSPAs to redeem, purchase, or retire the Senior Preferred stock, dividends were never considered to be interest or loan repayments.

In exchange for its commitment of liquidity to the GSEs, Treasury received Senior Preferred shares, the right to periodic commitment fees, and a warrant to purchase 79.9 percent of the GSEs' common stock – just under the percentage that would have required Treasury to consolidate the GSEs' financial statements into the government's financial statements. And to be clear, there were approximately zero policymakers who were interested in bringing the GSEs' almost \$6 trillion of unconsolidated debt into the Federal balance sheet, which at the time held "only" about \$12 trillion in debt.

THE GAAP GAP

The terms of the PSPAs did not provide for "liquidity, as needed." Instead, the Treasury pledged to plug any gap produced in the GSEs' financial statements prepared according to generally accepted accounting standards – or GAAP. This curious feature resulted in GSE draws from Treasury because of GAAP deficits caused by accounting entries, such as writedowns for estimated loan losses, the elimination of deferred tax assets, and timing differences in recording gains and losses in their derivatives portfolios, that had no immediate cash flow effects on the GSEs' ability to meet their obligations.

Almost immediately, both GSEs began drawing heavily, and by May 2009, fearing that \$100 billion might not

be enough, the newly installed Obama administration amended the PSPAs to increase the amount of liquidity promised to each GSE to \$200 billion.

By the end of the third quarter of 2009, Fannie Mae had drawn \$45 billion and Freddie Mac \$51 billion, and fearing that even \$200 billion would not be enough, Treasury again amended the PSPAs to allow each GSE to draw \$200 billion plus all the deficits they would incur through the end of 2012.

By the end of 2011, Fannie Mae had drawn almost \$112 billion, and Freddie Mac had drawn about \$71 billion. As the housing market began to stabilize and even improve a bit in early 2012, the GSEs increased their guarantee fees, helping to improve their financial performance. But with annual dividend requirements of \$11.2 billion for Fannie Mae and \$7.1 billion for Freddie Mac – earnings figures they had never achieved prior to the financial crisis – fears began to mount that the GSEs would be forced to draw from Treasury in order to make their 10 percent dividend payments back to, well, Treasury, creating a kind of "dividend death spiral" that would eventually deplete the remaining funding commitment to the GSEs.

Accordingly, in August of 2012, the PSPAs were once again amended, requiring the GSEs to pay to the Treasury Department all of their net worth each quarter, except for a specified capital reserve amount to enable them to absorb short-term and non-cash flow GAAP losses.

TERMINATING CONSERVATORSHIP

By almost any measure, conservatorship seems to have contributed to the stabilization of the financial markets following the 2008 crisis and to have provided at least some support to many homeowners, helping them remain in their homes by allowing lenders to work with them to modify the terms of their mortgages. Importantly, the GSEs retained their access to the capital markets, and the U.S. dollar retained its position as the world's reserve currency.

Still, it is difficult to believe that the architects of conservatorship intended it to last indefinitely, and in

fact, current FHFA Director Mark Calabria contends that, as one of those architects, it never was so intended.

During the Obama administration there were several bi-partisan attempts to introduce legislation to reform the GSEs and to address conservatorship, but as the economy stabilized and housing prices began to return to their pre-crisis levels, housing reform lost much of its urgency, and none of the bills ever came to a vote in either the House or the Senate.

FHFA implemented significant structural reforms while under the leadership of former Congressman Melvin Watt, appointed by President Obama in 2014 as the Director of FHFA. Director Watt led the initiative to complete a standardized securitizing platform to be used by both GSEs, while maintaining a primary focus on maximum home retention policies and credit availability.

Meanwhile, nothing is ever simple, including attempts by dedicated civil servants to stabilize the nation's housing system. In response to the August 2012 "third amendment" to the PSPA, often called the "Net Worth Sweep," several large investors in the publicly-traded equity of the GSEs filed multiple lawsuits against Treasury and FHFA, challenging the government's authority to "sweep" all the GSEs' earnings.

With the election of President Trump in 2016 and his announcement that Steven Mnuchin would lead the Treasury Department, many GSE watchers expected that given Mnuchin's background in mortgages and the lending industry, GSE reform would become a signature issue of the Trump administration. However, there was a catch. FHFA was still helmed by Director Watt, whose term would not expire until January of 2019.

Once Director Watt's term ended, the Trump administration didn't waste any time moving forward with its program of GSE reform. On March 27, 2019, President Trump issued a Presidential Memorandum directing the Treasury Secretary to

...develop a plan for administrative and legislative reforms to achieve the following housing reform goals: (i) **ending the conservatorships** of the Government-sponsored enterprises...upon the completion of specified reforms; (ii) facilitating competition in the housing finance market; (iii) establishing regulation of the GSEs that safeguards their safety and soundness and minimizes the risks they pose to the financial stability of the United States; and (iv) 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.³ (Emphasis is mine.)

³ U.S. Department of the Treasury Housing Reform Plan, Pursuant to the Presidential Memorandum Issued March 27, 2019, September 2019, pg. 1. <https://home.treasury.gov/system/files/136/Treasury-Housing-Finance-Reform-Plan.pdf> (accessed January 30, 2021).

Less than two weeks later, on April 9, 2019, Mark Calabria assumed his position as the Director of FHFA, stating, "I enter this office with a sense of urgency. The foundations of our mortgage finance system remain vulnerable, and we must not let this opportunity for reform pass."⁴

Director Calabria immediately rolled up his sleeves, making significant alterations to the scorecards FHFA had issued for the previous seven years to measure the GSEs' performance toward meeting the requirements of conservatorship. Significantly, Director Calabria added to the scorecard the goal of preparing for a transition out of conservatorship.

In September 2019, Treasury issued its Housing Reform Plan, recommending substantial changes to the role of the federal government and the GSEs in the housing finance industry, preventing future taxpayer-funded bailouts, promoting increased market competition, and of course, ending the conservatorships.

The plan to release the GSEs from conservatorship appeared to be proceeding apace when in early February of 2020, FHFA announced that it had engaged the investment banking firm Houlihan Lokey "to assist in the development and implementation of a roadmap to responsibly end the conservatorships of Fannie Mae and Freddie Mac..." They would be further asked to consider "business and capital structures, market impacts and timing, and available capital raising alternatives" for the GSEs.⁵

THE CURRENT CRISIS AND CONTINUING CONSERVATORSHIP

And then came COVID-19.

As the lockdowns were implemented in response to the pandemic, unemployment skyrocketed, plunging the country into another economic catastrophe. During these worst of times, it certainly didn't seem like the best of times to be discussing radical changes to the GSEs or to their conservatorships. The known unknowns, as well as the unknown unknowns, have certainly accumulated during the past year, and the only certainty is that there is none, particularly with respect to how much forbearance homeowners will need and the effects all this will have on the GSEs' financial performance. As of this writing, the GSEs reported astonishingly good results during the first three quarters of 2020, with income from mortgage refinancings and home prices reaching near record highs. Nevertheless, at some yet-to-be-determined point in time, there is almost certain to be financial pain once generous (and mandated) forbearance terms reach their inevitable limit.

⁴ Federal Housing Finance Agency News Release, Dr. Mark Calabria Sworn In as Director of the Federal Housing Finance Agency, April 15, 2019, <https://www.fhfa.gov/Media/PublicAffairs/Pages/Dr-Mark-Calabria-Sworn-In-as-Director-of-the-Federal-Housing-Finance-Agency.aspx> (accessed January 28, 2021).

⁵ Federal Housing Finance Agency News Release, FHFA Hires Financial Advisor, February 3, 2020, <https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Hires-Financial-Advisor.aspx> (accessed January 28, 2021).

Throughout the COVID-19 crisis, while supporting the GSEs' role in helping borrowers remain in their homes and continuing to extend moratoria on home foreclosures, Director Calabria and Secretary Mnuchin believed there was much that could be done to reform the GSEs without congressional help, and they continued to pursue a strategy for ending conservatorship, or at least for significantly altering its structure.

As if there weren't enough obstacles to their efforts to end conservatorship, in June of 2020 one of the investor lawsuits received a boost when the U.S. Supreme Court handed down its decision in *Seila Law v. the Consumer Financial Protection Bureau*, ruling that the single-director structure of the CFPB was unconstitutional. The decision heartened the GSE investor plaintiffs challenging the 2012 Net Worth Sweep because it seemed to indicate the Supreme Court would be sympathetic to their arguments in the *Collins v. Mnuchin* case. In that case, the Fifth Circuit Court of Appeals handed down a decision in June of 2019 that FHFA's structure was unconstitutional, in part because of its single-director structure. The Government's appeal of the Fifth Circuit's decision was heard by the Supreme Court on December 9, 2020, and a decision is expected in June of this year.

Should the Court rule that FHFA's structure is unconstitutional, it would mean that the President has the right to appoint FHFA's director, who would no longer be protected by a five-year term. And if that is the Court's ruling, most observers believe it is a near certainty that President Biden will choose to replace Mark Calabria with a Director who is not as likely to be as enthusiastic about ending conservatorship.

While it could be argued that during the first half of January the Executive branch of government was occupied with far more pressing issues than GSE reform, on January 14, 2021, less than a week before President Biden's inauguration, the Treasury Department announced another change to the terms of the PSPA. Treasury would no longer sweep the GSEs' earnings. Instead, the GSEs would be allowed to retain their earnings to build equity consistent with the requirements set forth by FHFA in its December 2020 Final Rule on Enterprise Capital. The Rule stipulated that the GSEs should hold capital in an amount deemed sufficient to "facilitate their ability to operate through a severe downturn" and that collectively, the GSEs should hold more than \$280 billion in risk-based capital. The January 14 announcement was, in other words, essentially a reversal of the 2012 Net Worth Sweep, as well as a giant pause button on the requirement for the GSEs to pay dividends to Treasury.

Of course, no changes to the PSPAs are set in stone; the PSPAs can be amended at any time by Treasury Secretary Janet Yellen or any future successor. In theory, Congress could also intercede and modify the GSEs' charters and

create legislation to release them from conservatorship, although that seems unlikely in the present climate.

The very purpose of conservatorship is to implement critical reforms that will produce a stronger and more resilient housing finance system. This is not just a free market goal but also a social goal. And therein lies much of the predicament facing policymakers when confronting GSE reform. Fannie Mae and Freddie Mac were always weird animals: stockholder-held, SEC-listed, publicly-traded companies, but chartered to serve a social purpose – not fully public, but not completely private either. Instead of being taken into bankruptcy for restructuring or liquidation, they were placed into government-supervised conservatorships, where they have remained for more than a dozen years.

And once again, the GSEs have been asked to step in to help mitigate the damages that an entirely free housing market would almost certainly extract from homeowners. Those whose mortgages are held by the GSEs are being assured that they will be offered forbearance and mortgage modifications, and it is FHFA, as the GSEs' conservator, that is directing the GSEs to take those initiatives.

Will the GSEs need to draw on their PSPAs once again? Fannie Mae's remaining PSPA commitment is \$113.9 billion, while Freddie Mac's is \$140.2 billion. FHFA and Treasury are now committed to allowing the GSEs to retain capital, with no obligation to pay dividends to Treasury. But there's still a lot of uncertainty. No one knows how much longer this pandemic will last or how bad its long-term consequences will be.

It would be foolish to engage in any kind of prognosticating after all we've recently been through. Almost no one predicted Brexit, Donald Trump's presidency or the COVID-19 pandemic and its accompanying economic damage. Still, it is difficult to imagine President Biden mustering the enthusiasm to end the GSEs' conservatorships. And there just might be something to be said for conserving the GSEs' conservatorships during a time of continuing crisis. Just ask Jamie Spears, who continues to control the purse strings of his daughter's vast entertainment empire.

ABOUT THE AUTHOR



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Anne Eberhardt is a Senior Director in the Forensics and Litigation Consulting Practice of the New York office of Gavin/Solmonese. She has extensive experience working during periods of extreme crisis, including within conflict zones. Her career was forged during the collapse of the oil and gas industry and the accompanying savings and loan bailouts. A significant portion of her career was spent working on projects relating to the government-sponsored entities, both prior to and following the economic crisis of 2008.