INDUSTRY PERSPECTIVES

Treasury's GSE Reform Plan: My Top Ten Political Economy Insights

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JCHS
JOINT CENTER FOR HOUSING STUDIES
OF HARVARD UNIVERSITY

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The US Treasury released on September 5th its much-awaited plan for reform of the Government-Sponsored Enterprises (GSEs) of Freddie Mac and Fannie Mae.[1] As directed by the president, it addressed both reforms that could be done via legislation and also those that could be done solely by administrative means. The latter is generally considered by far the more relevant option, as the strong conventional wisdom in Washington is that Congress, with all its specific disagreements on what housing finance reform should look like against the backdrop of a highly partisan environment, is very unlikely to successfully do anything legislatively for some time to come.

There has and will continue to be much technical commentary on specific items in the fifty-page document. But the simple fact is that because the government backs over two-thirds of all mortgages, the American housing finance system is naturally highly politicized. So, I have developed a top ten list of key insights on the "political economy" behind the plan, which are necessary to really understand what is going on, why the recommendations are what they are, and what the path forward might look like.

The conclusion of this list – my tenth and final insight – is that the plan has a lot of specific and reasonable content and represents a substantive start to housing reform, but that it also has a lot of open issues, some based upon significant and politically-sensitive research that has not even started, with years likely required to fully work through it all. As a result, private capital sources are not going to be willing to invest in the needed amounts for some time as it is not yet clear exactly what they would be investing in. And then, on top of that, there is a fundamental contradiction in the Treasury's "Housing Reform Plan." Is the objective to have the two GSEs be normal competitive companies, largely left to running their own affairs like most private sector firms, even regulated ones; or is it to have them be more like government agencies, working under extremely tight regulatory and legal limitations and

[1] US Department of the Treasury, "Housing Reform Plan," September 2019, https://home.treasury.gov/system/files/136/Treasury-Housing-Finance-Reform-Plan.pdf.

generally micromanaged by the government? Until this contradiction is worked out, building capital on any kind of normal terms, except by retaining earnings, is going to have to wait.

Insight #1 – The plan confirms the political rehabilitation of the GSEs.

The official position of the Obama administration with respect to the two GSEs was that they should be "wound down" – that is, they should gradually run down to zero and cease operating.[2] This policy was developed in the immediate aftermath of the 2008 Financial Crisis, after the GSEs had lost market confidence and thus had to be rescued by the government in September of that year. Cumulatively, Treasury injected nearly $200 billion into the companies over the next three plus years to make up for their losses. As Democrats had generally been friendly to the GSEs and Republicans not, this rather extreme position by a Democratic president is indicative of just how politically toxic the companies were as the Financial Crisis unfolded. What was unclear, of course, is what would replace the GSEs at the heart of America's housing finance system if they were, indeed, to be wound down.

But the two companies became profitable again in 2012 and have remained strongly profitable ever since (including more than paying back the $200 billion in full). Also, the conservatorship of the GSEs has been a time of great reform of the companies: instead of focusing too much on hidden subsidies and lobbying, they actually turned towards running better as major financial institutions – managing risk better, offering better and more efficient operations for their customers, and so on.

The mortgage industry, on the front line of dealing with the GSEs, began to notice these improvements, and slowly but surely began to talk about accomplishing needed reforms by *building upon* the two companies, rather than by replacing them. The industry's stance also reflected the fact that all the proposed methods of replacing or modifying the GSEs, a topic much discussed from 2009 through 2016, had not done well in the policy and political process

[2] This policy was officially called for in the report "Reforming America's Housing Finance Market" (February 2011) issued by Treasury and the Department of Housing and Urban Development.

in Washington: these methods were judged unimplementable or highly disruptive in most cases, or just politically too difficult to get through Congress. By late 2016, when the Obama administration was getting ready to leave office, its policy was still nominally to "wind down" the GSEs, but that policy had clearly passed its sell-by date. By late 2018, in fact, the "build upon the two GSEs" view was held relatively broadly in the housing industry, as became apparent to the public when the National Association of Realtors, one of DC's most powerful industry associations, put out its "New Vision" for the two companies shortly after the end of the year,[3] calling for them to stay in place and be regulated as utilities.

Even the Republican senator who chairs the Senate Banking Committee, Michael Crapo of Idaho, confirmed this political rehabilitation of the two GSEs – and the dearth of workable ideas to replace them – when he announced his own "Housing Reform Outline" in February 2019. His plan looked for additional competitors to be added but for Freddie Mac and Fannie Mae to continue to exist (although forced to shrink their high market shares via some unspecified mechanism).

The Treasury plan completes this political rehabilitation. There is no talk of wind-down at all. There is not even talk of forced shrinkage in the GSEs' market shares. There are directions to modify rules so the GSEs are not unduly advantaged, that they are focused only on their specific legislated roles, and to allow others to enter the business, but that's about it – any reduction in their size and market presence will happen, if it happens at all, only as a result of these changes and competition, according to the Treasury plan.

And this is from an administration of Republicans, who long have been skeptical of the GSEs, as they represent a tradition of big, rather than limited, government.

[3] National Association of Realtor's Working Paper: A Vision for Enduring Housing Finance Reform, https://www.nar.realtor/fannie-mae-freddie-mac-gses/working-paper-nar-s-vision-for-housing-finance-reform

Insight #2 – It is not clear what the proposed administrative reform really is: so far, it's mostly a "plan for a plan" with no deadlines and few specifics.

In business, or government, when there is a very big project to be done, it is quite normal and reasonable to study it overall, and then break it up into pieces, assigning people with the right skills to do each, arranging it all to hopefully come together at the end for a successful completion. This initial step is sometimes referred to as developing a "plan for a plan."

That is, in essence, what the administrative reform proposal in the Treasury document mainly is: a plan for a plan. Many individual projects are listed: for example, (1) developing the specific fee to be paid by the GSEs instead of continuing the net worth sweep; (2) finalizing, after whatever revision is needed, the capital rule to apply to the GSEs post-conservatorship; (3) developing specific plans to raise the very large amount (i.e., over $100 billion) to exit conservatorship; and there are many more – the document lists 31 projects just for administrative reform.

So far, this is all reasonable for such a big undertaking. But the Treasury's document is subject to criticism for two reasons.

> *First*, time may be running out: the Trump administration ends in about one and one-third years, and that's likely not enough time to get all the work done to complete the many steps of administrative reform. (Of course, if President Trump is re-elected, then there is abundant time in his second term.)
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> *Second*, it exacerbates this timing problem that none of the projects and studies listed for the Federal House Finance Agency (FHFA, the regulator and conservator of the two GSEs) and Treasury has a firm deadline – not one. This is unusual. Even the limited, near-term project of developing the specifics needed to end the net worth sweep has no deadline, though it was expected in the industry to be the one task most concretely

specified by Treasury (with a year-end deadline being much talked about).[4] There may be confidential deadlines not known to the general public, but a public deadline would be more likely to be adhered to than a private one.

In sum, unless the FHFA and Treasury start coming out with results of all the required studies unusually quickly, their ability to fully implement the plan for administrative reform is in question unless President Trump is re-elected. And only upon the completion of those studies will the public find out exactly what the specifics of the administrative reform will be.

Insight #3 – It's a horse designed by a committee, trying to satisfy key administration interest groups by using unclear wording - and thereby creating policy confusion.

Any presidential administration encompasses a big tent to some degree. In the case of the Trump administration and GSE reform, there appear to be three key groups involved: (1) moderate conservatives with actual markets experience, centered in Treasury, who want incremental, non-disruptive and readily-implementable changes with the GSEs sticking to their core missions and having more competition; (2) ideological conservatives (e.g., Tea Party members) who ideally would like the GSEs to be fully wound down, centered around Budget Director Mulvaney; and, joining the debate most recently, (3) Trump-style populists (i.e., not traditional conservatives), centered in the White House, who do not want average working people, many of whom are core Trump voters, to have housing credit reduced or made more expensive, or indeed much of anything controversial to occur, prior to the 2020 presidential election.

The Treasury plan reflects the input of all three groups. You can see the populists at work in the plan's prioritization of avoiding disruption to housing finance under administrative reform, deferring many things to studies or reports for unspecified later dates. You can see

[4] In a hearing the following week in front of the Senate Banking Committee on September 10, 2019, Treasury Secretary Mnuchin indicated that negotiations with the FHFA to end the sweep were underway and would be completed soon. Since then, in follow-up interviews, Secretary Mnuchin and FHFA Director Calabria have made references to a target interpreted to be the end of September.

Treasury at work in trying to make changes practical and as grounded as possible in specific steps to make the system work with reduced reliance on the two GSEs, and also avoiding market disruption. You can see the ideological conservatives at work in many of the proposed studies to consider reduction of the GSEs' "footprint" and also in rule changes to hopefully unleash the private sector's ability to compete with them.

As a compromise between these three groups, the plan actually seems to do a reasonable job of handling many issues – but hardly all. In fact, the Treasury document makes the path forward with regard to several major issues very confusing. And that confusion, as will be discussed in a later section, will have implications when it comes to raising capital. Here are four such areas of confusion:

> *First, the role of Ginnie Mae*.[5] It has become an inside-the-beltway idea to have Ginnie Mae also handle the securitization of the GSEs' production, as part of the general anti-GSE policy of the ideological conservatives; as far as I could determine, this idea has nil support in the mortgage industry which, to put it politely, believes that Ginnie Mae's track record makes it clear that it does not have the managerial or technological capabilities to do anything of this magnitude. But it caught the eye of Senator Crapo and so is included in his reform "outline." Treasury's GSE Reform plan says that FHFA and Ginnie Mae should "identify and assess the operational and other issues" posed by undertaking this task. Without waiting for the results of this assessment and what those would imply for moving forward, the plan makes the assessment almost moot because it then says that Congress, as part of legislative reform, should "authorize" Ginnie Mae to do the securitization of the GSEs' loans (both single-family and multifamily). But note – it does not say that the securitization should actually be moved to Ginnie Mae. It just says it should be studied and that Congress should authorize it (i.e., make it a

[5] Also known as GNMA, the Government National Mortgage Association is a very small agency that provides the legal mechanism for a guarantee by the government of the timely payment of principal and interest on residential mortgage loans that are insured by the Federal Housing Administration, the Veterans Administration, and other parts of the federal government.

possibility). This looks like clever wording to make the ideological conservatives happy the idea is still alive, while Treasury knows it may be unimplementable or disruptive. The rest of us are thus left uncertain as to which way this significant issue can go.

Second, cash-out refinances and other loan categories. The ideological conservatives, always looking for a way to reduce the size and business impact (or "footprint") of the GSEs, have pointed out several types of mortgage loans that, in their view, the GSEs should perhaps not be allowed to buy for securitization. These include, most controversially, "cash-out refinances," where the homeowner refinances a loan for a lower rate, but also increases the amount of the loan above its then-current unpaid amount (the requested amount could still be equal to or less than the loan's original principal amount, of course). There does not seem to be any legal basis for excluding such loans in the actual legislation that applies to the GSEs. But the Treasury plan calls for the FHFA to assess, as part of its plan for administrative reform, whether these loans, along with a list of other types of loans and even a catch-all category of "other subsets of GSE-acquired loans," should continue to be offered. That leaves everyone uncertain: will there be, regardless of what happens to the Treasury reform plan, a major cutback on loan purchases by the GSEs during conservatorship, when the FHFA can order the GSEs to do pretty much whatever it wants? Or, will the Treasury plan just generate a recommendation for Congress to consider as part of legislative reform? Again, the plan's wording appears meant to make different groups happy at the cost of policy clarity. And this issue is not just an inside-the-beltway one: it will dramatically impact the revenues and business model of hundreds of small mortgage lenders, especially those not affiliated with banks.

Third, the role of the GSEs in affordable lending. The GSEs were created to make credit more reasonably priced and more readily available to the broad middle and working class – that is their core mission. But over the years, they were also tasked with doing more to improve access to credit for targeted groups: this aspect of their mission includes both formal “affordable lending goals” and a more recent obligation called “duty to serve” for certain markets (like manufactured housing). Additionally, the cultures of the two companies are generally supportive of trying to figure out how to make loans of acceptable credit quality to more challenging borrowers. This work all comes under the heading of “affordable lending,” among other names. Republicans are very suspicious of these programs, complaining with some justification about lack of transparency about where the money goes, how effective the spending is, and so on; Democrats seem to be highly supportive of these programs, and would like them, if anything, expanded. This fundamental disagreement seems to be the biggest stumbling block in ever getting congressional agreement on housing finance reform legislation.[6]

And where does the Treasury plan come down on this sensitive issue? It calls for the FHFA, prior to any legislation, to “consider more efficient mechanisms” for reaching the specific affordable lending goals – leaving it totally unclear whether mechanisms can be implemented by the FHFA without such legislation. It also calls for Congress to “replace” the current system with one that is “more efficient, transparent and accountable” and for some of it to be “potentially transferred to HUD.”

The simple fact is that this wording is more than enough to enrage (and this is not too strong a word) the various activist and community groups that support affordable lending (along with the Democratic elected officials who support them). It also leaves how to proceed up in the air, except to mention as an “alternative approach” to all the current affordable lending obligations the collection of a fee, a favorite recommendation of many conservative groups.[7]

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[6] As I acted in 2014 as a technical adviser at various points in the development of the Corker-Warner bill (later reconfigured and renamed Johnson-Crapo), I got to see this disagreement firsthand. I also participated on a panel where Gene Sperling, head of the National Economic Council when much of these events occurred, named this stumbling block as a political fact.

[7] Conservative and Republican groups have proposed ending all the goals and programs for affordable lending that apply to the GSEs and replacing them with a new fee to be paid to the government to fund an on-budget program to support housing finance. Senator Crapo’s Housing Reform Outline includes this idea. It should be noted that a small such fee already exists; the conservative/Republican proposal would expand it.

The political economy result of all this is that the Trump administration is making little effort to make its plan attractive to the Democrats with respect to affordable lending. While it does override the ideological conservatives to say good things about the core mission of the GSEs to support low- and middle-income borrowers (what I call the broad working and middle class), there is no hint of some compromise about the existing activities and programs that go beyond this core – and so the prospect of a legislative solution is in this sense no closer now than prior to the Treasury's announcing its plan.

And fourth, the need for government support. Perhaps the most bizarre statement in the entire Treasury plan – clearly revealing the various interest groups trying to advance their agendas – is that Treasury "does not believe a Government guarantee is required" by the GSEs.[8] Though the statement is a little vague, as it does not specify exactly what the guarantee is required *for*, it is clearly a sop to the ideological conservatives, for in my seven years at the heart of housing finance as CEO of Freddie Mac, I never heard anyone support this view except those ideological conservatives. MBS investors, in particular, are vehement and vocal that such government support is needed, and their industry association recently released a requirement that any GSE reform by legislative means include a full-faith-and-credit guarantee.[9] And so Treasury knows government support is actually needed in some fashion, which is why it then goes on to say it is going to ignore its statement: it will keep the Preferred Stock Purchase Agreement (PSPA, by which Treasury supports the GSEs so they have near-Treasury-quality access to debt markets) in place during administrative reform, and it is supportive of a full-faith-and-credit guarantee in legislative reform.

[8] On page 2 of the report.

[9] SIFMA (the Securities Industry and Financial Markets Association, the industry association of the MBS investors) issued a press released on September 5, 2019 concerning the just-announced housing reform plan. It states, in its second sentence, that "we believe an explicit government guarantee is necessary," and goes on to list several things for which it is necessary. See https://www.sifma.org/resources/news/sifma-statement-on-housing-reform-plan/.

But Treasury does say the guarantee should only go to the MBS issued and not to the GSEs' other debt obligations, a common proposal heard around DC in the last few years. This proposal could hinder the ability of the GSEs (or new guarantors) to actually continue operating their guarantee businesses as the market has come to expect, but such difficulties are just glossed over.[10] It is unclear if Treasury understands these problems but had to compromise on the wording, or if it simply does not understand them.

Insight #4 – Surprise: Treasury gave the "investors" no new news related to their investments. In a major reform effort aimed at something as large as housing finance – with its $5 trillion of GSE-backed mortgages alone – there will be many interest groups to consider in constructing a plan. If too many oppose it, the practical political realities are that it is not likely to survive; at least several key constituencies must be supportive.

One key interest group for GSE reform is the "investors" – those who own the existing common and the public preferred stock. While many individuals and small banks have historically been investors, this interest group has become dominated by large specialty institutional investors – mainly private equity and hedge funds – that have organized to do lobbying and opinion-influencing, and spend big dollars to do so. The value of the common and public preferred stock took a big nosedive when the GSEs entered conservatorship in 2008; they took a further hit when the PSPA was amended in 2012 to sweep almost all profits to Treasury in exchange for its support. A subset of these institutional investors organized major and long-running lawsuits against the government trying to reverse that "net worth sweep"; if they win, it will lead to a big increase in the value of their investment, which was bought at depressed prices in 2012 and after.

[10] Various proposals for legislative reform, including one from the FHFA, included a limited amount of assets that could be funded with unsecured debt carrying the government support, since those assets were needed to carry on the core business of the GSEs.

Those institutional investors were publicly predicting that the announced plan would be favorable to them in some fashion – that it would include indications that the common and public preferred stock would not end up worthless. Such indications could take many forms (e.g., saying that receivership, which could totally wipe out the value of the investments, is no longer under consideration); investors however made no prediction as to exactly which of the specific options Treasury would adopt.

But no – the investors got *nothing* from the Treasury's GSE reform plan, no news at all. The document listed several possible approaches, all of which have been common knowledge for some time, that ranged from being very favorable to the investors ("negotiating exchange offers") to very unfavorable (the already-mentioned receivership). Treasury did not tip its hand in any way; no one learned anything new from the plan.[11]

As a result, the price of the stock of the two GSEs – which trade in conservatorship not on the fundamentals of the two companies but on the potential of government actions or lawsuit results – took an immediate one-day tumble (of over 8 percent).

So, when it comes to the Trump administration building support for its proposals, you cannot yet count on those institutional investors, who so far have been left financially twisting in the wind.

Insight #5 – By contrast, Treasury is very much trying to gain the support of the mortgage lending industry, especially small lenders.

Treasury is clearly trying hard to get the support of the mortgage lending industry, by contrast. The very largest lenders (e.g., Wells Fargo) are conflicted – they benefit from the GSEs' existing as they do today, but they can also conceive of having their own expansion opportunities if the

[11] While the institutional investors were classically counting their chickens before they hatched, there was in fact well-known political pressure for the administration to say nothing favorable to those investors. That's because, if the plan could be characterized as being a "gift to [Secretary] Mnuchin's hedge fund friends" or a "bailout of Wall Street," then all the Democrats in Congress, and probably a lot of Republicans, would be instantly dead set against it.

GSEs are dramatically reduced in size. Small lenders – and in this context that means all but the biggest – have no such conflict: they want vibrant GSEs operating much as they do now, and if there are to be more guarantors added, small lenders want them to be as pro-small lender as the current two. And small lenders, as there are over 1000 of them that deal with the two GSEs spread through every single state and congressional district, are influential and well-liked in Washington by both Republicans and Democrats.[12] They are also well-organized into several industry associations.

These small lenders have made clear what they want in a housing reform plan. And Treasury has delivered several of their most strategic priorities, dubbed in the plan "equitable access to the secondary market." Three specific policy recommendations fall under this heading:

> *Level G-fees.* The retention of the "level G-fee policy" – the policy, implemented during conservatorship, that G-fees are not higher or lower by size of lender – has been a key objective of smaller lenders. They feel extremely strongly that the pre-conservatorship policy, under which the GSEs gave volume discounts to larger lenders, was unethical and objectionable. Treasury therefore calls for a policy of level G-fees to be continued in both administrative and legislative reform.
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> *Cash window.* There are two paths by which lenders sell loans to the GSEs for securitization. Smaller lenders sell individual loans to the GSEs through an operational mechanism called the "cash window,"[13] with the GSE later pooling them as it judges best into a series of MBS issuances. Larger lenders have a sizeable enough flow of new mortgages that they can, and do, pool their loans into MBS issues themselves, arranging the specifics and timing on their own (subject to GSE rules, of course). The Treasury plan

[12] A senator once told me, back in 2014, that "the R's and D's both love small lenders."

[13] While this phrase harkens back to earlier days of banking when there would be a teller behind a "window," in fact there is no physical location with such a GSE "window." It's just an operational mechanism, with communications via telephone and computer making it all work.

calls for each guarantor – both existing and new – to be required to operate a cash window for small lenders; it's another requirement by small lender organizations for their political support.

Nationwide presence. This is a requirement that all guarantors, both existing and new, must operate nationwide (including their cash windows), not cherry-picking certain geographies from which to buy loans. This requirement is especially important to small lenders from rural areas, who otherwise fear having second-class access to the secondary mortgage market.

Given that these three "equitable access" requirements are firmly part of the plan, there is every reason to believe that the broad mass of the influential mortgage lending industry will support the plan. (There is one potential roadblock: see below about separation of the primary and secondary mortgage markets.) At the tactical level, some lenders might not like certain things, but at the strategic level, they should be quite supportive. And that will be a big help to the plan's eventually succeeding in both its administrative and legislative forms.

Insight #6 – The plan is based upon a concept of competition that is just not realistic.

The Treasury's Housing Reform Plan has at its core the intertwined concepts of competition and a level playing field. It mentions them over and over. Does this core make sense? Is it realistic? The answer is somewhat yes and somewhat no.

First, before getting to the usual focus on adding more guarantors, Treasury lists a whole host of topics where change is needed outside of the FHFA and GSEs to eliminate barriers or frictions so non-guarantor sources of mortgage finance can be more efficient. This list ranges from the Consumer Financial Protection Bureau (CFPB) redoing the qualified mortgage (QM) rule, to bank regulators revising capital requirements and risk retention rules to not penalize the ownership of non-GSE-issued mortgage securities (known as Private Label Securitizations, PLS) to the Securities and Exchange Commission revising its rules on reporting requirements related to PLS. It also calls for capital requirements on mortgage credit risk to be harmonized between whatever would apply to the GSEs and the banking system.

On a policy basis, this is all unobjectionable. The simple fact is that the non-FHFA regulators, in the aftermath of the Financial Crisis, didn't get everything perfectly right or consistent, and some thoughtful revision is perfectly fine.

But it is unclear how much impact these reforms will have. Putting aside the CFPB/QM issue (which has a deadline and could be impactful if not handled properly), these other agencies actually would have to do the revisions specified, which is not a sure thing as they are independent and do not answer to the administration or Treasury. Even if they did such revisions, would the impact on the GSEs be material or not? Most of these suggestions come across as pretty small-bore items, even just a matter of paperwork requirements (which is hardly going to change market shares); my best estimate is that in total they are at most only modestly impactful.

Second, when it comes to looking for more competition by adding new guarantors, as I have written about elsewhere, the barriers to being a successful competitor are probably insurmountable. And Treasury seems to understand this, at least partially, which is why it lists some possible forms of help new entrants could get from the government on a temporary basis. Putting aside the sad history of temporary government help to companies and industries somehow becoming permanent, the types of help specified do not get at the core problem of the barriers to entry. (So, I remain highly skeptical that new competition will emerge quickly, if ever, and thus still believe the regulated utility model is a more real-world way to move forward.)

But, third, the biggest conceptual problem is the inherent contradiction when the Treasury plan talks about a level playing field, with the apparent objective of having totally open, on-an-equals-basis competition between the GSEs and others. This makes no sense. The

GSEs were explicitly created to make it easier for the broad middle and working class to get mortgages – and they were given advantages to do just that. So, they are – even if indirectly – subsidized. And if they are subsidized, how can competition with unsubsidized competitors be on a level playing field?

Treasury should therefore get away from the doctrinaire focus on a level playing field and back to reality: *the playing field should be un-level only where Congress and the government created a specific advantage for the GSEs*; it should be level otherwise, and the GSEs should absolutely not benefit from unintended or hidden subsidies. So, the investment portfolio limitation makes sense, as it was a source of unintended and hidden subsidy; getting rid of the historic unduly low capital requirement pre-conservatorship and replacing it with one that is "full" according to current thinking makes sense also to get rid of another hidden subsidy. But access to the government support to enable the GSEs to provide the 30-year fixed rate mortgage at attractive rates is not a fluke – it is the intended advantage the GSEs have been given by the government to help the broad middle and working class.[14]

The lack of policy clarity, especially about the crucial difference between the GSEs' intended and unintended advantages, creates a political economy problem: the legislative reform being proposed simply cannot deliver the full level playing field seemingly being promised. Treasury seems to be just trying to play a weak hand as best it can. But this push for competition, note, is almost all about legislative reform, leaving the more-likely-to-be-implemented administrative reform to be undertaken without this contradiction bedeviling it because without any change in legislation there are just two competitors – Freddie Mac and Fannie Mae.

[14] So that this benefit does not go to wealthy individuals buying expensive homes, there is a limit on the size of the mortgage that can be bought by a GSE. The GSEs also are advantaged in not paying state and local income tax. In fact, the Freddie Mac multifamily business, which has been extremely successful, demonstrates how impactful the specific benefit of access to the government support can be; I will write about this matter in a subsequent article.

Insight #7 – The FHFA may be overwhelmed by all the required studies called for by the plan, putting at risk its timely execution.

The FHFA is a very young agency as a financial regulator, dating back only eleven years to 2008. By comparison, other financial regulators are much more established: the Federal Reserve goes back over 100 years, the Office of the Comptroller of the Currency (which regulates national banks) goes back to the Civil War, and even the Securities and Exchange Commission goes back to the early New Deal era of about eighty-five years ago.

Furthermore, the FHFA has been not just the regulator of the GSEs (and the Federal Home Loan Banks), but also the conservator of the GSEs for over a decade now. This conservatorship is unprecedented in scale and scope and has put a major workload on the agency beyond the scope of normal regulation: as conservator, the agency must approve many routine business decisions that would normally fall well outside the direct scrutiny of a regulator.

And then the Treasury's GSE reform plan has added a long list of projects to be studied and decisions to be made, with the FHFA taking the major brunt of the workload. Of the forty-nine specific projects and actions included in the plan, the FHFA is solely or partially involved in a staggering twenty-nine of them (with some overlaps, to be sure). And most of these issues are in fact "meaty" – requiring homework, analysis, possibly consultation with other regulators, vetting with the industry, and coordination with Treasury and sometimes other parts of the government (potentially including congressional committees). And some are quite politically sensitive, so speed may very well be secondary as an objective.

I just put it out there that this is going to be daunting to the FHFA. The project list is interesting, it is potentially quite impactful, but it does threaten to overwhelm the agency's resources – in terms of not just the number of people involved but also its range of expertise.

After all, as a new agency, it does not have the deep bench found in its much older sibling financial regulators.[15]

The plan's potential to overwhelm the FHFA is in very strong tension with the speed that would be required to implement it by the end of the current Trump administration, in just one and one-third years. To meet that goal, the FHFA would be required to do an unprecedented amount of work at a very fast pace.

Some of the projects assigned to the FHFA could have been retained by Treasury to do itself. But it is clear that Treasury wants to be the reviewer/approver rather than the underlying "doer" on the long list of projects. The FHFA, under its new director, Mark Calabria, is clearly biting off a lot, which will maximize its influence – but we shall see how well it chews it all. It will require significant management and leadership at the agency to increase and organize its resources to do everything it is being assigned to do on an expedited basis.

Insight #8 – The plan conspicuously ignores or punts on several crucial issues.

The Treasury's "Housing Reform Plan" is a forty-five-page document, which has a lot of substance to it. But amidst all the specifics and generalities about the very complex field of housing finance, industry experts will notice some issues are conspicuous by their absence. The Trump administration has punted on these issues, perhaps hoping not too many less-expert people notice.

Here are three such issues that have been avoided, presumably because of the politics of the situation:

First, budget impact. The turnaround of the profitability of the two GSEs, combined with the net worth sweep instituted late in 2012, means that the federal budget has

[15] The "deep bench" for prior such projects by the FHFA was located in all practical terms at the two GSEs which, in conservatorship, are at its disposal. The reality is thus that the FHFA has often used the two GSEs for data and analysis, almost outsourcing this kind of non-decision-making data and analytical work to them. The two GSEs between them have over 15,000 employees; the FHFA has ballpark 600 to 700.

benefitted from their large dividend payments to Treasury. Cumulatively, Treasury has received about $100 billion more than it put out to support the companies. The amount per year, in recent years, has been ballpark between $15 billion and $20 billion.

Given the amounts, there was talk starting several years ago that the government was getting “addicted” to the revenue, and would have a hard time giving it up as its loss would have a material impact on the overall federal budget, creating yet one more impediment to the GSEs exiting conservatorship.

In fact, federal budgeting is done in ten-year horizons, and the GSE dividend payments are considered by Treasury to be worth about $160 billion during the next ten years (and this is indeed a reasonable estimate). The budget impact, therefore, of ending the net worth sweep is to open up a “hole” in the budget – already much in deficit – of that $160 billion, minus the unknown (i.e., not yet decided) amount of fee that the two GSEs would pay for government support instead.

It is not an inconsequential amount – it amounts to, I would estimate, very roughly $1,000 per US household in the ten-year budget – and Treasury says *nothing* about it. It is definitely conspicuous by its absence.

Second, FHFA structure. The FHFA is run by an individual with the title “director.” That sounds conventional but is in fact controversial. The FHFA is an independent agency, and its director has a fixed five-year term and can be fired by the president only for “cause” (that restriction is the working source of the independence desired). This means he has almost unaccountable power, which is inconsistent with the Constitution – because the agency does not cleanly fall into one of the three branches of government (executive, legislative and judicial).
This esoteric question became a front-burner issue when a lawsuit against the Consumer Financial Protection Bureau (CFPB), which similarly has a single director in

charge, led to a court decision (now under appeal) declaring that structure unacceptable. Note that almost all other financial regulators have commissions or boards (e.g., the Securities and Exchange Commission, the Federal Reserve Board) – a structure that has been ruled by courts to be constitutionally acceptable because it does not have an unaccountable single individual. In a just-announced appeals court decision, the FHFA's directorship has similarly been ruled unconstitutional, in line with the prior CFPB decision; the remedy is that the director now serves at the pleasure of the president (i.e., no "cause" need be cited for terminating him).

After the CFPB ruling, the Republicans began agitating to have the FHFA restructured[16] to be run by the typical five-person bipartisan[17] commission, with one commissioner being a chair. At that time, of course, the agency director was a Democrat appointed by President Obama, still working through his fixed five-year term.

But lo and behold, the Treasury reform plan mentions this issue not once. It's conspicuous by its absence. And it is reasonable to conclude that this is likely because, now, the administration has "its person" in place running the FHFA.

Third, mixing primary and secondary mortgage market operations. In the years since the Financial Crisis, as many people proposed replacing the GSEs with a "new system of housing finance," one issue came to the fore about which there was very strong industry feeling and seeming consensus: keeping the primary and secondary markets separate. Translated into English, this means that the GSEs or additional guarantors or replacement guarantors could not be owned or controlled by the same companies that

[16] Senator Crapo's recent "Housing Reform Outline" clearly calls for this change.
[17] Note that "bipartisan" does not mean "nonpartisan." In fact, all the bipartisan commissions are extremely partisan, as each commissioner officially represents either the Democrats or the Republicans. (The party of the president gets three seats, the other party two.) This partisanship heavily impacts who is nominated for the positions (often congressional staff members from one party or the other) and what policies they support. Ideally, the commissions should be nonpartisan, but Congress unsurprisingly likes the bipartisan structure better. The Federal Reserve Board is an exception: it is nonpartisan.

also deal directly with the public to originate mortgages. (The latter are called primary lenders, and the GSEs are secondary market lenders, as they only buy mortgages from primary lenders and never, ever deal directly with the underlying homeowner in the origination process.)

This separation was held almost sacred by the mortgage industry, and it was listed as a feature of just about every reform plan proposed during the post-Crisis years.

But it may be back in question. Senator Crapo's recent "Housing Reform Outline" prohibits an insured depository (i.e., a bank or S&L) from also being a secondary guarantor, but it makes no such prohibition for affiliates of insured depositories (i.e., other subsidiaries of the bank's parent holding company) – a loophole that makes the prohibition almost meaningless. And there are no such clauses or requirements in the Treasury plan – the topic of separating primary and secondary mortgage markets is not even mentioned. In the absence of prohibitions, Wells Fargo or another bank-based mortgage originator could start up its own guarantor, organized as a non-bank subsidiary of its parent holding company, to compete with Freddie Mac and Fannie Mae. A non-bank mortgage originator, like Quicken, could have its own guarantor as well.

This threat to the separation of markets is anathema to the smaller lenders, who strongly fear that it will again tilt the playing field against them; I expect them to make clear to Treasury that this cannot stand, that the primary and secondary markets must be kept separate. Their support for the plan, despite the equitable access features, could as a result very much be in jeopardy.

Insight #9 – The plan calls for the FHFA to be granted extreme regulatory powers.

The FHFA is today both the regulator and the conservator for the two GSEs. Being "conservator" means that, legally, the agency is fully in charge of the companies and thus can micromanage them as much as it wishes, and it has been creeping steadily into doing so as the years have passed. But if the Treasury's plan were to achieve its goal of ending the conservatorships, the FHFA would go back to being "just" a regulator.

But this is problematic to many policymakers. They really want Freddie Mac and Fannie Mae to be strongly under the thumb of the government – as they remember pre-conservatorship times when the two companies were free-wheeling and among the very biggest lobbyists in Washington.

So, Treasury has a very expansive view of what the FHFA would be able to do as regulator post-conservatorship, which as best as I can tell from the document's wording includes: set credit underwriting standards in detail that the GSEs must adhere to; set not just investment portfolio limits but also limits to what can be invested in; approve all new activities or products so that they are, in its judgment, "permissible"; and restrict the type of mortgage loans to be purchased to fit its view of what is consistent with the GSEs' statutory mission.[18] No court would seemingly be involved in adjudicating what Congress meant in laws about housing finance – instead, the FHFA would apparently have the authority to be judge and jury instead.

These powers go well beyond what a typical financial regulator does.

In other words, Treasury's idea is that the FHFA would be a super-regulator, with many conservatorship powers retained even after conservatorship is over. While Freddie Mac and Fannie Mae would be privately owned companies, in practical terms they would be thoroughly under the thumb of the FHFA, on a permanent basis. And the FHFA would be, arguably, unconstrained in its role – because nowhere in the Treasury plan is there a mention that the FHFA would have an obligation to allow the two companies to earn a "fair return" on their capital, which is the standard and core requirement of utilities and utility regulation at the state

[18] In the September 10, 2019 Senate Banking Committee hearings, Director Calabria reaffirmed he would like the power as regulator to control even guarantee fee pricing.

level. So, it's all very one-way: the FHFA is granted extraordinary powers as a regulator, but has no obligations to the shareholders of the two companies.

This model has never been seen before, and it is reasonable to question how it would work or even if it can actually work at all.

Insight #10 – The plan's many and strong uncertainties will scare off potential new investors in the GSEs, which then become almost solely dependent upon retained earnings for recapitalization for years to come.

The ultimate test of the Treasury's plan, considering all its positives and negatives, is whether the current GSEs can attract capital from new private sector investors in a sufficient amount,[19] and on reasonable enough terms,[20] so they can exit conservatorship – which is a necessary condition for administrative reform. A further question is whether new guarantors, which will require many billions of dollars each of additional equity investment, will be able to come into being – which is an additional core component of the recommended legislative reform.

Right now, the answer to both these questions is a firm "no."

Consider what possible new investors, from their vantage point, are looking at in administrative reform:

- Needing to wait years for studies to be finished and new policies implemented to know what revenue streams and expenses are going to be. Matters affected include not just the size of the investment portfolio but also the range of the fundamental product line of mortgages which the GSEs can purchase.

[19] The amount to be raised – at least $100B – is immense. The largest IPO of an American company, ever, was $20B for General Motors to emerge from bankruptcy in 2010.

[20] The current level of G-fees, where the cost of capital accounts for about two-thirds to three-fourths of the total cost, is based upon a cost of capital associated with a large, publicly traded company, which probably has the lowest cost of all capital sources. Private equity capital, by contrast, is higher-cost, so raising capital from private sources would inevitably lead to an increase in G-fees.

- Not knowing what capital requirements will be, and thus not being able to forecast return on equity, a key measure of attractiveness for an investment.
- A super-empowered FHFA which can make material changes at any time in what the GSEs do and how they do it, all decided by a single director who is politically appointed and generally unaccountable.
- Needing a few years to see if the reforms suggested by Treasury can make the PLS market or banks more effective at competing with the GSEs, and thus take market share away from them.
- The FHFA having no obligation to have the two companies earn, as utilities normally are promised, a "fair return."

So, there is no way to even construct a proper offering memorandum for equity investors (e.g., no financial forecasts that can be constructed) without at least several years going by; during that time, hopefully, a track record can be developed of the GSEs' operating under new rules, and some restraints can be put on the FHFA in terms of its ability to micromanage the GSEs in ways not traditional for a regulator. Otherwise, it will be a giant pig in a poke to investors.[21]

There is also the overhang of legislative reform – that is, an investor putting equity into the GSEs during an administrative reform period will be betting it all that Congress does not make material unwanted changes as part of legislative reform. Legislative reform could change everything about an investment's attractiveness by impacting major components of the GSE business model and how revenues and expenses are generated – effectively possibly "stealing" much or all of the investors' money in the process. That risk is not acceptable to an investor.

In the background of these uncertainties facing investors is the long-standing pattern of contradiction inherent in the Treasury plan and many other housing finance reform proposals.

[21] This issue can be confused when policy people ask some Wall Street firm or institutional investor if they might be interested in investing. Every one of those people knows what a free option is – so, when asked, there is no cost to them for saying "sure." And they do. But it signifies little until there is a real transaction with real terms and real skin in the game to get away from the "free option answer."

The push is to have the GSEs be, as much as possible, normal competitive companies. But this flies right in the face of the history that Congress and all the interest groups in DC, since conservatorship started, have treated them as objects for everyone's desire to engage in policy engineering at a micro level. While Treasury wants its plan to take away virtually all the GSEs' historic advantages (some justified, I might add) versus others, it then lists all sorts of specific and tight limitations to hem them in, including that the FHFA will be empowered to micromanage virtually all aspects of the business. So, which is it: are the GSEs to be competitive companies able to largely run their businesses as they see fit, or quasi-government agencies working under tight rules about what is allowed? The Treasury plan, at its core, is trying to have it both ways, as best as I can tell. And that is not going to fly with investors.

These fundamental contradictions must be worked through, and retaining earnings can bridge several years while that process is underway. But eventually equity investors are going to render a judgment. So long as the present uncertainties remain, I predict that judgment will be a "no."

That leaves the recapitalization plan to get the GSEs out of conservatorship and to be able to stand on their own feet almost wholly dependent upon retained earnings for the foreseeable future. The math is clear: with just retained earnings, it will take a very long time to do – probably in the range of a decade.

And that's a long time to wait.

So, sooner rather than later, the administration should make its plan much more concrete and more rational to attract new investors. Otherwise we will indeed be looking at a very long wait.