By Anne M. Eberhardt

The Continuing Conservatorships of Fannie Mae and Freddie Mac

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Once again, there are tremors in the world of financial institutions, and somehow, Fannie Mae, Freddie Mac and home mortgages are involved. Fifteen years ago, housing finance was at the center of a global financial crisis and an enormous rescue effort by the Treasury Department. Today, headlines cry out everywhere for answers: Are we facing another housing crisis? Is this 2008 all over again? Or worse, is it 1929?

In September 2008, the two government-sponsored enterprises (GSEs) at the center of the nation's housing finance system — the Federal National Mortgage Association and Federal Home Loan Mortgage Corp., commonly known as Fannie Mae and Freddie Mac — were placed into conservatorship, and the Treasury Department entered into senior preferred stock agreements (PSPAs) with them. Credit markets had seized up, bringing down venerable financial institutions and investment banking firms. The Treasury made a commitment to provide financial support to the GSEs during the biggest financial crisis in nearly 80 years.

Almost 15 years later, the GSEs' conservatorships have survived and become profitable. Accordingly, it is worth revisiting their story, along with the lessons that 2008's intervention may hold. The story of systemic housing finance begins during the Great Depression, and the evolution of the GSEs into the titans they have become mirrors the story of the nation's efforts to grapple with issues that grew out of periods of great economic turmoil.

The Creation of the GSEs

Fannie Mae was one of the entities created when the federal government attempted to stimulate the economy through home construction in response to the Great Depression. Chartered in 1938 as a government corporation, Fannie Mae's purpose was to operate a secondary market for the purchase of loans guaranteed by the Federal Housing Administration. Fannie Mae's mission expanded following World War II when the Department of Veterans Affairs was created, and Fannie Mae was given the authority to purchase mortgage loans guaranteed by the Department of Veterans Affairs.[1]

In the late 1960s, the Department of Housing and Urban Development was created, and the Government National Mortgage Association (Ginnie Mae) was spun off from Fannie Mae. Ginnie Mae's purpose was to assume administration of the portfolio of mortgage loans expressly insured by the federal government, while Fannie Mae continued to operate in the secondary markets. By 1970, Fannie Mae had transitioned to a shareholder-owned corporation with a government charter authorizing it to acquire mortgages that were not insured by the federal government. Freddie Mac was created to provide competition to Fannie Mae.

At first, the business models of the GSEs were different. Both acquired mortgages from lenders, but Fannie Mae retained the mortgages on its books, while Freddie Mac securitized most of its mortgages into pass-through participation certificates. Fannie Mae began securitizing its mortgage acquisitions in the high-interest-rate environment of the early 1980s after it was nearly pushed into insolvency because of the interest-rate risk it retained through its mortgage holdings.

Following the savings-and-loan and Latin American debt crises, regulators began to address capital adequacy at financial institutions. The GSEs' relatively limited capital requirements, well below those required of thrifts and other banks, created a competitive advantage for holding mortgage-related risk. The *perception* that the GSEs' mortgage-backed securities and debt securities were guaranteed by the federal government allowed the GSEs to operate with higher leverage than non-government-insured mortgage lenders, creating incentives for financial institutions to sell mortgage loan originations to the GSEs.

The portfolio of mortgages that the GSEs retained grew markedly in the 1990s, increasing from about $135 billion in 1990 to more than $1.5 trillion in 2003. Again, the *perception* of a government guarantee permitted the GSEs to use their advantageous borrowing rate to fund investments in mortgage portfolios retained on their books. During this time, the GSEs' unsecured debt grew to $1.7 trillion, while the federal debt held by the public was $4 trillion.

Conservatorship and the PSPAs

In mid-2006, when President George W. Bush nominated Henry Paulson to be Treasury Secretary,

1 This section is drawn from the Housing Reform Plan issued by the U.S. Department of the Treasury in September 2019, pp. 4-7, and 31-32, *available at* home.treasury.gov/system/files/136/Treasury-Housing-Finance-Reform-Plan.pdf (unless otherwise specified, all links in this article were last visited on May 22, 2023).

Fannie Mae was in the middle of a multi-year accounting restatement. (Freddie Mac's own restatement was completed three years earlier.) High on Paulson's list of objectives was GSE reform, but he soon learned the nature of the resistance he would encounter. In his account of his time at the Treasury Department, Paulson described his initial briefing on the GSEs:

> But change was hard to come by. The GSEs wielded incredible power on the Hill thanks in no small part to their long history of employing — and enriching — Washington insiders as they cycled in and out of government. After accounting scandals had forced both GSEs to restate years of earnings, their CEOs were booted, and House and Senate efforts at reform broke down in a dispute over how to manage the size and composition of the GSEs' portfolios. These had been expanding rapidly and moving into dicier assets — exposing Fannie and Freddie to greater risk.
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> Answering one of my many questions, [David] Nason pointed out a simple fact: "Two-thirds of their revenue comes from their portfolios, and one-third comes from the securitization business."
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> I didn't need to hear much more than that. "That's why this is next to impossible to get done," I said. Their boards had a fiduciary duty to resist giving up two-thirds of their profit, and they would.[2]

Paulson saw that the way to GSE reform was to build congressional support for establishing a new regulatory entity: the Federal Housing Finance Agency (FHFA), which would hold powers similar to those of banking regulators. The White House was in favor of congressional rather than regulatory action, but once the Republicans lost both chambers in the November 2006 elections, Paulson worked to build support for the FHFA's establishment.

However, the legislation authorizing its creation, the Housing and Economic Recovery Act, would not pass until July 2008, in the middle of the world's most devastating financial crisis in decades. While in Beijing for the 2008 Summer Olympic Games, Paulson learned that "Russian officials had made a top-level approach to the Chinese suggesting that together they might sell big chunks of their GSE holdings to force the U.S. to use its emergency authorities to prop up those companies. The Chinese had declined to go along with the disruptive scheme, but the report was deeply troubling — heavy selling could create a sudden loss of confidence in the GSEs and shake the capital markets."[3]

In early September, the FHFA placed the GSEs into conservatorship and Paulson exercised the authority provided under the Housing and Economic Recovery Act to initiate the PSPAs. The Treasury committed to providing each GSE with equity infusions following any quarter in which reported total liabilities exceeded total assets in accordance with Generally Accepted Accounting Principles (GAAP), up to a limit of $100 billion each.

In return for this commitment, the Treasury would receive nonvoting senior preferred shares, warrants to purchase 79.9 percent of the GSEs' outstanding common stock, and the right to a periodic commitment fee. Dividends on any amounts the GSEs drew from the Treasury would be 10 percent (12 percent if not paid in cash). The GSEs were further directed to wind down their mortgage portfolios according to a prescribed schedule.

Early Conservatorship (2009-12)

By the end of the second quarter of 2009, Fannie Mae had received $15.2 billion in funding from the Treasury, while Freddie Mac had received $44.6 billion. Alarmed, President Barack Obama's administration made the decision in May 2009 to increase the Treasury's commitment to $200 billion for each GSE.

By the end of the third quarter of 2009, Fannie Mae had received $44.9 billion in funding, while Freddie Mac had received $50.7 billion, forcing the Obama administration to again amend the PSPAs, providing for a funding commitment of $200 billion for each GSE plus any additional deficit amounts incurred between 2010 and 2012, less any positive GAAP-based shareholders' equity as of Dec. 31, 2012.

By the end of the first quarter of 2012, Fannie Mae had drawn $116.1 billion, while Freddie Mac had drawn $71.3 billion, translating to annual dividend requirements of $11.6 billion and $7.1 billion, respectively — amounts far exceeding the GSEs' annual earnings in the five years preceding conservatorship. The Treasury feared that the GSEs would be forced to make draws on the PSPAs in order to pay back dividends to the Treasury.

Return to Profitability (2012 Forward)

As the housing market stabilized, the GSEs began to show signs of returning to profitability. In August 2012, the FHFA directed the GSEs to increase their single-family guarantee fees by 10 basis points as a step toward encouraging greater private-sector participation in the mortgage markets. At the same time, the Treasury announced another modification to the PSPA. Among other things, this "third amendment" replaced the 10 percent dividend with a variable dividend to address fears that the GSEs would draw cash from the Treasury for the purpose of paying dividends back to the Treasury.

The third amendment required the GSEs to sweep all of their earnings to the Treasury, except for a specified amount that they were allowed to retain as a capital buffer, which would decline over the succeeding five years. Beginning in 2018, the dividend would consist of the entire net worth amount.

This action was not without controversy. The third amendment was criticized as an inappropriate expropriation of the GSEs' earnings, and a number of shareholder lawsuits followed. As earnings began to improve, the GSEs reduced their provisions for loan and guarantee losses and released the valuation allowances against their net deferred tax assets to reflect improved market conditions. These accounting entries had the effect of temporarily magnifying earnings for the next few years, distorting the perception of the GSEs' profitability. In 2019, the PSPAs were again modified to allow the GSEs to retain earnings to build capital reserves of $25 billion for Fannie Mae and $20 billion for Freddie Mac.

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2 Henry M. Paulson, Jr., *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System* (2013), p. 57. Nason was assistant secretary for Financial Institutions from 2005-09.

3 *Id.* at p. 161.

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Successes — and Failures — of Conservatorship

There is very little doubt that the PSPAs served their primary purpose, which was to stabilize the housing markets and calm investors who feared the GSEs would default on their obligations. Writing five years after completing his tenure as Treasury Secretary, Paulson expressed satisfaction with the PSPAs' stabilizing effect but dismay that conservatorship had survived into 2013. He was further concerned that the GSEs dominated the housing market more completely than ever.[4] To this day, very little private capital has re-entered the residential mortgage market.

Winding down the GSEs and returning housing finance to the private sector was a shared goal of the Bush, Obama and Trump administrations, but only Congress holds the power to modify the GSEs' charters, and most GSE-watchers believe that congressional action is unlikely to come for many years. Recent changes to the GSEs have come through regulations originating from the Treasury and FHFA.

The Treasury's remaining funding commitment is $113.9 billion for Fannie Mae and $140.2 billion for Freddie Mac. Since 2012, the GSEs have only drawn on the PSPA once, in 2018, because of accounting changes to the rules governing loan-loss reserves. The GSEs' financial positions appear to be stronger than ever, and the GSEs proved to be a stabilizing force during the COVID-19 pandemic.

The View Ahead

The solutions developed during the 2008 crisis have become institutionalized, forming the basis of a new status quo. However, it is worth recalling that before 2008, the status quo was similarly built on a set of creative solutions that had become normalized following the savings-and-loan crisis, the War on Poverty and the Great Depression. Each of those solutions contained within them the seeds of the next crisis.

The collapse of Enron in 2001 and the passage of the Sarbanes-Oxley Act of 2002 led to a flurry of financial accounting investigations and restatements. The GSEs were the subjects of accounting restatements between 2002 and mid-2007, and during that time, every major accounting firm in the nation parked thousands of accounting consultants at the GSEs' headquarters. These consultants pored, for years, over the GSEs' books and records.

By the time the last consultants had packed up their laptops, the first rumblings of the Great Financial Crisis were ripping through the daily headlines. Those thousands of consultants at the GSEs, buried in the contracts and books and records of these two behemoths, did not see it coming. In their defense, neither did Secretary Paulson and the GSEs' regulators,[5] which should instill a little humility in anyone who would predict the future.

In mid-March 2023, when the news broke of the collapse of Silicon Valley Bank, with its balance sheet full of Fannie Mae and Freddie Mac mortgage-backed securities, it might have been natural to feel a case of the jitters. When First Republic Bank was brought down in part by its portfolio of jumbo mortgages, those jitters might have solidified into feelings of mild panic.

Because of their now fairly explicit federal guarantee, GSE securities remain a desirable investment, and financial institutions actively seek to bolster their balance sheets with them. They are no longer full of toxic mortgages poisoning the bloodstream of the global financial circulatory system.

Silicon Valley Bank, and to a lesser extent First Republic Bank, failed because of an inflation-caused duration mismatch: Short-term obligations were financed by long-term loan assets. In an inflationary environment, with assets composed of 30-year fixed-rate mortgages, those securities lost value, causing bank runs by panicked depositors.

Conclusion

Conditions in 2023 are different from 2008. The good news is that the U.S. dollar remains the world's reserve currency, and there is no credible alternative to it. The demand for U.S.-backed securities of all kinds remains high across the global economy.

The bad news is that geopolitical tensions between the U.S. and China are greater now than ever, while tensions with Russia are near the boiling point. Alternatives to currencies backed by a nation state are rising as an economic force. Growing impatience with U.S. leadership and the ability to manage its financial affairs feeds a narrative of crisis and panic, and calls for decoupling the globalized financial system from the U.S. dollar are being heard not only from Russia and China, but increasingly from relatively friendly places, such as Saudi Arabia, Brazil and India. The U.S. national debt is nearly treble its 2008 level, while inflation and higher interest rates are back after a generation of dormancy. In short, what we have to fear most, in the words of another Bush-era cabinet member, are the unknown unknowns.[6] abi

4 *Id.* at p. xxxii.

5 *Id.* at pp. xviii-xix.

6 This is based on something said by former Defense Secretary Donald Rumsfeld. *See* Dan Zak, "'Nothing Ever Ends': Sorting Through Rumsfeld's Knowns and Unknowns," *Washington Post* (July 1, 2021), *available at* washingtonpost.com/lifestyle/style/rumsfeld-dead-words-known-unknowns/2021/07/01/831175c2-d9df-11eb-bb9e-70fda8c37057_story.html (subscription required to view article).

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