The Trump Administration Plays Its Last Cards on Fannie Mae and Freddie Mac

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On Thursday evening, January 14, the US Treasury and the Federal Housing Finance Agency (FHFA) took the last steps on housing finance reform we will see from the Trump administration, an effort they committed to early[1] and mapped out in a 2019 white paper.[2] In this brief, I summarize how the administration modestly increases momentum for the eventual release from conservatorship of Fannie Mae and Freddie Mac (the government-sponsored enterprises, or GSEs) but largely leaves their fate to the incoming administration.

The Trump Administration's Final Push on Reform

Treasury and FHFA have changed the contracts by which Treasury supports Fannie Mae and Freddie Mac (the senior preferred stock purchase agreements, or PSPAs), in a manner designed to create momentum for the GSEs' eventual release from conservatorship and constrain their activities well after their release.[3]

Creating Momentum for the GSEs' Release

Treasury and FHFA have amended the PSPAs to allow the GSEs to build the level of capital required under FHFA's recently released capital requirements (see Parrott, Ryan, and Zandi 2020), or $283 billion. This is a *sixfold* increase in the current capital limits of $25 billion for Fannie Mae and $20 billion for Freddie Mac. The GSEs will still owe taxpayers a quarterly dividend on their senior preferred shares equal to the entirety of the GSEs' quarterly profits, as they have since 2013, but the GSEs will be able to pay that dividend through dollar-for-dollar increases in the taxpayers' senior preferred position rather than cash, allowing them to use their profits to build capital until they meet their required capital levels. Once they hit these capital levels, they will again pay their dividend in cash, but the dividend amount

owed will instead be the lesser of either their quarterly profits or 10 percent of the taxpayers' senior preferred position.

Unless the taxpayers' senior preferred position is written down significantly, the 10 percent option will never be the lesser of the two options. To reach the $283 billion capital requirement, the GSEs will need to build another $248 billion above what they have today and, in doing so, compensate taxpayers with a $248 billion increase in the taxpayers' senior preferred position. This will bring the taxpayers' total senior preferred position to an astounding $477 billion, putting a 10 percent dividend well beyond the GSEs' means. Once the GSEs reach their required capital levels and the cash dividend kicks back in, they will thus once again pay Treasury all their quarterly earnings.

Treasury and FHFA also agree that FHFA may release the GSEs from conservatorship once the litigation related to the conservatorship is resolved and the GSEs have built equity capital equal to 3 percent of the GSEs' total assets (see section 5.3(b) as amended).[4] This authority is limited indirectly by a separate provision prohibiting the GSEs from raising additional equity capital until the litigation is resolved and Treasury has exercised its warrants on 79.9 percent of the GSEs' common equity.

Constraining the GSEs' Activities after Conservatorship

In addition to putting the GSEs on a clearer path out of conservatorship, Treasury and FHFA are amending the PSPAs to constrain the GSEs' business practices upon their release from conservatorship.

The PSPAs now reduce the caps on the GSEs' investment portfolios from $250 billion to $225 billion, giving the GSEs enough room to manage nonperforming loans that need to be pulled from pools but not enough room to take the investment risk they did in the run-up to the crisis.

Treasury and FHFA also codify in the PSPAs the small lender protections that FHFA has put into place by directive during the conservatorship. The GSEs will be prohibited from offering volume-based pricing discounts or more favorable treatment for pools of loans than loans sold through the cash window, and they will also be required to limit the volume of loans that any one lender can sell through their cash window. These steps are intended to level the playing field in the GSE channel between the large and small lenders.

The final way that Treasury and FHFA amend the PSPAs to constrain the GSEs' practices is by imposing limits on the support the GSEs can provide for various products, limits intended to capture roughly the levels of support they are providing in these markets today. The PSPAs now limit support of multifamily lending to $80 billion a year, half of which must be mission-driven as defined by FHFA. They limit the GSEs' purchase of "high-risk" single-family loans to 6 percent of their purchase money mortgages and 3 percent of their refinancing mortgages. These are defined as loans with at least two of the following characteristics: the loan is more than 90 percent of the home's value, the borrower's debt is more than 45 percent of their income, or the borrower has a credit score below 680. They limit support of second homes and investor properties to 7 percent of their acquisitions. And they limit GSE acquisitions to loans deemed qualified mortgages under the ability to pay rule, with a few modest

exceptions.[5] The GSEs appear to be inside of these caps already, so while the new limits will impede an expansion of access to credit, they should not contract it.

A Quick Take on the Implications

While it will take time to digest the full import of these changes, there are a few implications worth noting. First, while it might *appear* that the agreement has put the GSEs' release from conservatorship out of the Treasury's control, it has not. Second, the modifications to the dividend will mean that in the end, taxpayers are likely to either go unpaid for a large share of its investment or in effect take over the GSEs. And third, the move to lock in the GSEs' current risk profile is likely more optics than substance.

Treasury Still Has Significant Control over Whether and How the GSEs Are Released

While the PSPAs now allow FHFA to release the GSEs once the litigation is resolved and they have hit 3 percent equity capital, Treasury still retains significant control over their fate for several reasons. As noted, under the agreements the GSEs cannot raise the equity capital it will need to exit conservatorship until and unless Treasury exercises its warrants on 79.9 percent of their common equity. Second, as a party to most of the litigation at issue, Treasury will have some control over when and how it is resolved. And third, Treasury's consent will be required to make the PSPA changes needed for the GSEs to meet the 3 percent threshold within a reasonable time frame.

The last of these sources of control is worth additional explanation. As of June 30, 2020, the GSEs had $6.6 trillion in combined adjusted total assets. To hold capital equal to 3 percent of those assets, they would need to build about $200 billion. They will likely want to maintain a buffer of at least 10 percent above that minimum, bringing the threshold up to $220 billion. Beginning from the $35 billion in combined capital they have today, they would thus need to build another $185 billion to get to the capital level needed for their release.

Their earnings over the past two quarters imply a combined annual return of about $22 billion. That number will decline given the new capital rule and other steps that the FHFA has taken to decrease the GSEs' risk, but even at that level, it would take the GSEs more than eight years to hit 3 percent using retained earnings alone. For the GSEs to meet that level in a more reasonable time frame by raising capital in the capital markets, Treasury and FHFA would have to amend the PSPAs again to restructure the government's overwhelming ownership interest. This ensures that Treasury will retain a critical role in when and how their path out of conservatorship would play out.

Taxpayers Are Likely to Either Get Stiffed or Walk Away Owning the GSEs

The PSPAs provide two forms of compensation to taxpayers, one backward-looking and one forward-looking. Taxpayers are supposed to receive a dividend for their investment to date and a commitment fee for the backstop they provide going forward. The latter has never been applied because the GSEs have never been able to afford it given their dividend obligations. Once they can afford both, however,

Treasury and FHFA are obligated to set the level of the commitment fee and begin charging the GSEs for the backstop.

The dividend was first set at 10 percent of the senior preferred position.[6] Once it became clear in 2012 that the GSEs could not afford it, it was converted to whatever they could pay, meaning their profits from one quarter to the next.[7] In 2017, Treasury and FHFA allowed the GSEs to begin using their quarterly profits to build up their capital levels to $3 billion each, paying the economic equivalent owed under the dividend through increases in the taxpayers' senior preferred position until they hit the new limits, after which the GSEs went back to paying their dividend in cash.[8] They repeated the move in 2019, allowing Fannie Mae to build up to $25 billion and Freddie Mac to build up to $20 billion.[9] This latest move pushes the level up once again, to the $283 billion they need to meet their requirements under the new capital rule, after which the dividend will shift to the lesser of their quarterly profits or 10 percent of the taxpayers' senior preferred position.

By increasing the capital levels again and allowing the GSEs to pay yet more of their dividend in senior preferred shares, the taxpayer appears to come out on the short end of the stick. FHFA and Treasury will have to write down the taxpayer position well below where it is today for the GSEs to attract new private capital. Thus, the additional dividend payments that taxpayers are to receive under the new terms are not going to be worth anything. And because taxpayers are not getting a commitment fee either, they are in effect no longer being paid for their support of two of the world's largest financial institutions. The profits that the GSEs are making today and in the days ahead will benefit whoever ultimately owns the institutions, not the taxpayers to whom they are actually owed, amounting to a remarkable transfer of wealth.

Unless, that is, all this winds up being a path to government ownership rather than private ownership. After all, at the end of this, taxpayers will wind up with an interest in the GSEs equal to close to half a trillion dollars and warrants on 79.9 percent of their common equity. That is a good deal closer to government ownership than private ownership, so the next administration could decide that it is easier, and better policy, to simply convert the well-capitalized GSEs into government-owned utilities. And this is indeed what several of us have proposed as the best course of policy (Parrott et al. 2016).

The Moves on Risk May Not Mean Much

Finally, the steps taken to lock in the GSEs' current risk profile will simply codify in contract risk measures that the current FHFA would have maintained anyway through rule and directive. And just as policies in place by rule or directive will be changed by a new FHFA director where they do not fit the new director's vision for what the GSEs should be doing, presumably a new director will also work with the new Treasury to change PSPA terms that do the same. So, it is unclear how the moves to embed these policies in the PSPAs will change the GSEs' behavior, either during the tenure of Director Calabria or after.

Conclusion

The steps that Treasury and FHFA have taken amount to a legacy statement on how they think Fannie Mae and Freddie Mac reform should proceed in the years to come. While they increase momentum down their preferred path, whether the GSEs continue down that path or change course entirely has been left largely to the incoming administration.

Notes

[1] Kathy Otron, "Fannie Mae, Freddie Mac Should Be Privatized, Treasury Secretary Nominee Says," *Washington Post*, November 30, 2016, https://www.washingtonpost.com/news/where-we-live/wp/2016/11/30/fannie-mae-freddie-mac-should-be-privatized-treasury-secretary-nominee-says/.

[2] US Treasury, "US Department of the Treasury Housing Reform Plan," press release, September 5, 2019, https://home.treasury.gov/news/press-releases/sm769. See also Goodman, Parrott, and Zandi (2019).

[3] US Treasury, "Treasury Department and FHFA Amend Terms of Preferred Stock Purchase Agreements for Fannie Mae and Freddie Mac," press release, January 14, 2021, https://home.treasury.gov/news/press-releases/sm1236.

[4] US Treasury, "Treasury Department and FHFA Amend Terms."

[5] "Ability to Repay and Qualified Mortgages (ATR/QM)," Consumer Financial Protection Bureau, accessed January 15, 2021, https://www.consumerfinance.gov/compliance/compliance-resources/mortgage-resources/ability-repay-qualified-mortgage-rule/.

[6] "Senior Preferred Stock Purchase Agreements," Federal Housing Finance Agency, last updated January 14, 2021, https://www.fhfa.gov/Conservatorship/Pages/Senior-Preferred-Stock-Purchase-Agreements.aspx.

[7] "Senior Preferred Stock Purchase Agreements," Federal Housing Finance Agency.

[8] Steven T. Mnuchin, letter to Melvin L. Watt, director of the Federal Housing Finance Agency, December 21, 2017, https://www.fhfa.gov/Media/PublicAffairs/Documents/GSEletteragreementfnm12-21-2017.pdf.

[9] US Treasury, "Treasury Department and FHFA Amend Terms."

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