INDUSTRY PERSPECTIVES

The Many Flaws and Weaknesses of FHFA's 2021 GSE Scorecard

A Hollowed-Out Document

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Introduction

The Federal Housing Finance Agency (FHFA) on February 16 released its 2021 Scorecard for the government-sponsored enterprises (GSEs) Freddie Mac and Fannie Mae (and their securitization processing joint venture).[1] This is the tenth such scorecard, a tool originally developed by FHFA Acting Director Edward DeMarco in 2012 to give the GSEs specific policy direction as the conservatorships – originally expected to be of short duration – dragged on with no end in sight. It was designed to be a public document to provide transparency to the mortgage industry and policy community so their members understood where the FHFA was taking the GSEs during conservatorship; more broadly, it was meant to show transparently to taxpayers, who were (and still are) financially supporting the companies, what was being done with their money. A year later, it was complemented by an "internal conservatorship scorecard" that had more details and specifics – even down to quarterly targets – than were appropriate for a document readily digestible by the public.

Until current FHFA Director Mark Calabria revised the scorecard's title a year ago, it was called the "conservatorship scorecard." That is because it focused on the housing finance policy actions that the FHFA director (first Mr. DeMarco, then Mr. Mel Watt), *acting as conservator,* wanted the two companies to pursue.[2] It had only a small overlap with the FHFA's regulatory responsibilities that focus primarily on safety and soundness. It also had only a small overlap with the conservator's stewardship of the companies' commercial activities.[3] Stewardship of those activities was mainly delegated, though with close oversight by the FHFA's staff, to the companies' boards, which were then heavily populated by directors with strong commercial pedigrees from financial institutions and housing-related careers.[4] This delegation of commercial supervision to the boards reflected the limited commercial skills and experience of the FHFA staff who, as one would expect, almost all have had long careers in government rather than in commercial housing or finance organizations.

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[1] See FHFA, "2021 Scorecard for Fannie Mae, Freddie Mac, and Common Securitization Solutions," https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2021-Scorecard.pdf. This report is known colloquially as the "conservatorship scorecard," which it historically was officially called.

[2] The FHFA director, as conservator, has full legal power to direct the activities of the two companies, in lieu of their shareholders and boards of directors, and even their managements.

[3] Such commercial activity issues are extensive, covering everything from prioritizing systems development projects to training entry-level hires to measuring customer satisfaction and on and on – the thousand-and-one things a company must do to be well run.

[4] Very specifically excluded from this delegation were matters related to the companies' capital. As any capital actions would directly impact the government's investment in the two companies, the conservator retained all powers related to decisions about capital, delegating none to the two boards.

The 2021 scorecard has at least thirty-six specific goals[5], and they are riddled with problems. Quite a few requirements duplicate already-existing (and publicly known) obligations on the companies, others are contradictory, some are just unclear, and several others are outright impossibilities. Not every one of the thirty-six goals is problematic, but enough are so that the document overall seems to me to be quite weak. At times, the scorecard seems to engage in signaling about ideology rather than providing implementable direction to the GSEs. Furthermore, the criteria for its listed goals are entirely qualitative and judgmental, never quantitative; this absence of quantitative criteria erodes the scorecard's level of transparency. All together, these weaknesses decrease the scorecard's value as a communications vehicle: it conveys less content with less value, and it does so less transparently.

This is all quite unfortunate. The reality is that the scorecards through 2019 did deliver tremendous policy transparency to the public, and I found were generally regarded in the industry as decent-quality products, regardless of whether one agreed or disagreed with specific items. Regrettably, my conclusion is that this level of quality has been lost these past two years. We now have a hollowed-out GSE scorecard.

Repeating the Already-Known

Prior to 2020, as referenced above, the scorecards were called "conservatorship scorecards," and their purpose was to give the GSEs housing finance policy-related goals, as established by the director of the FHFA acting in his capacity as their "conservator." Also as stated above, the scorecard's requirements overlapped only minimally with the FHFA's safety-and-soundness regulation (which will continue past conservatorship) and with other obligations upon the companies' commercial operations. Thus, the goals listed in the scorecards prior to 2020 had some real transparency value, telling the public something new – i.e. not already publicly known - about what the GSEs were to do.[6]

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[5] One can calculate the number of specific goals differently depending upon (1) how one counts nested items (i.e. requirements that include both an aggregate direction and multiple specific directions under it), and (2) how one counts more general admonitions concerning how the GSEs will be "assessed" (i.e., graded) upon their performance at the end of the year (e.g., delivering "work products that are high quality"). Thirty-six is the smallest possible count; the maximum is considerably higher.

[6] The 2019 Conservatorship Scorecard, for example, ranged across a wide variety of topics, such as (1) working on making the mortgage-application process easier for borrowers with limited English proficiency, (2) evaluating the liquidity requirements for non-bank seller/servicers to determine if they needed to be updated, (3) conducting research and outreach on loans that finance energy and water efficiency improvements in multifamily properties, and more. While a few of the items in the scorecard referred to known requirements on the GSEs, many (such as the three examples just cited) were unique to initiatives developed by the FHFA, acting as conservator, and would not have obviously be known publicly if not for the scorecard.

In the last two years, though, this clarity of focus has been lost to a considerable degree. The result is that a significant portion of the scorecard duplicates already existing and known obligations that apply to the GSEs, thereby adding little value by their inclusion in the scorecard.

Here are seven examples of such duplicative goals in the 2021 Scorecard:

1. "Fulfill the Enterprises' Housing Goals and Duty-to-Serve plans…" This is required by legislation and existing FHFA regulatory rules.
2. "Continue implementation of the final Credit Score Rule…" Again, this is required by legislation and an existing FHFA regulatory rule.
3. "Continue to ensure that there is an effective transition from LIBOR…" This has effectively been mandated, in a very public manner, by the Federal Reserve for all large financial institutions.
4. "Continue efforts to enhance business resiliency and recovery management…" This is required by existing safety-and-soundness requirements as well as by the internal and external auditors of the two companies. (Interestingly, the pandemic has shown that the two GSEs have done a credible job when it comes to business resiliency, as they have been able to process dramatically higher volumes than normal despite their employees overwhelmingly working remotely.)
5. "Continue efforts to protect the availability, security, integrity and confidentiality of information." Ditto.
6. "Continue efforts to establish and improve enterprise-level data management and governance capabilities." Ditto again.
7. "Timely resolve [*sic*] supervisory findings to FHFA's satisfaction…"[7] This is a standard requirement by any regulator over the firms it regulates.

Such requirements come across, at least to someone familiar with the scorecards going back to 2012, as a type of filler: all are existing and known requirements that need no inclusion in the scorecard. This means more than one-sixth of the scorecard (i.e. seven out of the thirty-six goals) communicates no material new information to the public.

[7] "Supervisory findings" are the specific criticisms of a regulated firm in a report written by regulator's examiners (who are like auditors) following an examination on a particular topic.

Contradictory Directions Regarding Credit Risk Transfer

Every scorecard, including the first in 2012, has given the GSEs a goal about credit risk transfer (CRT). This year, the goal is "to transfer credit risk to private markets in a commercially reasonable and safe and sound manner." Almost everyone in the field of housing finance regards the CRT program as a great success: it has protected taxpayers by efficiently eliminating a systemically unhealthy concentration of immense mortgage credit risk in the two GSEs, among other benefits.

Unfortunately, what the 2021 scorecard says about CRT is not really so straightforward. This is because the 2021 version has two other clauses that, behind the scenes, relate to CRT. First, it says the GSEs are to "ensure the efficient utilization of capital targeted to support the core guaranty business with adequate returns to attract the private capital necessary to enable an exit from conservatorship." Translated into non-technical English, this means the GSEs should drive decision-making by whether taking on or laying off risk has the proper economics to provide a reasonable return to shareholders. Such return calculations are usually heavily based upon the amount and cost of the capital allocated to transactions. This is perfectly fine – it is what any large private-sector financial institution would do on a routine basis, including on CRT transactions, and all without any regard to the issue of being in or out of conservatorship. However, the scorecard also requires the two GSEs to switch their capital allocation system to the recently approved Enterprise Capital Rule. That system of capital allocation gives the GSEs too little capital relief relative to the actual amount of risk they shed through CRT; it therefore takes away much of the economic incentive to do CRT.[8]

The interaction of these two scorecard requirements means, in practical terms, that the GSEs should do virtually no CRT transactions, as the Enterprise Capital Rule's bias means that the financial analysis of any proposed such transactions will not provide an adequate return to shareholders.

The result is that the 2021 scorecard is telling the GSEs, in their CRT activities, to turn both left (i.e., *do* CRT transactions as a routine part of the business model) and right (i.e., *do not do* CRT transactions as a routine part of the business model) at the same time! It just cannot be done. And this phenomenon is not just theoretical – it has been causing visible problems for almost a year now. Speaking to 2020's full year results, the industry publication *Inside Mortgage Finance* reported "that Freddie Mac issued a record $10.37 billion in CRT debt notes [the most common form of CRT

[8] The capital rule has been much criticized for its hard-to-fathom anti-CRT bias. For more on this topic, see my earlier article "FHFA's Final GSE Capital Rule: Little Credibility and a Short Shelf Life," https://jchs.harvard.edu/blog/fhfas-final-gse-capital-rule-little-credibility-and-short-shelf-life. Also, see the many comments submitted by the public on the proposed capital rule, available at the FHFA website: https://www.fhfa.gov/SupervisionRegulation/Rules/Pages/Comment-List.aspx?RuleID=674.

transaction[9]] in 2020 while Fannie's issuance for the year came in at just $5.26 billion, its lowest level since launching its CRT program at the end of 2013."[10] In other words, Freddie Mac ignored – at least for 2020 – the impact of the newly-approved capital rule on CRT, while Fannie Mae accelerated its implementation of the rule to virtually cease CRT activities starting about mid-year.

This resulting contradiction – one GSE pushing full steam ahead on CRT, and the other virtually ceasing it, while both are "following the rules" according to the scorecard – reflects the most extreme example of policy incoherence I have seen in housing finance since I began my seven year run as Freddie Mac's CEO in 2012. This incoherent guidance regarding CRT is therefore absolutely a major flaw of the 2021 scorecard.

PSPA Denial

In its first paragraph, the 2021 scorecard says that its purpose to ensure that the GSEs will "operate in a manner appropriate for entities…with limited capital buffers." Later, under the heading "Ensure Safety and Soundness," the scorecard calls for risk limits "appropriate for regulated entities with limited capital cushions."

What exactly is meant by the phrase "limited capital buffers"?[11] In conservatorship, there is first the capital the GSEs have on their own books – which was near zero in the immediate years post-the 2008 Financial Crisis. But the whole purpose of the government rescue of the two companies was to regain market confidence that their liabilities had near-Treasury credit quality, and the method chosen to do so was through the "preferred stock purchase agreement" (PSPA), according to which the US Treasury by legal contract agrees to provide additional capital *as and when needed* up to very large amounts (currently a further $140.2 billion for Freddie Mac and $113.9 billion for Fannie Mae; for some years prior to the end of 2012, the amount was in fact unlimited). Confidence in the two companies could have been restored in other ways, but the government chose this one.

What this means is that the "capital buffers" of the GSEs were explicitly designed by the government rescue to be seen by the marketplace as consisting of (1) what capital they had on their

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[9] Total CRT transactions, not limited to just those in the form of debt notes, on single family mortgages amounted to $16.9 billion. The difference is almost entirely accounted for by insurance-structured transactions.

[10] See Dennis Hollier, "CRT: Fannie and Freddie Go Different Ways," *Inside Mortgage Finance*, February 19, 2021, https://www.insidemortgagefinance.com/articles/220578-crt-fannie-and-freddie-go-different-ways. The article reported that most of Fannie Mae's reduced volume was in fact issued during the early months of 2020, and almost none after mid-year.

[11] The scorecard uses the terms "capital cushions" and "capital buffers" interchangeably.

own books *plus* (2) what capital they could additionally draw down from Treasury on an as-needed basis, up to the limits specified in the PSPA.[12] That totals today $156.6 billion for Freddie Mac and $139.2 billion for Fannie Mae, or $295.8 billion in total. These capital cushions are not "limited" in any actual financial sense – they are in fact very large capital cushions, well large enough in the eyes of the capital markets to handily absorb the GSEs' potential losses, which is why the GSEs continue to be treated as having near-Treasury credit quality.

Instead, the reference to "limited capital buffers" is a continuation of the FHFA's denial, since Director Calabria took charge, that the PSPAs should be considered available to support the two companies' risks.[13] The inaccurate description of these buffers as "limited" is meant to somehow argue that only the capital on the books of the two companies, and not their ability to draw further capital under the PSPAs, should be considered. These capital levels – just $16.4 billion for Freddie Mac and $25.3 billion for Fannie Mae at year-end 2020 – are indeed very small in proportion to their risks, as the two companies have only recently been allowed to retain earnings to build capital.

But if the scorecard truly meant what it actually says – that the risk limits of the two GSEs and their operations should be aligned with just the "limited capital buffers" on their books, as the PSPAs are not to be considered available to the companies – then the two companies would have to cease purchasing any mortgages whatsoever immediately, as they would be radically undercapitalized. Since they have instead massively increased their mortgage purchases through the pandemic (in line with their congressional mandate, I might add), this cessation is clearly not happening. *The only interpretation left is that the scorecard doesn't mean what it says* – instead, the scorecard seems to be just engaging in some ideological virtue signaling (mainly about "shrinking the footprint," a mainstay of GSE opponents) and no more than that.

My view is that scorecards that don't mean what they plainly say, in order to engage in political signaling instead, are flawed, and inconsistent with a level of honesty and accuracy that the public has a right to expect from an independent regulatory agency.

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[12] In finance, capital is defined as the funds available to "absorb unexpected losses." On that basis, the capital available through the two PSPAs was every bit as good as the capital held on their books.

[13] Director Calabria, by his comments in various venues, has made it clear he would regard any drawdown of funds by the GSEs under the PSPA as being another "bailout," and thus something to be avoided at all costs. This view has unfortunately translated into the scorecard's being designed as if the PSPAs do not exist, which is simply inaccurate. For my first and more extensive documentation of the FHFA's PSPA denial, see "The FHFA's Proposed GSE 'Living Will' Rule," JCHS, February 2021, https://jchs.harvard.edu/sites/default/files/research/files/harvard_jchs_fhfa_living_will_rule_layton_2021.pdf.

Overly General and Exclusively Qualitative

Prior to 2020, the scorecards had a significant "hardness" to them in that they specified goals with a combination of quantitative criteria and granularity that helped the public understand what to expect. In 2020 and now 2021, by comparison, everything is qualitative (i.e., there are no quantitative targets at all!) and very general. It is therefore hard to figure out exactly what is going to be done to meet scorecard requirements.[14]

Consider credit risk transfer, for example. In 2019, this is what the scorecard contained with respect to just single-family mortgages:

- Transfer a meaningful portion of credit risk on at least 90 percent of the unpaid principal balance (UPB) of newly acquired single-family mortgages in loan categories targeted for credit risk transfer, subject to FHFA target adjustments as may be necessary to reflect market conditions and economic considerations.
- For 2019, targeted single-family loan categories include: non-HARP, fixed-rate mortgages with terms greater than 20 years and loan-to-value ratios above 60 percent. Additional information on CRT targeted loan categories is in Appendix B.
- Report the actual amount of underlying mortgage credit risk transferred.[15]

This was supplemented by a similar section on CRT for multi-family mortgages. By comparison, in 2021, the scorecard has only the following, which applies to *both* multifamily and single-family mortgages:

> Continue to transfer credit risk to private markets in a commercially reasonable and safe and sound manner….

And that is it.

This vague, merely qualitative guidance is indicative of the 2021 scorecard's overall lack of "hardness" as compared to those produced through 2019. Only a very general direction is set, and it is not at all clear to the public how much risk transfer will take place, how much in single-family versus multifamily, and on what products.

Again, this makes the scorecard less valuable to the public, and just a weaker and more hollowed-out document overall. In fact, the 2019 scorecard was approximately twice as long as the 2021

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[14] The "internal" scorecards presumably have much more granularity and quantitative specificity, but of course these are not available to the public so I can't be sure of that.

[15] FHFA, "2019 Scorecard for Fannie Mae, Freddie Mac, and Common Securitization Solutions," December 2018, https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2019-Scorecard-12192018.pdf.

version – another indication of how much the scorecard process has deteriorated these last two years in informing the public about the FHFA's plans for the GSEs as their conservator.

Unacceptable Lack of Clarity

The concept of the scorecard, going back to its first appearance in 2012, is to provide transparency to the activities of the FHFA as conservator of the two GSEs. The scorecard should therefore clearly explain what the GSEs must do as they seek to meet the scorecard's stated goals. Unfortunately, the 2021 scorecard fails to provide that clarity, leaving even the most knowledgeable reader unsure of what is being proposed. In other words, the scorecard is sometimes worded so unclearly that one can't figure out what it really means, leaving the FHFA with a blank check of sorts.

Here are two goals in the scorecard that are, to me, incredibly vague:

1. "Support strategies that enhance a level playing field for a wide range of mortgage market participants."

   That could mean almost anything. Does it mean the GSEs should increase pricing to make other sources of mortgage financing (e.g., the private label securitization market) more competitive? Does it mean the GSEs should dramatically force a shrinkage of their footprints, so other market participants can increase market share? Does it mean they should donate technology to Ginnie Mae,[16] so it can compete more successfully with them? It's really totally unclear – a real failure of transparency.
2. "Continue to assess additional data that could be made publicly available to… foster a competitive mortgage market that does not crowd out private capital."

   Again, this could mean almost anything. What is this "additional data"? Is it historical mortgage credit performance data (which is mostly disclosed already)? Is it data on how the GSEs' systems work – up to and including publishing the underlying programming code? Is it unit costs or capital allocation formulae used in pricing decisions?

While the internal scorecards that have or will soon be given to the GSEs will presumably be more specific, as they are not public, the public scorecard leaves the mortgage industry and policy community, and taxpayers, almost totally ignorant of what is actually going to happen to implement these two scorecard requirements.

[16] I have heard Ginnie Mae advocates propose this.

Impossibilities

I have identified above the 2021 scorecard's "PSPA denial." This is the first component of the scorecard that is not grounded in reality, as the PSPA is a legal document absolutely committing the US Treasury to provide the capital specified. I have also identified the contradictory directions given to the GSEs to both *do* CRT transactions and to *not do* them, as directed by different parts of the scorecard – a second such impossibility.

A third impossibility is the "resolution planning" requirement: each GSE is directed to create "a plan to resolve the Enterprise without recourse to extraordinary support from Treasury or taxpayers, that preserves the core business businesses of the Enterprise." I have already identified that this is an impossibility in my prior article about the "living will," as the resolution plan is colloquially known.[17]

Even just one impossibility erodes the credibility of the scorecard – three of them deliver almost a knock-out blow to it.

Conclusion

The flaws and weaknesses of the 2021 GSE scorecard listed above are rather extensive. And I did not include all the items I found questionable.

I therefore draw three conclusions from this review of the latest scorecard and of how different it is from those of 2012 to 2019, the years of Acting Director DeMarco and Director Watt.

First, the scorecard's value has diminished dramatically. With about half the page count of its pre-2020 predecessors, it describes fewer goals with less specificity, duplicates already-known requirements, and is frequently so general and unclear that one can't really tell what the FHFA intends for the GSEs to do. This is what I mean by the phrase "hollowed out."

In fact, since Director Calabria came into office almost two years ago, he has emphasized how much he wishes to have the GSEs exit conservatorship. Hence, the third section of the scorecard is unsurprisingly entitled "Prepare for a Transition Out of Conservatorship." Fair enough. But the scorecard's guidance regarding this preparation lacks all specificity. It gives goals to the GSEs to, for example, "continue to provide support to FHFA as needed to develop a roadmap with milestones for exiting conservatorship" and to "conduct such activities as directed by FHFA related to housing market reform." These directives are so vague that the public is learning virtually nothing about what the two

[17] Layton, "The FHFA's Proposed 'Living Will' Rule."

companies will be doing to exit conservatorship – except perhaps that the FHFA will exclusively be calling the shots and that the two GSEs are just to provide whatever support is asked.[18]

Second, the 2021 scorecard does some key "ideological virtue signaling" that really does not belong in a document from an independent regulator. Phrases like "crowd out private capital" and "enhance a level playing field" have long been politically loaded, being used exclusively by those looking to shrink or eliminate the GSEs. The scorecard's PSPA denial also fits into such signaling. I believe the FHFA is aware that these signals are indeed political signals, but went ahead and included them in the scorecard deliberately anyway.

Third, and finally, the FHFA evidently seems to care so little for the scorecard and its value as a method of communication with the public that one wonders why it bothered to produce one at all.

[18] In fact, many of the most sensitive and consequential decisions about the exit from conservatorship are either solely for Treasury to make, or for Treasury and FHFA to make jointly.