

Forging a Path out of Conservatorship for Fannie Mae and Freddie Mac

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Executive Summary

The mechanism that granted extraordinary powers to the US Department of Treasury and to the Federal Housing Finance Agency (FHFA), the regulator of Fannie and Freddie; namely the Housing and Economic Recovery Act of 2008 (HERA) has now 6 years after both GSEs entered conservatorship effectively left the housing market in a form of financial limbo. To a large degree, Congressional inaction over this period has effectively forestalled any serious plan for bringing one or both agencies out of conservatorship. The sheer complexity of GSE reform coupled with a nearly unprecedented schism between political parties explains why comprehensive GSE reform is for the time being elusive at best.

Meanwhile, the US housing finance system languishes in a form of suspended animation that poses considerable uncertainty to private investors and potential homebuyers alike. The right outcome for GSE reform, namely comprehensive legislation addressing Fannie Mae and Freddie Mac is unlikely to occur, however, a solution that would bring private capital back to housing markets, significantly limit but not eliminate taxpayer contingent liability, and address the issues that precipitated the demise of the GSEs is feasible. This solution is already possible within the HERA legislation by granting the FHFA authority to bring the housing GSEs out of conservatorship. This paper presents a roadmap for this solution to GSE reform by outlining the statutory language affording FHFA the powers to unwind

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the conservatorships, the rationale for such a move, an examination of the causes for GSE conservatorship that have or can be addressed independent from Congressional action and a review of the steps needed to bring the agencies out of conservatorship. The paper provides support not only for why recapitalizing the GSEs makes sense from a public policy perspective, but how it could be done as well as the prerequisites for such action.

The principal factors directly attributable to the GSEs entering conservatorship; i.e., weak regulatory oversight, low capital requirements, unchecked retained portfolio growth, and poor underwriting standards have effectively been addressed other than establishing a set of stringent capital requirements on the GSEs. And with stronger regulatory oversight in place, such capital requirements would also be possible and a prerequisite to any post-conservatorship environment for the GSEs.

Designing an exit from conservatorship for the GSEs would need to be carefully crafted in order to not disrupt the mortgage market. But as mentioned in the previous section, such an outcome would be less likely to disrupt markets than receivership for one or both entities. The keys to ending conservatorship lie in meeting the following requirements:

- Development of a recapitalization plan that complies with FHFA's capital buffers for the agencies
- Development of a set of stringent risk-based capital requirements that would be phased-in over a specified period of time
- Termination of the sweep of profits from the GSEs to Treasury
- Strict executive compensation requirements imposed by FHFA
- Accelerated wind down of both GSEs's retained portfolios