INDUSTRY PERSPECTIVES

The Path of GSE Reform:
Still Very Uncertain, and Not Just Because of the Elections

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JCHS
JOINT CENTER FOR HOUSING STUDIES OF HARVARD UNIVERSITY

Joint Center for Housing Studies
Harvard University

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Introduction

Today, more than twelve years into conservatorship, the path forward for the reform of Freddie Mac and Fannie Mae, the two government-sponsored enterprises (GSEs), is in some ways again as uncertain as it was five or ten years ago.

After a decade-plus of debate in think tanks, the mortgage industry, academia, Congress and two presidential administrations, and the introduction of many competing bills in Congress to reform housing finance (which usually meant just dealing with the two GSEs), the government at long last seemed to be implementing a chosen path. Specifically, starting in September 2019, the Trump administration began the process of the two GSEs exiting conservatorship and being recapitalized "by administrative means" (i.e., without any new legislation), but with the clear intention of keeping in place key reforms developed during the GSEs' conservatorship since 2008.

Unfortunately, the Trump administration simply started the process late, with only about one and one-third years left in its term, so it will not be able to complete many key requirements for conservatorship exit and full re-capitalization until a possible second Trump administration, which is far from a certainty based upon today's election polls.

In this paper, I will first, under an assumption that former Vice President Biden is elected, outline three alternative approaches that his administration might choose. For each, I will succinctly lay out the case why his staff would recommend it be pursued, and then discuss some observations on each.

Next, under the alternative assumption that President Trump is re-elected and the current effort continues, I will update how its implementation is proceeding, and what the path looks like going forward. It can be summarized as "likely to happen later than generally expected, still with significant choices to make and challenges to overcome."

I note that, in the vein of "never say never," predicting outcomes in Washington is not about certainty – it is about seeing likely paths and probable outcomes. I consider it "knowledgeable speculation" and the reader should take it in that spirit.

Also, one definitional issue needs to be tackled up front. "Exit conservatorship" meant one thing for most of the years since 2008: that the GSEs, whether in their current form or some other, would become fully capitalized and also leave the legal status of being in conservatorship. That means the "exit" would produce organizations operating as normally as a GSE can.

There is, however, a new, second definition developed by Mark Calabria, the current director of the Federal Housing Finance Agency (FHFA), the regulator and conservator of the two companies. This newer definition, tied into the administrative-means exit currently being pursued, is that "exit conservatorship" would mean that the two companies *only* leave the legal status of being in conservatorship; they would then operate under a regulatory "consent decree" for being undercapitalized. In a second step, the GSEs over time then would raise enough capital to become properly capitalized (however that is then defined) when normal operations would begin, as the consent decree would have been satisfied and thus fall away. In this formulation, the two firms would be under special FHFA control during that multi-year consent decree period, of which the details are totally unknown. Director Calabria has referred to this period as "conservatorship-lite" without no details of what might be "lite" about it; it could even be as extreme as "conservatorship by another name," with FHFA in total managerial control as it is right now as the conservator.

For the purposes of this paper, I am focused on the original definition: that one needs a path for GSE reform to take the companies, in their current or another form, not just through the legal exit from conservatorship but all the way through to being fully re-capitalized so they can, indeed, operate on a normal basis.

If Biden Is Elected: Three Possible Paths Forward

The three general paths forward I have identified that a Biden administration might adopt form a spectrum from "no change" to "major change."[1] For each, I present a one-to-two-page summary memo as I envision the staff of the National Economic Council (NEC) would write it when making each recommendation; I then follow-up with some observations on each.

Behind all three paths is an unusual situation that increases the policy choices a Biden administration would have. As the FHFA is an independent agency, its director has a set five-year term, currently expiring in 2024, and can only be removed "for cause." However, this governance structure is being challenged in a case now before the Supreme Court, with a decision expected by June of 2021. At issue is whether such independence is consistent with the Constitution when the independent agency has a sole director, rather than a commission. In a very similar case related to the Consumer Financial Protection Bureau decided in the just-completed Supreme Court term, the "for cause" requirement was struck down. It is very likely that the FHFA's case will be decided similarly. The Biden administration would then be able to immediately replace Director Calabria (who has a long pedigree as an ideological

[1] There are many possible variations on the second and third paths. (There are obviously not for the first path, keeping the status quo.) The specific ones I chose are just an example of a range of possibilities.

conservative and a reputation of letting that ideology impact some of his decisions at the FHFA) upon the ruling being announced and then nominate someone more to its liking.

Policy Choice: Defer Reform Until a Later Date

Recommended policy: Defer consideration of GSE reform via legislation or via a formally organized administrative program for now; revisit in a year or two.

There are six reasons to recommend this policy path:

1. *The mortgage and housing finance system is working quite well, even under the stress of the pandemic (and being in conservatorship with explicit government support has clearly made extraordinary pandemic support actions by the GSEs easier). There is no major homeowner crisis or mortgage system dysfunction that needs addressing at this time, and record volumes are being processed without disruption. So, to the average homeowner there is no "problem to be solved."*
2. *The administration has other first-year priorities that are much more important and urgent (due to either campaign commitments or just impact on the country) for all the administration people that would need to be involved – things like tax revisions to raise revenue, revising financial institution regulation to be tougher, constructing a new pandemic relief bill, etc. By comparison, GSE reform, while important, is just not urgent at this time.*
3. *There will be many proposals from and a push by specialized groups involved in housing finance that the Biden administration make GSE reform a priority. The practical reality, however, is that there is little upside to doing so at this time, especially with other first-year priorities clearly more impactful and/or urgent. Given the risk of disrupting the mortgage system with any aggressive program of GSE reform – which could harm millions of families in the next few years – there is significant downside risk from a transition. Thus, GSE reform is a one-sided issue: it offers little benefit in the eyes of the average homeowner if done right (in fact, it is not even clear the reform would be noticed by homeowners), but much to lose in the eyes of the average homeowner if not.*
4. *Reform via legislation by Congress has not yet come close to fruition in more than a decade, despite the relevant committee chairs of both parties indicating it was a top priority at various times. The topic has proven to be so complex and time-consuming for members on, and staff support to, the Senate Banking and House Financial Services*

Committees that prioritizing it and reconciling different views even among just Democratic members of Congress could prove quite difficult. Thus, it would also drain congressional resources which need to be devoted to more urgent priorities in this administration's first year in office, and success would be far from assured.

5. *Conservatorship continuing for the time being is an acceptable outcome to this administration … as long as we get to replace the current Republican-nominated director, Mark Calabria, who has developed a reputation as regulator and conservator that is notably controversial and political. Given that there is a case currently before the Supreme Court on whether he can be fired only "for cause" or not, and that a very similar case was decided just last term with a verdict that the "for cause" clause was not constitutional, it is very likely the President will be able to replace him no later than approximately June of 2021. (Note: We do not expect significant pushback from the mortgage or housing industries if he is dismissed and replaced.)*
6. *To the degree there are specific issues related to the GSEs that might be important to both a major reform effort and administration priorities, many of them could likely be resolved to our satisfaction via Treasury and a newly-appointed FHFA Director working together, while the GSEs remain in conservatorship, on a relatively efficient basis. One obvious administration priority would be ensuring that mortgage credit availability is consistent with delivering the benefits of homeownership to as many people, especially minorities, as we can on a safe-and-sound basis – and keeping the two firms in conservatorship enables that to be directly done.*

This approach makes a compelling story that can be attractive to a new administration that will have far more policy priorities than resources for its first year in office. This was the policy implicitly adopted by the Obama administration in its entire eight years, and even for the first few years of the Trump administration – which turned to GSE matters only after two-thirds of its term was over, which turned out to be very late given all the work required for the chosen path of administrative reform to be implemented.

It will be easy to determine if this path is being chosen because key officials, such as the secretary of the treasury and NEC chair, will simply not spend priority time addressing GSE reform. In Congress, committee chairs might hold hearings and have some staff work done on the issue, but if it is not treated as a front-burner priority by the chairs personally, then it is implicitly a "status quo" choice being adopted.[2]

Policy Choice: Support the Utility Model, Already Favored by Senator Brown

Recommended policy: Implement GSE reform once and for all via a "utility model" – that is, a model in which the FHFA, in addition to being a safety-and-soundness regulator, sets guarantee fee (G-fee) pricing and other key terms of service of the two existing and recapitalized GSEs (much as does a state-level public service commission for electric utilities). Senator Brown[3] as ranking member of the Senate Banking Committee in past years, has voiced considerable support for this model, saying how there seems to be a broad consensus that it is the right way to go.[4]

There are six reasons to recommend this policy path:

1. *This policy choice continues decades of Democratic Party support for the GSEs operating in the interest of expanding homeownership and making it affordable, while also newly ensuring via "utility-style regulation" that the two companies not prioritize profits over executing upon their public mission.*
2. *This is a low-risk approach. It leaves the two GSEs in place performing their existing core role of supporting mortgages for low-to-moderate-income households and preserving the classic thirty-year fixed rate mortgage. It also continues the many valuable reforms to the GSEs that were instituted during conservatorship, most of which were done under Obama-appointed FHFA Director Mel Watt. In fact, in many ways, the two companies are already operating in conservatorship in such a "utility model," so the degree of change required is limited. It also, of course, avoids any disruption that would accompany pursuing a more aggressive business model change, which might well create ill-will with the homeowning public.*

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[2] Hearings are often held as ostensibly part of developing legislation, but they are also used to generate headlines and, to some degree, "shake the money tree" from special interests. (I was once told by an ex-congressman that the House Financial Services Committee and the Senate Banking Committee were "fund-raising committees" for their members, and hearings – with no actual intention to follow-up with legislation – are part of the Congressional fund-raising process.) So, such hearings do not necessarily mean legislative reform is truly being prioritized.

[3] Senator Sherrod Brown (D-OH)

[4] Senator Brown would still likely be ranking member if the Republicans maintain a majority in the Senate in the upcoming elections; if the Democrats in the election take the Senate majority, he would presumably then be the Chairman of the Senate Banking Committee. It should be noted that Senator Brown is not considered a moderate Democrat, even though the utility-model is considered a "moderate" policy choice; he is a long-standing progressive Democrat. It is unclear if he would continue to support the utility model given the overall tone of the current Democratic party, or might jump to supporting something stronger in terms of change.

3. *Senator Brown is correct that there is a strong industry consensus for the utility model, especially among smaller lenders that disproportionately serve minority communities. Such lenders in particular wish to avoid a risky transition that will disrupt the housing finance system. The National Association of Realtors and the National Association of Homebuilders have also spoken favorably about the utility model, as do left-leaning think tanks in the field.*
4. *The biggest implementation challenge for this policy choice is actually raising the capital for the two GSEs to reduce the taxpayers' exposure to their risks to a more reasonable level, and the difficulty of making all the choices needed to support such capital raising (some of which are politically sensitive). This complex process would be implemented by Treasury and the FHFA working together. (This policy choice is, of course, contingent upon the president getting to appoint soon a new FHFA Director, which is likely given the current case before the Supreme Court mentioned above.)*
5. *As both a safety-and-soundness regulator and a utility-style regulator, the FHFA would be in an excellent position to ensure that the two GSEs do not return to engaging in behavior counter to good public policy, or paying themselves excessive executive compensation (as happened prior to conservatorship). The historic "GSE lobbying bullies" should be a thing of the past, not to return.*
6. *The utility approach can be pursued both via legislation and/or via administrative actions. We recommend this program first be pursued between Treasury and the FHFA on an administrative basis, where utility-style regulation – with many details needing to be developed – is created by amending the existing support contract between Treasury and the two GSEs; this work should take maybe two years to accomplish. This administrative approach would require less time and resources than a legislative process, and it would avoid the risk of unwanted features that could arise in any legislation. Once administrative reforms have been established, legislation could be pursued to just lock in those reforms.*

This approach puts GSE reform, after more than a decade, finally to bed. Additionally, it does so in a way that is low-risk and does not require inordinate focus and resources in the White House or Congress during the administration's all-important first year. Any market disruption in a transition using a more aggressive change in business model is a one-way political risk to the White House: if things go wrong, the public gets upset; if things go right, the broad public hardly notices. It absolutely builds upon decades of Democratic Party support for the GSEs, but the extra layer of utility-style price regulation can fit the need for ultimate government control over the GSEs as shareholder-owned companies, arguably getting the best of private and public. And by pursuing administrative reform first, promising legislative reform later to lock in the changes, it can be pursued much sooner than would otherwise be the case, as Congress could easily take a year or more to even begin to focus on it seriously.

If this is the policy choice, it will be apparent when the White House obtains Senator Brown's public support to move in this direction, and then follows up with the Secretary of the Treasury and a newly appointed FHFA Director publicly announcing they will pursue it. Progress will be discernible when many of the decisions listed in my previous paper "Treasury's Long Capital To-Do List: Clearing the Decks for Investors"[5] start actually getting made, rather than ignored or continually deferred.

Policy Choice: Support a Strongly Progressive Government-Centric Model

Recommended policy: Undertake GSE reform, in a once-in-a-lifetime opportunity, to fundamentally restructure the housing finance system to be more just and equitable, by turning the two GSEs into a single, government-owned corporation. This will at last eliminate the conflict of interest in which the GSEs, endowed with advantages by Congress, faced two incompatible objectives – on the one hand, shareholder enrichment, and on the other, pursuing a congressionally defined mission – firmly in favor of the latter.

There are six reasons to recommend this policy path:

1. *The government corporation is an existing, tried-and-tested approach to get the job done, as demonstrated by the Tennessee Valley Authority, which has successfully executed upon its mandate since 1933. It has a Board of presidential appointees (subject to Senate confirmation), who choose the CEO and supervise its affairs. This would be the template.*
2. *There would be immediate savings to the typical borrower. As part of the legislation needed to implement this approach, there would be a full faith and credit government guarantee applied to the single corporation, which would have the benefit of immediately reducing mortgage rates on loans now sold to the GSEs (which are about half of all those outstanding); specialists estimate rates would drop by about ten basis points.*

[5] https://www.jchs.harvard.edu/sites/default/files/harvard_jchs_treasury_to_do_list_layton_2019.pdf

3. *This approach would mean we would never again have the embarrassment of a GSE CEO making tens of millions of dollars a year in compensation, as occurred prior to conservatorship, thanks to the GSEs' congressionally-endowed advantages. It would, in many ways, lock up and continue how the two GSEs have been managed in conservatorship for over a decade now, which by all accounts has been a general success.*
4. *We do run an obvious risk that, in any such legislation, there can be design features or other requirements that are less than ideal. We believe that if the administration (via Treasury and the NEC) takes a strong hand in the design of the legislation, this risk can be minimized as everyone in Congress understands that the field is so complex that reasonable deferral to experts makes a lot of sense.*
5. *Raising capital for the new single corporation to absorb enough risk ahead of the taxpayer will be based upon retained earnings (plus possibly new issuance of preferred shares), a lot less uncertain path than being dependent upon Wall Street's supposedly being able to raise record-setting amounts of common equity. As the objective is to eliminate ownership of any common equity by private-sector investors, the transition will also require that the current ownership of common shares (other than by Treasury) be eliminated.[6] There are several possible routes to do that; we would task Treasury and the FHFA to determine which one specifically is the best. Implementation by this route will take many (probably more than five) years for the corporation to become fully capitalized (a level which would be defined by the legislation), but it has the advantage of not requiring the government to inject taxpayer funds via the federal budget into the company.*
6. *The transition risk from two shareholder-owned GSEs to a single government-owned corporation, which is not insignificant (e.g., there could be shareholder lawsuits to disrupt it, massive computer systems integrations are required, etc.), can be adequately managed. This transition would be devolved to the director of the FHFA to plan so as to minimize the risk of its not going well, and there would be a generous timeframe to complete the task, determined by a realistic estimate of how long it will take to*

[6] There are existing preferred shares outstanding owned by the investing public, now known as "junior preferred" in comparison to the "senior preferred" owned by Treasury. These junior preferred shares, with a face value of about $33 billion between both GSEs, can be left outstanding; however, it may be desirable for them to be eliminated in some fashion to reduce possible legal risks.

implement while minimizing the risk of any disruption to the housing finance marketplace.

This progressive alternative is reported by several sources to have considerable support among the Democratic majority of the House Financial Services Committee, including the chair herself, Representative Maxine Waters. Such an approach would be highly partisan and likely to garner zero Republican support, and since it would require legislation to implement, it assumes not only that the Democrats take majority control of both the House (likely based upon today's information) and Senate (uncertain) along with the White House, but also that they have strong enough majorities to overcome more moderate Democrats who will be suspicious of such a big-government approach with significant risk of mortgage market disruption. That's a high political bar under any circumstances.

To determine if such a path is being seriously pursued, rather than just being paid lip service to appease progressive groups inside the Democratic Party "big tent," watch for the administration to put out a specific plan (and such a major change will require a lot of specifics) that is supported generally by Chair Waters, and then assign administration staff to flesh out many details in order to help Congress turn it into legislation that will actually do what is intended. This will require significant resource commitment by Treasury and the NEC, including personal time commitment of the Secretary of the former and the Chair of the latter. Watch for negotiations with leading moderate Democrats on the Senate Banking Committee (e.g., Senators Tester (D-MT) and Sinema (D-AZ)), whose support will be key.

Also, the role of the FHFA would have to change. Independent regulators exist to regulate private sector companies, not the government itself (for example, there is no independent regulator of the FHA's mortgage activities). It probably therefore makes sense for considerable resources from the FHFA to be relocated to work for the single corporation's board, giving its presidentially appointed directors a strong capability, independent of management, to supervise the company in depth.

The Lame Duck Period

In any of the above scenarios, there will be the lame duck period between the election on November 3 (or on whatever date afterwards that a winner seems to be clear) and the inauguration on January 20, 2021. During this period, it is possible, perhaps even likely, that FHFA Director Calabria and also possibly Treasury Secretary Mnuchin will take some GSE reform-related actions, which could be for reasons of good policy (e.g., wrapping up activities already under way) or of just partisan politics (e.g., pre-empting certain options that otherwise would be available to the incoming Democrats); some such actions could arise from both motives at once.

I have identified four noteworthy possible actions that could very well be taken that are relevant to the future path of GSE reform; for each, I comment on the likely reaction of the incoming Democrats.

1. Eliminate the retained earnings limit. When the net worth sweep[7] was replaced in September 2019 by allowing the GSEs to retain their earnings, there was a $45 billion limit ($25 billion for Fannie Mae, $20 billion for Freddie Mac). This limit creates a "cliff" that will soon push the GSEs back to the controversial net worth sweep. I believe that allowing earnings to be retained without limit is supported broadly, including by Democrats, so this should be non-controversial.
2. Institute a fee to pay for the government support. The PSPA is needed for the two GSEs to operate their long-time business models. The taxpayer is currently being compensated for its PSPA-based support by an unusual and unsustainable mechanism by which every dollar of net worth not swept to Treasury (but retained instead) is added to the face value amount of preferred held by Treasury. There is a broad consensus that this mechanism should at some point be replaced by a fee charged to the GSEs for the support, and the PSPA even references such a possible fee (which it calls a "periodic commitment fee"). As long as the fee is reasonable (meaning not too high), putting it into place during the lame duck period is likely to enjoy general support, including by Democrats. In my own thinking, I estimate a fee of .05 percent on the total liabilities of the companies – which amounts to about $3 billion per year – being roughly correct, but many will have their own views as it is fundamentally a judgment call.[8]
3. The FHFA approves its proposed capital rule. The FHFA could do so almost any time, as the comment period required by the Administrative Procedures Act ended this past August 31. It generally is very time-consuming to finalize a proposal of this type after receiving so many public comments, so it might or might not happen (with whatever changes the FHFA chooses to make) before the election. Regardless, the proposal will be controversial unless substantially revised, and thus I would expect the Democrats to look to replace it under

[7] The "net worth sweep" is the colloquial description of the terms of the PSPA from late 2012 till September 2019 n which almost all GSE earnings were paid to Treasury as the dividend on the senior preferred owned by Treasury.
[8] The amount of such a fee is indeed highly judgmental. (Comments that it should be determined "actuarially" are simply uninformed, as there is no data upon which to make any actuarial calculations for losses greater than what could be absorbed by the GSE's capital in a proper capital system, as losses have never been that large.) The fee could be tied to liabilities, as I have suggested, or perhaps another financial measure. It could be a flat percentage, as I have suggested, or vary with the riskiness of the companies due to their capital levels being high or low. At some point, though, it just has to be decided on and implemented.

almost all circumstances as soon as they are able to appoint their own person as the agency's director.

4. Take each GSE out of conservatorship and place it under a consent decree.[9] If done during the lame duck period, this would be controversial, but it is unclear if the Democrats would truly object or not. It certainly helps simplify a range of future actions a Biden administration might take about the GSEs. However, if the incoming administration wishes to preserve its option to pursue the government corporation approach referenced above, exiting conservatorship in this manner could create a significant barrier to doing so. I would say, therefore, that the reaction could be mixed, and also depend upon what is contained in the related consent decree. Of course, that decree could easily be revised by a Biden-appointed FHFA director. It is unclear, however, since the GSE conservatorships are so unprecedented, if the actual ending of conservatorship could be reversed if the Democrats wished to do so.

If Trump Is Re-elected: Administrative Reform Continues with Many Unknowns

The fourth possible path is, under the assumption that President Trump is re-elected, that the process now underway continues. This process was kicked off in September of 2019 by the issuance of the administration's housing reform plan.[10] However, that document had a "cover all the bases" tone to it, which I believe reflected compromises inside the administration. In practice, its implementation has gone exclusively down the route of "administrative reform" by the FHFA and Treasury.

However, the plan did not get into virtually any specifics of how the administrative reform plan would work or be implemented. After late that September, when the PSPA was amended to allow the build-up of the $45 billion of capital (as described above), it really was up to the FHFA and Treasury to just figure it all out.

The FHFA took up the task with gusto. Director Calabria has spoken very frequently in public about his intentions, with the media adopting a tone that the FHFA Director could do it all by himself. (In fact, that is incorrect.) An administrative reform plan (for the companies to exit conservatorship legally *and* become fully re-capitalized, as per my discussion of the "definition" of ending conservatorship in the Introduction) requires that the FHFA and Treasury both take many steps, some requiring joint

[9] In recent congressional testimony, Director Calabria seemed to commit to not do any such thing during 2020. This does leave three weeks in 2021 for him to do so, however.
[10] US Department of the Treasury, Housing Reform Plan, September 2019. https://home.treasury.gov/system/files/136/Treasury-Housing-Finance-Reform-Plan.pdf.

approval and some separate approvals – ideally with them all being integrated. So far, the FHFA's frequent communication on what it is doing is matched by the total silence of Treasury on what in turn it is doing – or whether it has done anything at all. This helps create a bit of a muddle as to where things actually stand right now, to say nothing of the specifics of the path forward.

To parse through where the existing path is indeed going in what is, by necessity, a long and complex process, I have divided it up into four categories: regulatory capital rule, PSPA amendment issues, per share issues, and capital raising plans.

Regulatory Capital Rule

A core requirement of any exit from conservatorship is to establish what the ongoing regulatory capital requirement will be; without one, it is impossible really to get to first base on any recapitalization plan. As the historic pre-conservatorship requirement (.45% on guarantees, 2.50% on investments) has no credibility, being way too low by any modern concept, the need for a wholly new requirement has long been recognized. The FHFA proposed one in 2018 that was received reasonably well, but had a few specific issues to address (e.g., many officially commented that it was too pro-cyclical). However, Director Calabria, taking office in 2019, withdrew it entirely, and issued a new one earlier in 2020.

The public comments that were received on this revised regulatory capital rule were extremely negative – well past the usual resistance by an industry to increased capital requirements. The primary criticisms were (1) that the aggregate amount was too high – by a lot; (2) that it was specifically and puzzlingly hostile to credit risk transfer, which is generally regarded as one of the most important and favorable developments since conservatorship began;[11] and (3) that it is dominated by non-risk-based requirements that will lead to distortions in economic decision-making, including creating false economic incentives for the GSEs to make high-risk loans.

It is totally unclear at this point how this will all work out. If Director Calabria only makes superficial or inconsequential changes, the new rule could derail the entire privatization process. Simply put, investors might just stay away as the GSEs would, without major increases in G-fees, have a clearly substandard return on equity.[12] An additional reason for investors to stay away is the surprising hostility

[11] Virtually no credible or non-partisan group of which I am aware supports this hostile approach to CRT. It reflects an extreme viewpoint.

[12] It will take years for increased G-fees to work their way through the financials to produce a return-on-equity (the single most important measure of performance for a financial institution) that is acceptable, as current G-fees (keyed to the 2018 capital proposal) would prove materially inadequate.

to CRT.[13] Without CRT, credit risk will likely be reconcentrated into the GSEs, which is a more questionable (and risky!) business model than had developed during conservatorship.[14]

In other words, if the capital rule is outside of the mainstream of regulatory capital thought in a way that is unfriendly to investors (which the current proposal most certainly is), it will put a damper on any capital raising, maybe even rendering it almost impossible for the next several years at least.[15] It is unclear how well this linkage is understood. Regardless, we shall see what eventually the final rule looks like. But until we see that, it is impossible to really get a good feel for how conservatorship exit – which in my view includes being fully capitalized – will proceed.[16]

PSPA Amendment Issues

In GSE reform via administrative means, a primary channel to impose upon the GSEs certain policy requirements, which would normally be specified in legislation, is through amending the PSPA. Thus, these requirements would be binding on the companies by contract, rather than by law.

There are four requirements most commonly discussed that would be handled in this manner. They are (1) that the GSEs will have "level G-fees" – that is, they will not give larger lenders volume discounts on their guarantee fees;[17] (2) that the investment portfolios of the two GSEs would be limited;[18] (3) that the GSEs will pay a specific fee for ongoing Treasury support (as discussed above); and (4) that the GSEs would subject themselves to utility-style regulation so that the FHFA, akin to a state public service commission, would set their guarantee fees to produce a fair return to the shareholders of the two companies.

Utility-style regulation is the most uncertain and controversial of these issues at this time. (The first two are just continuing existing policy, and are not overly controversial. The third has to be done at some point, and everyone involved knows it – only the specific formula to compensate Treasury for the PSPA support is uncertain.) The administration has not formally adopted utility-style regulation as policy, but Director Calabria has made comments in September 2019 Congressional testimony that seem to

[13] The capital rule renders most CRT falsely uneconomic; the natural consequence is that the GSEs will end the program. As of today, Fannie Mae has pre-emptively done so.

[14] Such a riskier business model will require a higher target return-on-equity to entice investors.

[15] See my related blogpost "The FSOC Secondary Mortgage Market Review: A Grade of F," September 2020 (https://www.jchs.harvard.edu/blog/fsoc-secondary-mortgage-market-review-grade-f.) for more on this topic.

[16] Again, the exit from conservatorship could happen in two steps: first an exit from the legal status of conservatorship, and then raising equity to become properly capitalized during a consent decree period.

[17] Such level G-fees have been instituted in conservatorship. The amended PSPA would just preserve them.

[18] Ditto: such limits have been instituted in conservatorship, and they just need to be maintained.

support it (even if indirectly). There is a broad consensus among many industry participants that it would be a proper way to have the GSEs operate, but the administration has just left the issue hanging, making it another major uncertainty in how reform via administrative means would proceed in a second Trump administration.[19]

Per Share Issues

There is a long list of related issues that primarily Treasury has to decide that I have grouped under "per share issues" as they impact how much each share will be worth; an ability for investors to reach a determination of their value is a necessary condition before capital raising can commence. Politically, some of these decisions are highly sensitive. Here is a quick list of some of the more important ones:

- What to do with the $200 billion-plus senior preferred outstanding held by Treasury? Waive it as paid, due to all the earnings swept into Treasury since 2012? Convert it into common (and if so at what exchange rate)?[20] Something in between?
- What to do with the $33 billion face value of junior preferred held by the investing public? Let it go back to 100-cents-on-the-dollar in a conservatorship exit? Negotiate some sort of discount, possibly through a tender offer?
- When to exercise the 79.9% warrants Treasury holds in each company? Related to this are issues such as: (1) Should a promise be made to new common equity investors that Treasury will somehow limit exercising its voting rights on these shares (and, if so, what those limits would be), as otherwise the shares give Treasury effective majority voting control over the two companies for some time, which reduces the value of new shares?[21] (2) What would Treasury promise new private market investors about the timing of any sale of its shares (obtained by exercising the warrants), as any such sale would push down the market price of newly issued shares then trading? Will Treasury promise not to sell its shares for twelve months after investors have purchased theirs? Twenty-four months? Thirty-six?

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[19] The Treasury's housing reform plan document prioritizes a future state in which there would be more than two GSEs, so competition (rather than utility-style regulation) would presumably keep G-fees from being excessive. However, that change would require legislation, and so the plan was silent on what to do when pursuing an administrative reform path where, by definition, there are just the same two GSEs continuing into the future.

[20] This is an ultra-sensitive political decision. If the senior preferred is "waived as paid," Democrats in Congress will erupt and call it a "give-away to the hedge funds," and many Republicans may join them.

[21] If Treasury is in effective managerial control via its warrants and other ownership interests when new shares are sold to the public, the latter will only purchase shares that reflect a "minority investor" discount, if they would be willing to purchase at all.

I note that virtually none of the above issues can be decided now, because there is a case before the Supreme Court challenging the controversial "net worth sweep" clause of the PSPA that came into effect in late 2012; that case will be heard later during the current term and a decision is expected by June 2021. Until that occurs, the Treasury, FHFA and any equity underwriters literally cannot make a calculation of anything on a per share basis. So, a lot of the tasks needed for exit (again, including being fully capitalized) just sit and wait upon the court's decision.

Capital Raising Plans

At some point, the two GSEs, their investment bank advisors, the FHFA and Treasury all together have to dig in and produce a detailed capital raising plan that integrates all of the above decisions and outcomes into something that can successfully raise record amounts of equity at a reasonable share price.[22] There has been inordinate media attention to this aspect of the exit (even though it is last in order given how many decisions on all the topics described above have to precede it) as Director Calabria has strongly focused on it in his public comments, as well as its potential impact on Wall Street underwriting revenues and prestige.

The plan has to address many issues that can't be decided yet. These would include, among many others, the following: (1) What is the business model going forward – with CRT or without? Are risk-based capital requirements dominant versus leverage-based ones, or not? Do G-fees have to be raised significantly to get an acceptable return-on-equity or not? (2) What regulatory capital should investors assume is needed to support that business model? (3) What will be the fee to be paid to Treasury to maintain its PSPA support of the companies, as it impacts earnings so much? (4) In meeting the new capital requirement, to what extent should the GSEs rely upon retained earnings versus new equity issues? (5) Will G-fees will be set by the FHFA via utility-style regulation and, if so, what are the terms and process of that regulation (for which no work has seemingly been done)? (6) How can equity raises by Freddie Mac and separately by Fannie Mae be coordinated so they don't crash into each other in the marketplace?

In short, right now, until so many decisions are made, investors would not know what they are economically investing in. And until they do, they won't invest in the record-breaking size required. So, it

[22] Depending upon the mix of retained earnings versus new share issues to be employed, the amount of new money raised could easily surpass $100 billion between the two companies. By comparison, the largest US company IPO ever was $18 billion (for VISA). So, the attractiveness of the two companies to investors will have to be quite strong to attract such astounding amounts.

is entirely unclear how all this will work out. (Director Calabria's public comments on timing have been revised several times further into the future, as makes sense given how much is not yet known.) There has been a large media focus on how the FHFA itself and the two GSEs have retained advisers as signs of progress – that's all well and good, but until many actual decisions (as listed above) get made, those advisers can't get very far without just spinning their wheels.

So, here we are, one solid year since the Trump administration published and then began implementing its housing reform plan for the GSEs via administrative means. And yet, it seems very little has actually been decided or accomplished in terms of specifics of how the chosen path will work, as distinct from hiring advisers or doing preparatory work. This impasse reflects the complexity of the topic, how much other priorities (especially the pandemic) have intervened, and how the timing with respect to key issues (e.g., the lawsuit at the Supreme Court about the net worth sweep and the FHFA Director's independence) can be beyond the control of Treasury and the FHFA.

In other words, as stated in the Introduction to this essay, the current implementation is "likely to happen later than generally expected, still with significant choices to make and challenges to overcome."[23] There is just so much that we don't know yet about how it will all work out.

Concluding Comments and Recommendation

A constant theme of GSE reform proposals and actions is how complex the topic is. The Trump administration's reform plan, after more than a year, still seems to have only scratched the surface in many ways. One starts with a very complex housing finance system, adds to it the complexity of the GSEs – which, being focused on securitization, are involved in the most complex part of housing finance – and then there are all the complexities associated with recapitalizing the companies to exit conservatorship.[24]

This complexity has thwarted all sorts of high-level proposals to reform the GSEs. The most detailed and well-regarded Congressional effort, by Senators Corker (R-TN) and Warner (D-VA) and their staffs in 2013-14, started to have problems when it went from high-level concept (i.e., to have more than two competing GSEs, a well-regarded idea in the housing finance policy community for some years

[23] And this should be a warning to anyone in a future Biden administration who thinks GSE reform will be quick and easy if they choose anything other than the status quo. It won't.

[24] This type of conservatorship-exit capital raising is totally unprecedented. The closest analogy is the government exiting its control of AIG, which I got to observe as a government-appointed director of the company from 2010 to 2012. I can state quite categorically that the GSE exit and recapitalization is far more complex.

at that time) to specific and workable features, including a plan to transition from the existing two GSEs. While the bill eventually failed due to political issues related to affordable housing, in retrospect there was "buyer's remorse" afterwards among many of its supporters as they realized that it was not obviously going to work in practice as hoped, and that the transition could have been quite disruptive. I heard that remorse politely summarized with the phrase "it was too complicated."

So, the first thing to do when talking about GSE reform is to be humble.

In reviewing the implementation of the GSEs via administrative means now underway, we really have only a limited idea how it is going to work out and how long it will take. If President Trump is re-elected, we know that the FHFA and Treasury will push forward – but not what that means with any specificity, as there are just too many still-unanswered questions (including the results of the Supreme Court case). My technocratic suggestion would be, while waiting for the court's decision, to work to simplify the process as much as possible so as to strengthen the ability to practically implement it.

If former Vice President Biden is elected, looking at the three alternatives, I cannot recommend they choose the third policy choice (i.e., the strongly progressive path). I hold this opinion due to purely technocratic and practical considerations (i.e., before any consideration of ideological or political views). Merging the GSEs into a single government-owned entity is just a general and high-level concept – more a statement of an ideological objective than a true plan. There is no real notion of how to get from where we are today to what is envisioned without potentially massive disruption to the mortgage system. Like most such high-level plans, it's heavy on intent but light on workable specifics; it leaves others (in this case, the FHFA and Treasury) to somehow, in some fashion, make the plan work – without its proposers first doing the homework to make sure it is, in reality, actually workable.[25] That is not a recipe for success in policymaking.

As to the other two choices outlined for a Biden administration to consider, both are low-risk by comparison. If the choice would be to really keep risk as low as possible for now, then leaving the two companies in conservatorship for longer makes the most sense. If the choice is to actually, once and for all, get conservatorship exit over the finish line, then the second alternative – which does require that the complex process of raising equity be executed – makes the most sense (especially if the timeframe is not overly rushed).[26] The Calabria tactic of legally ending conservatorship first, and then raising capital

[25] Based upon my knowledge of the GSEs, I believe the needed multi-year transition is very high risk in terms of potential for massive disruption of the mortgage markets, and I have very serious concerns whether it is truly workable or that it will perform anywhere near as its proposers claim and hope it will.
[26] In fact, the entire capital raising would be very significantly simplified if, at the extreme, the GSEs were to be recapitalized solely by retained earnings, with only the Treasury selling off its shares to private market investors.

during a consent decree period afterwards, is also a good one, and it could be included in how the implementation of the utility model can be simplified.

So, here we are, in the thirteenth year of conservatorship. Unfortunately, at this time, we really still have little idea of how long it will take for the GSEs, in any form, to exit the conservatorship and be able to operate normally (however that is defined at the time). Unfortunately, as described above, it's true regardless of whether President Trump or Former Vice President Biden is sitting in the White House.

All we can hope for then is that GSE reform design and implementation is done well in the future during the next four-year presidential administration, regardless of who leads it, to hopefully, at last, put this all to bed.

Thus, the primary capital raise (i.e. where the GSEs get the cash to increase their net worth) would be via retained earnings only, and the secondary capital raise (i.e. where the Treasury, as one investor, sells off its shares to other investors) would be via underwritten transactions.