How the Fannie and Freddie Conservatorship Has Undermined the Resolution Process

By William Isaac and Senator Bob Kerrey | April 2015

Preface

Seven years after the crisis that rocked the global financial system, we are still rebuilding and redesigning its structure and rules - and probably will be for years to come. As policymakers engage in this process, laws enacted to address the crisis must be faithfully executed or formally amended.

Otherwise, the government would introduce uncertainty into a marketplace that can ill afford it. Regrettably, uncertainty is precisely what is occurring with regard to the mortgage banking giants commonly known as Fannie Mae and Freddie Mac.

In the summer of 2008, the world's largest secondary financial market was unraveling. Given the size and systemic significance of Fannie Mae and Freddie Mac in the mortgage finance market, the Treasury Department intervened, based on authority granted to it by Congress in its passage of the Housing and Economic Recovery Act (HERA). Treasury invested $187 billion in senior preferred stock in Fannie Mae and Freddie Mac, carrying a ten percent dividend. As part of the deal, the government also effectively acquired ownership of 79 percent of the GSEs' common stock. As structured, these terms avoided a complete government takeover of the GSEs and protected taxpayers from future bailouts. The government was right to insist on tough terms given its indispensable role in restoring stability into the marketplace.

However, given its critical role, the government has a uniquely important obligation to abide by the terms of deals that it makes. That is why the government's actions in recent years are troubling. As this paper will detail, beginning in 2012 the government unilaterally changed the terms of HERA and began to sweep all of the GSE's profits into the general fund. Rather than "conserving and preserving" the GSEs' assets for their eventual restoration to a "safe and solvent" condition, as the HERA stipulates, the ongoing confiscation of 100% of the GSEs' profits does just the opposite.

This misapplication of the law has created several problems. First, it ignores the rights of shareholders. Second, it leaves the GSEs' vulnerable to the need for the infusion of taxpayer dollars should another market disruption occur.

Congress and the Administration will eventually decide what to do about Fannie and Freddie, and whether or not these institutions should have any role in the future of housing finance. Until that time, the government must follow the law, and not undercut its ability to act decisively in times of crisis.

Executive Summary

The conservatorship established for Fannie Mae and Freddie Mac in the midst of the severe financial crisis of 2008-2009 initially helped stabilize housing finance, but in the years since has thwarted the clear direction provided by Congress to the Federal Housing Finance Agency (FHFA) under the Housing and Economic Recovery Act ("HERA"). The conservatorships were accompanied by an investment by the government of $187 billion in senior preferred stock in Fannie and Freddie carrying a 10% dividend. The government also obtained warrants, convertible at nominal cost, into 79% of Fannie Mae's and Freddie Mac's common stock.

Under HERA, one of FHFA's primary duties as conservator is to "preserve and protect the assets and property" of the enterprises as well as to take actions necessary to putting Fannie and Freddie in a "safe and solvent" condition. In 2012, four years after FHFA established the conservatorships, the federal government unilaterally amended the agreements to sweep 100% of Fannie's and Freddie's profits to the U.S. Treasury. This action, and the resulting draining of the GSEs' profits and capital each quarter, actually reduces the effectiveness of future resolution efforts by the government in times of crisis. Resolution of financial institutions by federal agencies often requires participation of the private sector. In turn, established rules and law surrounding the priority of claims in such arrangements depends on the consistent and clear application of these rules. By placing public claims ahead of private stakeholders in the Third Amendment to the preferred stock purchase agreements, the federal government has adversely affected future resolutions of financial institutions by changing the rules of the game by putting one group of legal stakeholders ahead of others *ex post*.

In the meantime, the conservatorships endure. With no hope of recapitalizing without extraordinary intervention, the secondary mortgage market remains in a state of suspended animation, lacking private capital, exposing taxpayers to future losses, and raising the cost of mortgage credit and reducing its availability to creditworthy borrowers.

Historic Context and Policy Perspectives

On September 6, 2008, the U.S. mortgage market – the world's largest secondary financial market – avoided an unprecedented and catastrophic unraveling when both Fannie Mae and Freddie Mac were placed by their regulator into conservatorship. Conservatorship is a legal process taken by an entity at the time financial insolvency occurs to oversee its activities in an effort to return the company to solvency. Conservatorship is distinct from receivership, which is aimed more at an orderly liquidation of an enterprise that cannot be saved. The federal government, leading up to conservatorship, had few policy tools available to it to step in and provide stability to the GSEs. That changed when Congress enacted the Housing and Economic Recovery Act of 2008 (HERA) that created the Federal Housing Finance Agency (FHFA) and gave FHFA the authority to establish the conservatorships and manage both enterprises with a great deal of policy latitude. HERA granted FHFA authority and direction to "preserve and conserve the assets and property" of Fannie Mae and Freddie Mac along with the power to take actions to put the enterprises in a "safe and solvent condition." Four years later, in direct contradiction to these mandates, the federal government embarked on an unprecedented sweep of 100% of the enterprises' profits, thus denying both companies any chance of escaping from conservatorship and frustrating the point of conservatorship itself – *i.e.,* returning the undercapitalized financial institutions to health.

Conservatorship was not intended to be a long-term solution to the GSEs, but six years later the companies continue in a state of limbo. The management of these conservatorships has jeopardized future resolution processes by effectively changing the rules of the game between private and public stakeholders. By elevating the priority of public claimants over private interests, FHFA's actions regarding the conservatorships set a precedent with potentially negative long-term consequences. This could significantly impair private participation in future resolution processes while potentially raising the costs of housing and limiting credit availability across the markets.

FHFA has purposefully avoided engaging directly in any strategy that would end the conservatorships or place them into liquidation via receivership. In this political vacuum, the conservatorships have failed in meeting many of their objectives. FHFA's interpretation of its discretionary authority under HERA, coupled with unprecedented unilateral changes to the preferred stock agreements between the government and the enterprises, forestalls any chance for Fannie and Freddie to recapitalize without some intervention on their behalf. It also undermines the effectiveness of future resolution activities of financial companies during times of crisis by subverting well-established rules and laws relating to insolvency.

This report provides a review of the policy and strategy surrounding the conservatorships. The intent is to provide an objective and fact-based assessment of how the conservatorship has worked against stated objectives, how actions taken by FHFA and the U.S. Treasury have affected the enterprises, taxpayers, markets and homeowners, and what insights can be gained from these events that may be used in shaping a policy solutions for final resolution of the conservatorships.

Looking back, few policymakers would have expected the conservatorships to still be in place after more than six years. With investment in residential housing and associated housing services accounting for nearly one fifth of U.S. GDP on average over time, addressing the conservatorships of the two agencies directly responsible for financing the vast majority of this nation's mortgages is one of this nation's major policy imperatives. This is especially true as housing continues to recover at stubbornly slow pace, on average, in comparison with the economy as a whole.

Stabilizing Fannie and Freddie During the Financial Crisis

The charters granted to Fannie Mae and Freddie Mac were a uniquely American financial innovation originally designed out of necessity from the Great Depression to help get the nation's housing market on its feet. An urgent need to establish a deep liquid market for mortgages was clear when Fannie Mae was chartered in 1938. Both enterprises (Freddie Mac following much later in 1970) provided guarantees for credit risk embedded in mortgages that were bundled and used as collateral underlying mortgage-backed securities (MBS) sold by the enterprises to investors. These guarantees were not made explicit obligations of the federal government – to the contrary, all the legal documentation of the MBS and debt issued by the enterprises stated otherwise. However, markets interpreted the linkages outlined in their charters, including a line of credit from the U.S. Treasury, as implying some form of guarantee. This so-called “implicit” guarantee helped lower the cost of the enterprise’s debt, which in turn helped reduce the rates on Fannie- and Freddie-backed “conforming” mortgages relative to privately financed mortgages.

From a credit perspective, neither enterprise encountered a period leading up to 2008 that posed an insolvency risk due to credit losses. This is a critical fact that made the housing boom preceding the 2008 conservatorships an exceptional period in its own right and central to the discussion of the effectiveness and purpose of the conservatorships.

A combination of low capital requirements, poor oversight relating to GSE risk-taking, and a strategy to grow the retained portfolios and expand the credit risk envelope put the enterprises in a precarious position when the mortgage crisis broke, eventually sealing the fates of the GSEs in 2008. Both enterprises incurred combined losses of $108.8B in 2008, more than the total losses experienced by Fannie and Freddie in the 37 years leading up to 2008. At the time, the Office of Federal Housing Enterprise Oversight (OFHEO), which oversaw the GSEs, had limited authority to address what was fast becoming a systemic risk issue for the U.S. housing market as both enterprises’ financial conditions became increasingly dire as the financial crisis unfolded.

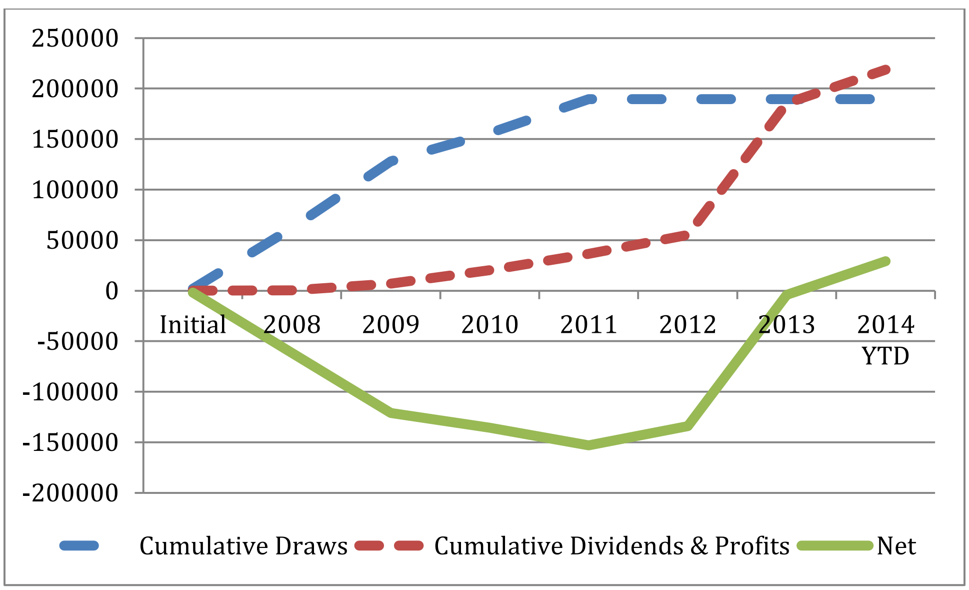
In response to the accelerating decline in the enterprises’ capital positions, increased borrowing costs, and potential liquidity crisis Congress passed HERA on July 30, 2008. HERA, among other things, created FHFA as the successor agency to OFHEO and granted it the authority to place the GSEs into conservatorship upon determining that the firms were undercapitalized or otherwise unable to meet their financial obligations. After a comprehensive review by the Treasury Department, Federal Reserve, the Office of the Comptroller of the Currency and FHFA, the FHFA director on September 6th, 2008 designated FHFA as conservator for both Fannie and Freddie, based on the results of that analysis indicating inadequate capital levels and an inability for the enterprises to raise a sufficient level of capital to maintain their solvency during this extraordinary period. According to statements from then Secretary of the Treasury Henry Paulson, the conservatorship was to maintain market stability and access to mortgage credit and to protect the U.S. taxpayer. Importantly, Secretary Paulson also indicated that conservatorship was intended to be a short-term solution to the enterprises' financial problems. In fulfilling its role as conservator, FHFA took over the assets of both firms, assumed the powers of the board and executive management and replaced the CEOs of both companies. Under HERA, FHFA suspended, but did not eliminate, shareholder rights in accordance with HERA until such time as the enterprises could be placed into a safe and solvent condition.

Senior Preferred Stock Purchase Agreements

Following enactment of HERA, the U.S. Treasury along with FHFA entered into the senior Preferred Stock Purchase Agreements (PSPAs). The PSPAs provided the mechanism for financial support (in the form of preferred stock purchases) to each enterprise, in return for $1 billion in preferred shares of that enterprise ($2 billion between them) and warrants that when exercised gave the Treasury 79.9% of the common shares of each company. By ensuring that the enterprises remained solvent, the holders of debt and mortgage-backed securities issued by the GSEs were protected from loss and stability of the secondary market was maintained. Initially, the preferred stock held by the Treasury had a dividend of 10% if paid in cash and 12% if paid in preferred stock, payable quarterly. Over time the PSPAs have been amended including a major change in 2012 – the Third Amendment to the PSPAs – requiring the companies to transfer 100% of all of their profits to Treasury without any credit for such amounts as pay-down of principal, and thereby preventing any possibility of the enterprises' eventual recapitalization and exit from conservatorship. This was "the profit sweep," leading shareholders in Fannie and Freddie to sue FHFA and Treasury for violating HERA.

The effect of this Third Amendment can be seen in Figure 1. Through 2012, Fannie and Freddie drew down on Treasury's financial support as they worked through their problems, and FHFA directed the GSEs to make cash dividend payments even though they were undercapitalized and had the option of making those payments in the form of stock. In 2013, the companies turned profitable, requiring no further draws on Treasury's financial support, and under the profit sweep they made enormous payments back to Treasury. As of the date of this paper, of the most recent fiscal quarter, Fannie Mae has paid $136.4 billion, after receiving $116.1 billion from Treasury. Freddie Mac has paid $91.8 billion, after receiving $71.3 billion from Treasury.

Figure 1 Treasury Draws and GSE Dividend Payments and Profits Over Time



Source: US Treasury and FHFA conservatorship data.

At the end of 2012, Treasury changed the PSPA to increase Treasury's dividend from 10% to 100% on a quarterly basis, effectively stripping the GSEs of their ability to ever rebuild capital again. This change coincided with a change in the financial fortunes of the enterprises. Beginning in 2012, both companies began turning a profit again as credit losses moderated in the years after the crisis. In the absence of any profit sweep, these profits could have gone directly to building capital that would be essential to maintaining the safety and solvency of the enterprises as required by FHFA under HERA. Conceptually, the change in the PSPAs in 2012 meant all profits made by the enterprises would be paid to Treasury going forward.

In 2008, in light of the fragility of the enterprises' capital and their systemic importance to the mortgage market and the financial system generally, establishing a backstop framework was essential to ensuring the stability and integrity of the mortgage secondary market, particularly in light of the evaporation of private-label securitization from the market. The government had every right to demand the terms it took in 2008. But whatever financial terms the executive branch of government took, it should have to live by those terms. It cannot change those financial terms in 2012. Having chosen conservatorship rather than receivership, FHFA has to follow its statutory mandate to "conserve and preserve assets" and "restore [then enterprises] to safe and solvent condition", it cannot wait for Congress to give it a legal mandate that it wants to follow more than the one that it has. If FHFA doesn't want to let Fannie and Freddie recapitalize, it has to make the requisite factual findings under the statute to send them into receivership.

The current Administration is following a course of action which has no clear resolution and has committed the U.S. housing market, homeowners, market participants, and taxpayers to perpetual conservatorships. The profit sweep was an unprecedented and unilateral change in the terms of the PSPAs that contradicted the clear intent of HERA to ensure FHFA would take actions to ensure the safety and soundness of the enterprises. By diverting all profits away from the GSEs, FHFA effectively precluded any ability of the companies to boost their capital levels and over time "earn" their way out of conservatorship. Moreover, the profit sweep contradicts FHFA's mandate to "preserve and protect" enterprise assets and property. Thus far, Treasury has made cumulative payments to the GSEs of $189.4

billion and received cumulative draws from the GSEs of $228.2 billion. Even giving pay-down credit to payments over the original 10% dividend level, the current value of the remaining preferred stock plus unexercised warrants, according to some experts, gives taxpayers $100 billion more. These numbers undermine FHFA and Treasury's claims that the sweep is needed to ensure that "the taxpayer gets paid back".

How the Net Worth Sweep Weakens Future Resolution Process

Importantly, the profit sweep from the GSEs has substantially weakened future resolution processes. During financial crises, the federal government time and time again relies on private capital to support resolutions of troubled financial institutions wherever possible, so that taxpayers do not have to step in unless there is truly no other option. Such public-private partnerships at times of crisis require consistency in the federal government's respect for, and protection of, private property rights. No private party will put capital at risk if they think the government can take it away from them in conservatorship or bankruptcy, however noble the underlying policy goals or inspiring the associated political rhetoric.

In the case of Fannie and Freddie, the government had the right to impose harsh terms on private sector investors when it intervened to save the GSEs from failure. It did that by taking 79.9% of the company from the private stockholders and taking a senior preferred stock with a 10% dividend. No problem so far. But for the government to come back four years later and unilaterally change the terms to a sweep of all profits is unconscionable and will cause significant problems in getting private sector investors to help out in future crises. There is a considerable body of insolvency case law that clearly describes how and in what priority creditors are paid out on the residual value of the firm. Contrary to these rules of the financial markets, the profit sweep had Treasury "jump the line" of legal priority ahead of Fannie and Freddie shareholders, in direct contravention of FHFA's legal obligation to respect those stakeholders. These actions establish a precedent now that is likely to have a chilling effect on future resolutions, as they undermine the integrity of the resolution process while introducing significant uncertainty into the process in terms of creditor administration.

Summary

The financial crisis precipitated an unprecedented policy response to the decline of Fannie and Freddie that led to their conservatorship. In taking this step, the U.S. Treasury, and Congress through its enactment of HERA, wanted to stabilize a housing market on the edge of collapse and reassure nervous global investors in mortgage securities, ensure liquidity and access to mortgage credit, and protect the US taxpayer.

But the conservatorships have left the enterprises in a state of suspended animation; neither private nor public entity and yet their business must continue. The government's decision to violate HERA in 2012 by invoking the so-called "profit sweep" has deprived the GSEs of their ability to rebuild capital and has put taxpayers at greater risk. It also undermines the government's role in times of future crisis. If private capital can't count on the rule of law, it won't participate in the future and taxpayers will have to pick up the pieces of what's left of the financial system.