INDUSTRY PERSPECTIVES

What Should We Do with the GSEs?

Common-Sense Reform Recommendations for the Biden Administration

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Introduction

What should we do with Freddie Mac and Fannie Mae, the two government-sponsored enterprises?

The GSE reform question, i.e. how should the two companies end their conservatorships, has proven to be one of the most vexing in Washington in the past decade. They have been under government control for over twelve years now with no concrete end in sight, even though conservatorship was meant to be a temporary arrangement. The question is renowned for its complexity, the intense politics surrounding it, and the immense amount of money involved.[1]

The Biden transition team, and other centers of Democratic power in Washington, already have members of the housing finance policy community selling them various ideas of what to do with the two companies – as did the Obama and Trump administrations before them. For many years these ideas focused on replacing the GSEs with something else, which has ranged from "no GSEs" to lender cooperatives to a government-owned monopoly, among others. The proposers of these ideas were mostly Washington-centric housing finance policy specialists, including think tank researchers, members of Congress, academics and others. However, in a dozen years, virtually all such replacement ideas have faded away as, upon further examination, they were found to be unworkable or unduly risky, and so never garnered the support required to pass the needed legislation in Congress. In addition, rarely did such proposals ever address how to transition from what exists today to what was being proposed while successfully avoiding an unacceptable, years-long disruption to the country's financing of homeownership.

In more recent years, ideas for GSE reform have shifted towards proposals that would reform the two existing companies rather than replace them. Organizations of smaller lenders have been particularly vocal in support of such an approach. Most prominent has been the "utility model," whereby the two current GSEs – after being reformed and recapitalized – would be released from conservatorship with their regulator, the Federal Housing Finance Agency (FHFA), empowered to set their guarantee fees, much as a state-level public service commission sets electric power rates. Many (myself included) believe it is not just a practical solution but actually quite a good one: fully workable, delivering a quality housing finance system to borrowers,[2] avoiding a multi-year disruption to transition

[1] The two GSEs together hold about half of the $12 trillion of residential mortgage assets in America, making each of them among the very largest financial institutions in the country.
[2] More specifically, it would preserve the wide availability to the broad middle and working class of the current 30-year fixed rate, self-amortizing mortgage that is freely prepayable at any time (known as the "American" mortgage). It would also preserve the attractively low rates paid by borrowers.

to a new system, and strongly protecting taxpayers. Some claim this approach to be a near-consensus at this point.

This paper is designed to help incoming Biden administration officials, and especially those who will work for its two key players on this topic – a new secretary of the Treasury and a new chair of the National Economic Council (NEC) – to avoid starting from scratch or pursuing paths already found to be dead ends. Such help will be needed because GSE reform has proven to be an incredibly complex topic, requiring expertise in how the GSEs operate, how housing finance more broadly works, how large financial institutions are managed and regulated, how unprecedented amounts of capital can be raised to support a reformed GSE system, and more.[3] And this is before even getting to extremely important social issues not directly related to the GSEs exiting conservatorship – such as the role the companies can play in reducing wealth inequality (which is of course heavily correlated to race in the US) via homeownership.[4]

The conclusion of this paper is that the Biden administration, if it is to successfully address the GSE question, rather than repeat the frustrating and ultimately unproductive attempts of its predecessors, must follow one of two possible paths in the next twelve to twenty-four months. Neither path involves the more radical approach of winding down the current GSEs and replacing them with something unproven; instead, both work with the existing two GSEs.

The first possible path is to leave the companies in long-term conservatorship – which has worked, and continues to work, unexpectedly well (including during the pandemic) – and then possibly revisit the question of conservatorship exit in a few years. This additional time in conservatorship should absolutely not be a period of stagnation; more operating reforms and improvements can be implemented, building on the many that have already occurred while the two companies have been under government control. The second possible path, based upon the only proposal believed to be able to successfully navigate all the complexities and risks of conservatorship exit, is to additionally implement, via administrative means, the early years of a long-term transition to the utility model. Under both paths, earnings could and should be retained to reduce taxpayer exposure to the risks of the companies.

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[3] Senator Bob Corker (R-TN), when working on a 2014 reform bill jointly with Senator Mark Warner (D-VA), at one meeting which I attended where details of the legislation were being developed, commented on the complexity that was being revealed: “Gee, and I thought that peace in the Middle East was complicated!” He was, at that time, the senior Republican on the Senate Foreign Relations Committee.

[4] Most policy focus is on income inequality, which is closely related to but not the same as wealth inequality. Housing finance is more oriented towards playing a role in impacting wealth inequality.

What Priority Should Be Given to GSE Reform?

The Biden administration, as in the first year of any new presidency, will have a long list of priorities, most prominently key and oft-repeated promises made to voters by the candidate as well as issues important to its core political constituency. These priorities will consume the available hours of its senior officials, and those priorities that require legislation will presumably be shared by its party's senior leadership in Congress. For a Biden presidency, when it comes to domestic economic policy, this set of priorities would include front and center, as one example, the promised revision to the tax code to increase revenue from families earning over $400,000 per year and corporations.

Against this background, what priority should thus be given to GSE reform? The answer, realistically, is "not a whole lot," despite the wishes of many people who specialize in housing finance. There are several reasons why.

First, the mortgage system is working well, and many industry players says it is performing very well. The average homeowner does not see anything that is particularly broken – in fact, the massive and record-setting volumes being processed this year in the pandemic, as mortgage rates have declined to record-low levels, are being handled without major disruption. Importantly, the GSEs are playing an outsized role in delivering those results: their share of new single-family first mortgages financed, in recent years averaging about 45% of the total, has rocketed to 65% and more lately, as banks and other lending institutions have backed off the market. So, there is no obvious "problem to be fixed" in the eyes of the homeowning voter. In fact, GSE reform is the classic "lose-only" political issue: if reform works well, the public hardly notices, but if reform creates disruption in the mortgage markets, it results in a very visible black eye for the administration.

Second, for many years people in housing finance claimed that it would be "unsustainable" for the two GSEs to stay in conservatorship for an extended time. Theoretically, that should be true. However, more than twelve years later, the hard reality is that conservatorship is in fact looking very sustainable. The dual conservatorship, in terms of its duration and size, is unprecedented, and no one knew quite what to expect when it started. It has turned out, however, that the two companies and the FHFA have actually made it work quite effectively.[5] In fact, there have been key operating improvements

[5] One of the core reasons for this effectiveness in conservatorship is that the FHFA, which has the legal authority to take over direct operational control of the GSEs as if it were the management, under Acting Director DeMarco (2009 to 2014) and Director Watt (2014 to 2019) pursued a policy of having the companies operate with respect to commercial matters under the supervision of professional boards of directors, with the FHFA retaining control of strategy and public policy issues. (One example of an issue where the FHFA has retained public policy control is the terms under which GSEs will do loan modifications for troubled borrowers; another example is whether, and if so

to the GSEs during conservatorship (discussed further below) that are considered major policy accomplishments, rather than the time under government control being just a “time out” with little or no change, as had originally been expected.

Third and last, by and large the “industry” – meaning mostly the many mortgage originators, servicers and investors – have become generally happy with how the GSEs have been operating for the last roughly seven or eight years.[6] In my view, most are nervous that any changes due to a particular reform plan might be problematic and harmful to their interests, and so are relatively content with the status quo.

The biggest argument in favor of tackling GSE reform, then, is that it is an embarrassment to the government that these two companies, designed as privately-owned, are staying in its hands for so long with no end in sight: they should either go back to private hands in some fashion, or be changed via legislation so that private ownership is eliminated. This argument is, however, important only to a limited number of people. The broader audience – consisting of voters, the industry and key interest groups important to the administration – is more driven by real-world impacts, and in the real world, things are going well. In short, the failure to complete GSE reform is theoretically a problem, but in practice it does not seem to be.

The result: the Biden administration should not especially prioritize GSE reform in its key first twelve to twenty-four months. It has far more impactful domestic economic policies to focus on instead. The GSE reform question does not need to be totally ignored, but it does not seem to be worth pursuing in a manner that consumes major administration resources or political capital.

The Importance of Understanding Legislative versus Administrative Reform

Soon after the 2008 financial crisis, members of the housing finance policy community began to focus on what to do with the two GSEs. In terms of legal options, this debate broke down into two choices: (1) have the companies exit conservatorship, operating largely as they had previously (known as “recap and release”), or (2) have Congress, which established the two companies in laws known as the GSE “charters,” pass legislation to change... well… pretty much anything it wanted. The two GSEs could become five or six, or perhaps just one; their owners could be private shareholders or the government

by how much, to reduce the mortgage investment portfolio even more than required by legal contract with Treasury). It is unclear whether this policy is still being observed by Director Calabria (2019 to present), who seems to be directing the commercial affairs of the companies in some detail.

[6] This is true through 2019. In 2020, the pandemic has created many strains and stresses where the FHFA and the industry have significantly disagreed. It is unclear how transitory these disagreements may be.

or perhaps mortgage lenders organized into a cooperative; their operations could be fundamentally restructured or left alone. Creative reform ideas were unleashed by the bold assumption that Congress would pass legislation to implement the proposer's idea of "reform," no matter how unusual or unproven.

There was, and still is, virtually no support for the two companies to return to their pre-conservatorship status unreformed, as the weaknesses of that business model became all too apparent.[7] So, from 2009 to about mid-2017, all the focus went to ideas for legislative reform in the hope Congress would address what was often described as the last piece of unfinished business from the Financial Crisis.

Despite so much focus on GSE reform legislation, Congress was unable to get anything passed, year after year; in fact, it didn't ever really come that close. There was usually not enough appetite to spend the time necessary to develop legislation in such a complex field. There was not enough agreement on what particular reform to adopt – not only did Republicans disagree with Democrats, but even within each party ideas varied tremendously. And legislation could be derailed by disagreements on a specific, focused issue, rather than only on the broader structure of a particular proposal for reform. For example, the most ambitious bi-partisan effort for GSE reform by legislation, the Senate's Corker-Warner bill, failed in 2014 because there was disagreement among Senate Democrats on the role and structure of how the two GSEs would take actions to increase access to credit, even though this disagreement was not directly related to the issue of exiting conservatorship.[8]

Eventually, most professional and independent observers lost faith in the ability of Congress to agree to GSE reform legislation in any reasonable timeframe, period. At that point, the only people pushing legislative reform ideas, claiming that "this year we can get it over the Congressional goal line," seemed to be the sponsors of a reform idea that required such legislation… and some members of the relevant congressional committees, who may have been motivated to do so as part of campaign fund-raising efforts. Such claims just had no broad credibility after a while.

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[7] See Financial Crisis Inquiry Commission, "The Financial Crisis Inquiry Report," January 2011, https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf, and the testimony of Armando Falcon, former GSE regulator, before the commission, https://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0409-Falcon.pdf.

[8] The disagreement was whether to keep the traditional "affordable goals" approach which had been in place for many years or replace it with a fee paid to the government to be used for similar purposes. Moderate Senate Democrats (and the Obama White House) were willing to support the fee approach in the interest of getting a bi-partisan bill; more progressive senators were not.

Meanwhile, inside the conservatorship, in 2016 senior FHFA officials and I began to discuss the concept of "administrative reform" – that is, being able to release the GSEs from conservatorship, with key reforms very much still in place, without needing any legislation. One could not change that there would be the two GSEs with the names of the Federal Home Loan Mortgage Corporation (the official name of Freddie Mac) and the Federal National Mortgage Association (ditto Fannie Mae), as both are specified in legislation, or that their obligation to support access to credit was to be structured as described in their existing charters. However, many important defects in the pre-conservatorship GSEs could be remedied. These remedies would take the form of certain regulatory changes by the FHFA plus clauses added into the legal contract, known as the Preferred Stock Purchase Agreement (PSPA), by which the two companies obtain financial support from the Treasury.

As background, the GSEs, for their business model to work, require that their guarantee of the credit risk to investors in the mortgage-backed securities (MBS) they issue be backed by the US government in some fashion. Prior to conservatorship, it was backed by the "implied guarantee." Since then, that backing has been by the PSPA, in which Treasury promises that, if necessary, it will inject equity (up to an extremely high limit) into the GSEs to prevent the net worth of either one from ever going negative. The PSPA allows the markets to act on the belief that the two companies would essentially never default on their obligations.[9]

The PSPA therefore needs to stay in place, regardless of whether conservatorship continues or not – at least until someday, maybe, legislation will replace it with something else acceptable to MBS investors (possibly a full-faith-and-credit guarantee). Thus, Treasury can say to the GSEs: "If you want my support through the PSPA to continue past the end of conservatorship, I want in return certain additional limitations and requirements on you." And the GSEs have little ability to not agree. Therefore, key reforms of their operations via administrative means can be locked up by contract (i.e., in an amended PSPA) to be unquestionably legally binding on the companies, rather than via legislation.

These reforms can include, as two examples, a requirement that they charge "level guarantee fees," meaning that there are no volume discounts given to larger lenders, and a limitation on the size of their mortgage investment portfolios (not having such a limit was a major defect in their pre-conservatorship business model).[10] It can also include their agreeing to subject themselves to utility-style price regulation of their guarantee fees by the FHFA (discussed further below).

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[9] In financial terms, that means the capital of the two GSEs – i.e. the financial resources designed to absorb losses – is on the books of Treasury more than on the books of the GSEs themselves.

[10] A limit on portfolio size already exists in the PSPA. It would presumably be revised and refined as part of administrative reform, as the current limits were set back in 2008.

This concept of administrative reform was kept confidential inside the conservatorship for a time, but then disclosed by Treasury during the Trump administration. It was eventually adopted in 2019 for implementation, because the likelihood of legislation – which Treasury Secretary Mnuchin said would indeed be his first choice, if it were possible – was just so remote.

The import of all this for the incoming Biden administration is that ideas for GSE reform that require legislation, regardless of their ideological or interest group attractiveness and regardless of the enthusiasm of their proposers, are just not worth pursuing, as the odds of getting legislation passed are too small (and of course the administration will have higher priorities for congressional attention initially). Claims to the contrary are just not credible given the historic track record. The focus, if reform is pursued at all, then has to be on reform via administrative means.

Interestingly, the lower risk of mortgage market disruption also makes reform by administrative means attractive, as discussed further below.

The Evolution of an Industry Consensus (2009 to 2019)

In September 2019 the Trump administration released its plan for GSE reform. In a hearing on September 10 dedicated to the topic, Senator Sherrod Brown (D-OH), ranking member on the Senate Banking Committee, stated that he understood there to be a broad consensus in the industry and among other interest groups (which he called "stakeholders") that the "utility model" was the right way to proceed in terms of GSE reform.[11]

The senator was, in my view, generally correct in his statement. But that consensus had come about only relatively recently, and it was a long and winding road to go from the thinking of 2009 to the thinking of 2019. For the Biden administration to avoid unnecessarily repeating that journey, it is important to review how the thinking evolved.

After the two GSEs collapsed into conservatorship in September 2008, the balance of political forces in the mortgage industry dramatically changed. Previously, the two GSEs had been heavyweight political and lobbying organizations, using their large profits to influence opinion to their advantage. But in conservatorship, they are prohibited from lobbying; in addition, the examination of the financial crisis by many groups had uncovered very significant defects in the GSE business model, as well as problematic behavior by the companies.[12] As a result, the two companies became, in the colloquial

[11] See "Housing Finance Reform: Next Steps," Hearing before the Committee on Banking, Housing, and Urban Affairs, September 10, 2019, https://www.banking.senate.gov/hearings/housing-finance-reform-next-steps.
[12] See "The Financial Crisis Inquiry Report," referenced above.

phrase, “politically toxic.” No one seemingly wanted the existing GSEs to exit conservatorship so they could go back to their “bad old ways” again.

Hence, the focus of GSE reform, as mentioned above, was almost exclusively on ideas that would require legislation to dramatically change the GSE duopoly. Reflecting this focus, the official policy of the Obama administration was that the two existing GSEs should be “wound down” and replaced by something else (the administration never specified the “something else,” leaving it to Congress to develop).[13] Unfortunately, this policy never panned out. There were plenty of creative ideas about what that “something else” should be, many of which did indeed sound attractive… at 50,000 feet. However, when they were examined more closely, as analysts descended to 5,000 feet or even to ground level, they were found to not be workable.

The most successful such idea was to have “many smaller GSEs” – i.e., five or six (or more) guarantors, all working under reformed rules based upon what was learned in the aftermath of the Financial Crisis, that would compete for the business of primary lenders. In 2014, Senators Corker and Warner collaborated to produce a bipartisan bill based upon this idea, personally spending an unusually large amount of time to master a complex topic enough to create legislation.[14] While its immediate failure was because of disagreement among Senate Democrats over how the two GSEs would support broad access to credit, it became clear over time that the actual proposed reform was not likely to work. It had sounded great (initially including to me) when viewed at 50,000 feet, but as we got down to ground level it began to show its core flaws: it looked too complicated to be sure it would operate as hoped and too likely to create a highly disruptive transition.[15] There was also no evidence that new guarantors would in fact show up, especially if they had to compete in some fashion against descendants of Freddie Mac and Fannie Mae.

The housing finance policy community, after seeing in this case how hard legislative reform could be, broadly then turned its primary attention to other issues of importance, and only secondarily maintained a focus on GSE reform. However, its reform ideas still concentrated on wholesale change to

[13] I was told of this policy repeatedly by Treasury officials from 2012 to 2016. See Barack Obama, “Remarks by the President on Housing,” Phoenix, AZ, 2015, https://obamawhitehouse.archives.gov/the-press-office/2015/01/08/remarks-president-housing-phoenix-az for President Obama’s speech on January 8, 2015, saying it explicitly.

[14] I became a technical adviser to them and their staffs. To ensure I did not take advantage of the opportunity to instead engage in lobbying, rather than just technical advising, I was always accompanied by an FHFA official.

[15] It failed to gain approval “at least in part over concerns that it was too complex and untested, and that the transition from the current system to the new one envisioned in the legislation would be too disruptive to the housing finance system,” according to the testimony of the representative from the American Bankers Association at the July 20, 2017 Senate Banking Committee hearing dedicated to smaller lenders.

replace the current GSE system, with an underlying view that the two companies were still politically toxic.

Meanwhile, without a lot of drama, Freddie Mac and Fannie Mae, in the conservatorship directed by the FHFA, had begun to reform themselves starting in 2012.[16] They introduced level guarantee fees, very much wanted by the smaller lenders. No longer focused on lobbying and political influencing operations to improve their profits via hidden subsidies and other advantages, they began to become much more competitive, introducing updated technology that reduced the costs incurred by lenders in dealing with them and shrinking the risk those lenders faced related to "representations and warranties."[17] Freddie Mac introduced credit risk transfer (CRT) transactions in 2013, with Fannie Mae following shortly thereafter, to reduce the immense and systemically risky concentration of mortgage credit risk on their books. And there were more reforms beyond those.

Many lenders and others eventually began to realize that the GSE portion of the mortgage system was working better than it had ever done in the past.

Between the failure of Congress to come up with a replacement system that worked, and the major improvements in how the GSEs operated – plus the passage of time since 2008 – sentiment about GSE reform began to shift, although quietly at first. Smaller lenders, in particular, began to vocalize fears that major change – that is, winding down the GSEs and replacing them with some new system – would put their firms at risk, not just of becoming a bit less profitable but possibly of being driven out of business altogether. The result was, in the summer of 2017, a major new voice being heard about GSE reform, with a decidedly different opinion, producing an inflection point in the debate. That new voice – the view of smaller lenders – has since come to be the dominant one as it spread to the bulk of the industry and other interest groups.

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[16] This reform was symbolized by the FHFA's issuing in 2012 the first "Conservatorship Scorecard," which gave specific policy objectives to the GSEs, many of which were about reforming themselves. The scorecards were public documents, although not every reform went through the scorecards. Also, "GSE Reform in Conservatorship" was in fact the title of a talk I gave in 2013 at the annual meeting of the Mortgage Bankers Association, so no one could claim that it was being done out of public view.

[17] This refers to the risk that the GSEs, purchasing loans that the lenders promised met all required GSE criteria, would find that the loans did not in face meet their criteria, in which case the lenders would likely have to buy the loans back. Prior to the reforms established in 2012-13, the GSEs would not check for such defects until a loan went into default, usually many years later. This practice led to massive required buybacks in the Financial Crisis. The reforms required the GSEs to make any such buyback claims in a short timeframe (usually ninety days). This new practice led to a major increase in "manufacturing quality" by lenders, as they fixed problems quickly upon learning about them within those ninety days rather than years later, and thus substantially reduced the risk of needing to dedicate funds to "buy back" loans. It was justifiably considered a major reform success all around.

This shift started with the coming together of a new group, the Main Street GSE Reform Coalition, which included two smaller lender industry associations along with some community groups and the NAACP. The coalition issued "Common GSE Reform Principles" in late June. On one page, it listed its principles, but what was refreshing and new was that the underlying approach was to have the two GSEs stay in existence – no more "winding down" was mentioned – and be released from conservatorship after being reformed and recapitalized.[18]

The coalition's action was quickly followed up on at a hearing of the Senate Banking Committee on July 20, 2017 that focused exclusively on the views of smaller lenders; six different industry associations affiliated with such lenders testified.[19] At the core of the clear majority of the testimony, leaving aside traditional special-interest pleading, was the view that the two GSEs should be maintained but reformed. "Use what's in place today and is working and focus reform on aspects of the current system that are not working or that put taxpayers at risk," said one; another said, "Fannie and Freddie need to be preserved and capitalized to ensure they can continue to play their historic role… a utility model helps ensure their focus on this role and their long-term sustainability."

One long-term observer of GSE matters in Washington summed up the collective testimony to me as follows: "*We are not interested in someone's idea of how housing finance should work as if we were starting all over again, because we're not. Instead, let's just fix the five or six big things wrong with the GSEs and move on*."[20]

That hearing, on top of the release of the Main Street GSE Reform Coalition document, drove a major shift in the views about ending the conservatorships. The smaller lender viewpoint quickly became widespread, supported by many in the industry as well as community groups. I was told once by a congressional staff member working on the Corker-Warner bill that "Both the R's and the D's love

[18] See Main Street GSE Reform Coalition, "Common GSE Reform Principles," http://thecmla.com/cmla/wp-content/uploads/2017/06/common-gse-reform-principles.pdf.
[19] The hearing was titled "Housing Finance Reform: Maintaining Access for Small Lenders." Testifiers represented the American Bankers Association, the Credit Union National Association, the Independent Community Bankers of America, the National Association of Federally-Insured Credit Unions, the Community Mortgage Lenders of America, and the Community Home Lenders Association. The written submissions of all six organizations are at "Housing Finance Reform: Maintaining Access for Small Lenders," Hearing before the Committee on Banking, Housing, and Urban Affairs, July 20, 2017, https://www.banking.senate.gov/hearings/housing-finance-reform-maintaining-access-for-small-lenders.
[20] This second-hand recounting was a reasonably accurate summary of the core message of the testimony on July 20, 2017. The specific testimony by Wes Hunt, representing the Community Mortgage Lenders of America, summed it all up. Hunt was particularly dismissive of the "big ideas" that had dominated the discussion since 2009 for being both inadequately grounded in how housing finance actually works and also biased towards the interests of large lenders. See "Housing Finance Reform: Maintaining Access for Small Lenders" (testimony of Wes Hunt), https://www.banking.senate.gov/imo/media/doc/Hunt%20Testimony%207-20-17.pdf.

smaller lenders," so politically it had a lot of oomph behind it. It was all made easier, of course, as the "political toxicity" of the GSEs was much mitigated by the confidence-building operating improvements instituted during conservatorship, as they had been going on at that point for the prior five years.

By 2019, the change in attitude was largely complete. There was indeed a consensus – not universal but very broad, broader than for any other proposal about how to structure housing finance – to stick with the two existing GSEs, set them up as utilities in terms of price regulation, institute those five or six big reforms, and do it all via administrative means.[21] This path seemed highly workable, and posed little risk of major disruption to the mortgage market during a transition period or of some unintended consequence generating operating dysfunction or political blowback. It was, therefore, a good solution in the eyes of many in the industry. Senator Brown's conclusion reflected all this.

Naturally, there are still those who would prefer to replace the GSEs (despite there being no obviously workable alternative), and strongly anti-GSE conservatives will never sign on to any plan in which the two companies survive intact. Also, the consensus did not address how to recapitalize the two GSEs, a very complex issue discussed further below. Nevertheless, for the first time, there seemed to be a credible path forward, something which had eluded Washington for a decade at that point. To date, in my view, it is really the only one that exists.

Interestingly, the Trump administration, after stating that it would like legislation to move forward on GSE reform, quickly pivoted to administrative reform when even the chair of the Senate Banking Committee, Senator Mike Crapo (R-ID), indicated in public, at his committee's hearing on September 10, 2019 about the administration's reform plan, that the likelihood of getting anything passed through Congress was very low.[22] The Trump administration, via Treasury and the FHFA, thus embarked on implementing what amounted to the consensus plan, as described above, with the notable exception of being silent about utility-style regulation of guarantee fees.[23]

<u>The "Five or Six Big Thing to Fix"</u>

The consensus on how to proceed with GSE reform, as described above, is contingent upon truly reforming the two companies, rather than returning them to their pre-2008 "bad old ways"; that's the

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[21] Most testimony at the Senate Banking Committee hearing still assumed that legislation was possible, but recommended targeted legal changes only. Over time, as it became clear that legislation was not likely on any basis, reform by administrative means became an acceptable second-best consensus viewpoint.
[22] See note 11, referencing the September 10, 2019 Senate Banking Committee hearing.
[23] Because the consensus has a Democratic tinge to it, the Trump administration did not ever state it was implementing the consensus. But the substance of what it was doing was just that.

"reform" component of "reform, recap and release." So, what are the "five or six big things" to be fixed in order to be able to release the companies from conservatorship? My suggestions are shown below. Importantly, in the absence of legislation, these "fixes" can become binding on the two GSEs through administrative reform only via one of two routes: (1) the fixes can be included in an amendment to the PSPA that the companies, by contract, must adhere to, or (2) they can be established by the FHFA in a regulatory rule that the companies must work within.

1. *Level guarantee fees.* This fix is important to smaller lenders, as it mandates that guarantee fees not include a volume-discount feature (which existed pre-2008). It has been implemented in conservatorship by the conservator mandating it via a directive.[24] Going forward, it can be included as a requirement in an amendment to the PSPA.
2. *Limited mortgage investment portfolio.* Prior to 2008, possibly the biggest loophole in the GSE system was the ability of the two companies to expand, without limit, mortgage investment portfolios funded by debt with a cost that was extremely inexpensive (because it carried the implied guarantee of the government). It was the "cheapness" of this debt that generated the majority of the two companies' profits. For this reason, the PSPA, when initiated in 2008, required a gradual reduction in the mortgage investment portfolios down to a level ($250 billion for each company, a decline of about two-thirds) more reasonably needed to support the guarantee business. The FHFA, as conservator, more recently has required further reduction. A new limit, perhaps structured as a percentage of MBS outstanding, should be promulgated, again by including it within the amended PSPA so it is binding on the companies.
3. *A proper post-2008, SIFI-consistent capital requirement.* One of the biggest flaws in the GSE system of housing finance prior to 2008 was that the amount of capital required, even against the lax standards of the day, was inadequate. Going forward, the FHFA needs to adopt a rule requiring a level of capital that is consistent with what applies to other systemically important financial institutions (SIFIs) post-2008 – that is, it should require the same level of capital for the same underlying risk. In fact, a new capital rule is now being

[24] Such "conservatorship directives" are binding on the companies only during conservatorship. When conservatorship ends, they lose their applicability. Thus, those directives that arguably should be kept as just good regulatory policy (which are many) must be replaced with something permanently binding on the two companies, most likely via inclusion in the PSPA or via a formal regulatory rule.

finalized.[25] This is a core requirement before the GSEs can be released from conservatorship.

4. *A fee for explicit Treasury support.* Establish a cash fee to be paid by the GSEs to the Treasury to compensate the taxpayers for their support under the PSPA. The fee should reflect both the volume of obligations being supported by Treasury and the relative likelihood of its actually being called upon.[26] This fee would be locked up in the form of an amendment to the PSPA. Such an amendment will finally end any trace of the free "implied guarantee" enjoyed by the GSEs prior to 2008.
5. *Prohibiting borrower-abusive products.* In the aftermath of the 2008 Financial Crisis, it became clear that there had been significant abuse of borrowers by exposing them to risky mortgage products (e.g., loans with teaser rates). As a result, the Consumer Financial Protection Bureau (CFPB), as required by the legislation establishing it, created a definition of "qualified mortgage" (or QM) that excluded such products. The FHFA then issued a conservatorship directive for the GSEs to similarly exclude such products from being eligible for purchase. This should continue and, post-conservatorship, it should be required by a regulatory rule and/or a PSPA amendment.
6. *Utility-style price regulation.* The flaw in the Trump administration's plan for GSE reform by administrative means is that while there will continue to be just the two GSEs, not five or six, there is, strangely, no mention of a utility-style regulator. (Under a legislative reform alternative, the administration called for more than two GSEs; theoretically, a larger number of enterprises would, through competition, keep pricing in line with risk and costs.) Without a utility-style regulator, however, the two companies could easily engage in implicit collusion (explicit collusion, of course, being illegal) to keep guarantee fees very high. The only solution to address this possible abuse is to adopt utility-style regulation of guarantee fees (and the pricing of any other GSE products), much as state-level public service commissions regulate electricity and water rates. A PSPA amendment should include the two companies agreeing to subject themselves to such regulation by the FHFA. However,

[25] The actual proposal is highly controversial because the requirement seems to most commentators excessive, i.e. too high versus the "same capital for same risk" standard. It may take several years for this all to be worked through.
[26] With a proper SIFI-consistent capital system standing in front of the taxpayer, the likelihood of taxpayer support ever being needed should be exceedingly remote.

the phrase "utility regulation" is actually very vague; considerable work needs to be done to specify exactly what it means for a PSPA revision.

These would be my top six "fixes." One that some would say is missing is a requirement to do CRT transactions to a certain degree. I very much disagree, despite being a strong risk transfer supporter: CRT transactions will occur on an efficient and economic basis as a byproduct of a proper capital system; *no further incentive is needed.* Proposals to, central planning style, mandate certain CRT volumes falsely treat them as transactions where calculations of the cost of risk reduction do not come into play, which in turn can lead to very bad unintended consequences, as calculating the cost of laying off the risk versus the cost of holding it is fundamental to running a capital-efficient large financial institution.[27]

It is possible others will have additional major "fixes" to suggest, and there are many smaller ones that can be addressed by the FHFA through rule-making over time. But the list above is clearly a good start.[28]

A New FHFA Director?

The ability of a Biden administration to impact or guide anything about the two GSEs must run heavily, if not exclusively, through the FHFA. This is because the FHFA has well beyond the normal authority of a regulator, as it is also the conservator of the two companies, which means the FHFA by law has all the authority of the shareholders, boards and management of the two companies – and therefore can do pretty much whatever it wants with them. In short, the FHFA is in virtually total operational control of the GSE system.[29]

The current director of the FHFA, Mark Calabria, has a five-year term that extends through 2024. Given his strong Republican partisan background and long public history of antipathy to the GSEs,

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[27] The amount of risk transferred in a CRT transaction can vary tremendously based upon the specifics of its structure. A volume-based requirement will tend to drive transactions that transfer relatively little risk but "still count." In fact, the entire exercise can easily become warped to be "pay as little as possible – which means transfer as little risk as possible – to get transactions that count" by some regulatory measure. This is a classic example of an unintended, though very predictable, consequence.

[28] This article, as stated in the introduction, is focused on GSE reform, meaning issues related to them eventually exiting conservatorship and being fully capitalized. It is possible to also make many changes related to the social obligations placed upon the two GSEs to expand homeownership (the most well-known being the "affordable goals"). That's a different, if overlapping, topic that is not addressed in this paper.

[29] However, while the FHFA has all this authority, it does not have the financial resources to support the two GSEs in conservatorship; only Treasury has those. Treasury has thus required the FHFA, as part of the legal agreement (i.e., a contract) whereby Treasury financially supports the two GSEs, to seek its approval or consultation on various items, thereby limiting the discretion that the FHFA otherwise has by statute.

cooperation between a Biden administration and Director Calabria is more likely than not to be limited and strained. Regardless, the administration will very likely be able to stop any steps made by the FHFA to release the companies from conservatorship, as Treasury must approve (per a clause of the PSPA) any exit from conservatorship.

But the new administration's ability to impact the GSEs will probably be much expanded by about June 2021. That is when a Supreme Court case (*Collins v. Mnuchin*), currently on this term's docket, is expected to be decided. As a result of that case, it is highly likely that the independence of Director Calabria – specifically, his immunity from being fired except "for cause" – will be eliminated, and he will then become immediately dismissible by the president with no restriction.[30]

If the case is decided as expected, it would be not just legal but totally reasonable for President Biden to immediately dismiss Director Calabria. The president should then be prepared to quickly nominate, hopefully with a short confirmation process, a replacement who obviously will be more in tune with the Democratic party's view of the GSEs – that is, that they have a key role to play in supporting homeownership and are a positive force in housing markets, especially with the reforms instituted in the last decade.

In choosing that replacement, it is important to remember that the FHFA is indeed in operational control of the two companies as conservator. The best candidate for director will therefore be someone with management experience at an actual mortgage company or large financial institution (possibly even at a GSE), rather than someone with a solely inside-the-beltway policy or political background. The ideal candidate, then, would be someone with both industry experience (to be a capable conservator) and also housing finance policy experience (to be a capable regulator).

Recommended Actions for 12 to 24 Months

Given the discussion above, there are four steps with respect to GSE reform that make sense for a Biden administration to pursue in the next one to two years. These are:

[30] A very similar case related to the CFPB was decided in the last SCOTUS term in this manner. The substance of the case is that the leadership of a federal agency cannot be made "independent" (by something such as the "fired only for cause" stipulation of the law establishing the FHFA) if it is headed by a single director; by contrast, commissions, such as the five-member Securities and Exchange Commission, are permitted. (The precedent for this goes back to the 1930s.) The remedy established by the court was that the single director is dismissible by the president without any condition; ideally, Congress would replace the FHFA single directorship with a commission to restore its independence, but no such proposal is currently prominent.

1. Immediately upon taking control of Treasury after the inauguration, put a stop to any in-flight actions that require Treasury approval with respect to the GSEs, pending further review. (This is, of course, standard operating procedure when a new administration takes power.)
2. Work with Director Calabria to amend the PSPA agreement in one specific manner: to eliminate the cap on retained earnings ($25 billion for Fannie Mae, $20 billion for Freddie Mac), an amendment which both political parties should support.[31] As a consequence of this amendment, it will be necessary to finally decide upon and implement a cash fee to be paid by the GSEs to Treasury for its support. Both things need to be done together as a package.
3. Search for and select a strongly qualified candidate to be the next director of the FHFA, with hopefully mortgage or financial services industry management experience as well as government-related policy experience. Be ready to terminate Director Calabria and immediately nominate the candidate upon hearing the Supreme Court case result (assuming it is decided as expected).
4. The new administration, at some point in this process, also has to decide which of two alternative paths to take with regard to GSE reform more generally. Both actions presume that a new FHFA director appointed by the Biden administration is going to be in place by late summer or so.
    a. Leave the two companies in long-term conservatorship, planning to possibly return to the GSE reform question in a few years when more urgent priorities have been addressed. With a new Biden-appointed director of the FHFA calling the shots, the GSEs will be run in a manner consistent with the Democratic Party view of them as being positive contributors to a broad-based housing finance system. Also, more operating improvements during conservatorship can be implemented, just as they have been going back to 2012. It is arguable that this is all that is really needed for the next few years. Retained earnings should also continue to accumulate during this period, helping to reduce the amount of taxpayer exposure to the risks of the two companies.
    b. Or, *in addition*, establish a working group from the FHFA, Treasury, and NEC to develop plans, without major public drama but with a specific deadline (e.g., twelve

[31] It is possible that this amendment will already have been made in the lame duck period prior to the inauguration.

months), to implement the first steps of the only currently known exit strategy that is both workable and broadly supported: patiently pursuing the utility model via administrative means. These first-step plans should include: (1) specifying the "five or six big fixes" are and how to implement them; (2) fleshing out what a "utility model" means in terms of regulatory rules, PSPA amendment language, etc.; (3) deciding what amendments to the PSPA more broadly make sense; and (4) opining on whether to employ a consent decree mechanism to allow legal conservatorship exit prior to full recapitalization and, if so, specifying exactly what would be in that consent decree.[32] These items all have to be part of an integrated and coherent package. (Note how even these first steps to a conservatorship exit are complex and will require considerable time and expertise to design and take properly. This complexity is indicative of how difficult GSE reform will be in totality.)

My personal recommendation would be to pursue the latter alternative. The working group's recommendations can be implemented in year two or three of the administration's tenure, and doing so would show that the Biden team is smartly putting a long-term issue, *finally*, on the road to being solved, rather than being left to fester even longer than it already has.

Recapitalization – A Bias to Start with Retained Earnings

The complete package of GSE reform really is centered around two goals which, as in a Venn diagram, partially overlap: (1) remove the companies from legal conservatorship in whatever form is chosen but with all the desired reforms maintained, and (2) recapitalize the two companies to their SIFI-consistent level through a combination of retained earnings and new stock sales. Both are extremely complicated topics, fraught with real potential for "getting it wrong" and having major unintended consequences if they are not thoroughly thought through and executed well.

In my prior article on GSE re-privatization, I show how immense the amount of money needed for capital is (currently, over $240 billion), and how it swamps many times over the largest IPO of a US company in US markets ever (just under $18 billion).[33] I also describe all the uncertainties that hang over the two GSEs in terms of their business model and regulatory policies that will make public equity

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[32] This idea was developed under Director Calabria, and seems to be a good one. However, he has never specified exactly what would be in the consent decree – a glaring omission that needs remedying.

[33] See "GSE Re-privatization: Will Washington Scare Off Private Capital?" October 2020, https://www.jchs.harvard.edu/sites/default/files/research/files/harvard_jchs_washington_private_capital_layton_2020.pdf.

issuance extremely difficult (unless at fire-sale prices) for at least several years until those uncertainties are adequately cleared up.

When it comes to focusing narrowly on the complexity of successfully issuing new equity in large amounts, there are a host of issues to be worked through. They are primarily the responsibility of Treasury, not the FHFA, to decide. Examples include:[34]

1. Deciding how to treat the current $200 billion-plus senior preferred shares. (The SCOTUS case *Collins v. Mnuchin* is relevant to this decision as well, in particular to whether the controversial net worth sweep provision is constitutional or not.) There are major political sensitivities attached to such a decision. Some argue the senior preferred should be written off as functionally fully repaid by prior dividends from the two GSEs to Treasury (which could cause major political blowback, with accusations of "giveaway to Wall Street" and possibly congressional legislation to stop the transaction); others argue it should be converted to common shares as was done for AIG (although no one has focused on what exchange ratio might make sense, which can make a very big difference).
2. Deciding how to treat the $33 billion of junior preferred shares held by the public. While this issue is lower-profile for sure, how these shares are handled can vary from being very advantageous to being rather disadvantageous to the current investors.
3. Deciding what promises by Treasury need to be made to new shareholders in an equity issuance, as Treasury will be, initially and for years to come, by far the largest shareholder of each of the two companies. These include:
    a. Promises that restrict Treasury's own voting power, as unbridled majority control by Treasury will be unacceptable to many potential share purchasers.
    b. Promises that restrict how Treasury eventually disposes of its shares (i.e., a secondary sale of shares), which have the potential to significantly depress share prices if not handled properly.
4. Deciding how to coordinate record-setting new equity issues between the two GSEs so one's successful transaction does not undercut that of the other. (To my knowledge, this is a truly unique issue.)

The closest precedent for this set of transactions was selling off the government's ownership of AIG, which stemmed from its rescue by the government in September 2008. I can say, based on first-

[34] For more specifics, see my previous article, "Treasury's Long GSE Capital To-Do List," December 2019, https://www.jchs.harvard.edu/sites/default/files/media/imp/harvard_jchs_treasury_to_do_list_layton_2019.pdf.

hand knowledge, that the GSE situation is far more complex: it involves both primary and secondary sales of equity, it involves two companies rather than just one, and there is political engagement (and often interference) far more for the GSEs than there was for AIG.[35]

I therefore recommend that, in the next three years (and maybe more), the recapitalization be focused exclusively, or almost exclusively, on retaining earnings. That will get the ball rolling and make all future capitalization issues smaller, as the remaining amount (which might be financed heavily via new equity issuance) slowly declines.[36] As described above, such recapitalization will require an amendment to the PSPA to eliminate a current cap on retained earnings of $45 billion ($25 billion for Fannie Mae, $20 billion for Freddie Mac); simultaneously, because the two are linked, a specific cash fee will need to be instituted where the GSEs pay for the explicit government support in the PSPA. These steps would take place against the backdrop of the GSEs showing their ability to generate earnings and an acceptable level of ROE (return on equity) in a post-conservatorship environment, with hopefully many current policy uncertainties getting cleared up to the satisfaction of global equity investors during this timeframe.

At the end of this minimum three-year period, if these steps have been taken successfully, the topic of speeding the GSEs' recapitalization through new equity issuance could be re-examined.

Conclusion

The much-reported dysfunction of Washington is very evident in how it has handled the GSE reform question. More than a decade after what was to be a short-term conservatorship, their future is still very much up in the air. Hopefully, the Biden administration will resolve this uncertainty, and break the pattern of producing lots of policy discussions but no real progress.

With the benefit of hindsight, we can see why there has been so little progress. First, the heavy politicization of the mortgage system automatically makes any change difficult. Second, the policy community focused almost solely on "big ideas" that appealed to ideological views or economic interests or, in some cases, just an interesting academic notion – but without actually doing the detailed homework to see if those ideas were practically workable. Even the "many small guarantors" model,

[35] I was appointed to AIG's board for 2010 to 2012 by the US Treasury, which got the right to appoint two board members as part of the rescue. I was CEO of Freddie Mac from 2012 to 2019. Thus, I have first-hand and insider knowledge of both situations.

[36] In 2024, three years after a Biden administration might embark upon a patient, administrative-means reform of the GSEs to be public utilities, they together might have $75 to $100 billion (as a rough estimate) of equity from retained earnings; that amount would considerably reduce the total needed from that point forward.

which was attempted in the Corker-Warner bill, and which had lots of support from many quarters back in 2014, eventually showed how hard it is to make big changes to our current system of housing finance that are actually practically implementable, and also not too risky in terms of a transition from what we have today.

Meanwhile, inside conservatorship, the operating improvements kicked off by Acting Director DeMarco's 2012 first Conservatorship Scorecard, and continued under Director Watt, began to gather steam, producing a steady stream of actual, implemented improvements in the GSEs and how they operate: (1) the mortgage investment portfolios were dramatically reduced; (2) CRT was developed and implemented at large scale, (3) representation and warranty risk was successfully revamped; (4) the utility-style regulation of guarantee fees was established, and more. *In fact, in a very unexpected twist, the GSEs under government control became materially more commercially competent and customer service-driven organizations than they had been previously, when they were private but also overly focused on lobbying and influencing to protect and expand their hidden subsidies.* Eventually, all these changes – which have amounted to major GSE reform during conservatorship – gained the confidence of much of the industry as the core to a path forward. Add in the development of the notion that reform can, and in practical terms should, be accomplished by administrative means – since it clearly became unwise to count on new legislation – and we have, at least in my view, the only path forward that has strong support and is workable without undue risk.

The incoming Biden administration thus has two choices, and two choices only, if it wishes to be pragmatic and move forward. One alternative is to leave the companies in long-term conservatorship for several more years. Combined with installing its own person as FHFA director, this path should be expected to deliver operating improvements and housing finance policy benefits, as has been happening in conservatorship since 2012; it can even have capital build via retained earnings. The other alternative is to *additionally* move GSE reform forward by patiently taking the first steps to implement the utility model by administrative means, which will concretely put the two companies on a defined, low-risk path out of conservatorship and towards normalcy.

Both paths are consistent with what I understand to be long-standing Democratic party policy objectives. Both are also refreshingly workable, with a low risk of disruption or unintended consequences undoing the best of intentions. The new administration just needs to choose which one to pursue.