INDUSTRY PERSPECTIVES

The FHFA's Proposed GSE "Living Will" Rule

Fatally Flawed and Unusually Vague

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More a Policy Implementation Document Than a Technical Rule

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Introduction

The Federal Housing Finance Agency (FHFA) recently announced and is seeking public comment on a proposed "living will" rule to apply to the two government-sponsored enterprises (GSEs) Freddie Mac and Fannie Mae, which it regulates.[1] The two companies together provide the financing on almost one-half of the $11 trillion of single-family mortgages in America.

Such a living will, more officially known as a "resolution plan," is defined by the Federal Reserve to be a "strategy for rapid and orderly resolution in the event of material financial distress or failure," where "resolution" means the partial or full wind-down of a bank or other financial institution until the impacts of the financial distress or failure are eliminated.[2] In a typical resolution plan, some pieces of a company are sold off as operating businesses and other parts are just put into "run-off" (i.e., assets allowed to mature or to be sold to generate the cash needed to pay off maturing liabilities) in as orderly a manner as possible. Colloquially, such a plan is sometimes compared to a "prepackaged bankruptcy," meaning a contingency plan for how a financial institution "will sell off assets or be liquidated in a manner that does not generate chaotic aftershocks elsewhere in the financial system."[3]

Only the largest banks, those designated as "systemically important," are subject to the requirement for a living will. The requirement is both important and very complex, for banks of this size will have potentially hundreds of operating subsidiaries, including in foreign countries under different legal regimes and in different currencies. For these banks, having liquidity and capital pre-positioned in the right operating subsidiaries and the right currency can make all the difference between a relatively orderly resolution and one that spreads financial distress. By their nature, then, living wills are mostly highly technical documents – they are about details and specifics rather than some financial vision or policy.

For the GSEs, though, a living will has relatively little value versus what it does for systemically important banks. There are three key reasons for this difference: (1) the structure of a GSE is, compared to that of a large bank, ultra-simple: a GSE operates almost totally via one legal entity, in one country and in one currency only, so the need for a detailed living will is substantially less; (2) because about 90

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[1] FHFA, "Resolution Planning Proposed Rule," 86 FR 1326, January 8, 2021, https://www.fhfa.gov/SupervisionRegulation/Rules/RuleDocuments/Resolution%20Planning%20NPR%20TO%20FR_for%20website.pdf. Hereafter, the rule's proposal document will be cited internally by page number.
[2] Board of Governors of the Federal Reserve System, "Living Wills (or Resolution Plans)," https://www.federalreserve.gov/supervisionreg/resolution-plans.htm.
[3] Jon Marino, "CNBC Explains: Bank Living Wills," April 14, 2016, https://www.cnbc.com/2016/04/14/cnbc-explains-bank-living-wills.html.

percent of GSE assets are financed by pass-through mortgage-backed securities (MBS), a GSE in a living will situation faces liquidity risks that are dramatically reduced compared to those faced by a bank; and (3) in some future GSE distress situation, when policymakers consider the health of the economy and homeownership, receivership will probably prove to be a very unattractive policy alternative compared to others that the government could deploy, so its likelihood of occurring is in practice quite minimal. (These three issues are discussed more below.)

Nevertheless, the proposed rule has been issued by the FHFA, and it indicates the effort for the GSEs to produce such a document will be quite a major undertaking: it will take years to do and I estimate will probably require thousands of pages of submissions. Trying to understand why the GSEs were being required to make such a major effort even though a living will has relatively little value for them, I reviewed the FHFA's proposal in depth, and quickly found that *the FHFA's living will rule proposal is fatally flawed.* At its heart are at least two key structural design features that are provably wrong: (1) the denial that the government support agreement for the GSEs exists and can be relied upon, and (2) the requirement that the GSEs plan to continue operations in receivership without that support, despite its being necessary and integral to their business model. These errors vitiate the entire rule: they are truly fatal flaws, and thus the proposed rule needs a complete revision.

In addition, I found several other key design features that are, despite sometimes pages of description, unusually vague as currently written, fundamentally calling for future judgments to be made by the FHFA without any substantial constraint on its views – an unusual blank check for a prudential regulator to do whatever it wishes with almost no current understanding by the public of what is really intended… which the public will find out only months or years after the rule is approved.

Furthermore, much of the usual content of a living will is conspicuously absent from the FHFA's proposal, which says little about the specifics of how the GSEs "will sell off assets or be liquidated." The absence of such details is indicative how much the proposed living will rule is different from a conventional large-bank one.

Given the two fatal flaws, the unacceptable regulatory vagueness, and in general the inconsistency of a big push for a living will regulatory requirement despite its relatively low value, it is hard to understand the FHFA's specific wind-down or liquidation objectives. In fact, the rule seems to be more a policy document than a technical one, reflecting FHFA Director Mark Calabria's well-known policy objective of shrinking the GSEs' footprint (i.e., their range and volume of activities). It also seems to reflect his view that the GSEs should transform from being two giant companies with special government support that are incredibly central to American housing finance into being just two of a

larger number of GSE-type companies, each much smaller than today's GSEs, that receive less, if any, of that special government support.[4] Thus the proposed living will rule, I found, can be regarded as a vehicle to implement this policy view.[5]

In addition, some of what the rule calls for as currently written seems to run directly counter to congressional intent, as expressed in the legislation establishing the two GSEs.[6] This clearly problematic clash between the rule proposal and the GSEs' charters is discussed further below.

So, in my opinion, the living will rule should undergo a major revamping through the current comment-and-revision process. This process should eliminate the fatal flaws at the rule's heart, more clearly communicating what will happen under it and clearing up the vagueness that currently allows too much discretion to the FHFA to do whatever it wants after approval; furthermore, the whole rule should be scaled back so the effort required to construct such a resolution plan matches the low regulatory value it has. This revamping should make the living will rule into the technical document that it normally would be, rather than the vehicle for policy implementation that it is in its current form.

If that major revamping does not happen, given the rule's deep shortcomings, it is very likely to be quickly replaced wholesale to make it more akin to mainstream regulation and consistent with congressional intent.[7] Such a change could take place upon the appearance of a President Biden-appointed FHFA director, who might well show up in 2021. The rule's potential for quick revision by a new FHFA director makes it, of course, very reminiscent of the recently approved and much criticized capital rule, which I have also predicted will be quickly revised when a Biden-appointed director arrives.

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[4] This vision is reflected in part by Director Calabria asking Congress, several times, to authorize the FHFA to charter additional GSEs. Congress, to my knowledge, has not seriously considered this request.

[5] Director Calabria is using other vehicles for the same purpose, i.e. the shrinkage, or at least the limitation, of the GSE footprint. For example, see my article on the topic of the just-announced changes to the PSPA agreement: "Revisions to the GSE Treasury Support Agreement: Some Substance, Some Political Optics, and Treasury Gains Power," https://www.jchs.harvard.edu/blog/revisions-gse-treasury-support-agreement-some-substance-some-political-optics-and-treasury.

[6] The quasi-governmental role of the GSEs – in effect, they are a hybrid of a government agency and a shareholder-owned company – comes directly from the mission given to them by Congress in their charters, which includes among their objectives "[providing] stability in the secondary market for residential mortgages" and "[promoting] access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas)." These are not objectives for a conventional shareholder-owned company.

[7] Given the low value of the living will in light of what the GSEs are and how they operate (as explained later in the text), that replacement living will rule might be de-emphasized relative to other priorities and be implemented – if at all – only after a long delay.

The Relatively Low Value of a GSE "Living Will"

In contemplating the living will rule for the GSEs, I was immediately struck by how different a GSE is from large, systemically important banks.

First, a GSE operates in only one country – the US. It operates with only one currency – the US dollar. By contrast, the largest banks operate in many countries, each with their own legal regime and currency. Most importantly, unlike a large bank with potentially hundreds of operating subsidiaries, the GSEs substantially operate not from hundreds of legal entities, or even dozens of them, but from just one each: the congressionally chartered companies Freddie Mac and Fannie Mae.[8] Thus, the classic living will strategies – for example, pre-positioning liquidity and capital in dozens or even hundreds of carefully selected subsidiaries – are virtually meaningless for the GSEs.

Second, banks and the GSEs have amazingly different liquidity risk profiles. Liquidity risk is extremely important in stress scenarios: whenever confidence in a large financial institution is lost (most often because of an expectation of very large credit losses relative to its capital base), liquidity dries up. For a bank, that drying up can take the form of a run on deposits, or commercial borrowers pre-emptively drawing down under lines of credit, or investors being unwilling to roll over existing deposits or loans to the bank (which is needed, in part, to carry longer-maturity assets). Hence, a living will not only gives considerable attention to maintaining strong liquidity in total, but also goes into great detail about how to structure that liquidity among carefully chosen operating subsidiaries so that none inadvertently or unnecessarily causes a default.

However, a GSE has precious little of all this. The reality is that about 90 percent of a GSE's balance sheet consists of mortgage loans financed by the classic pass-through mortgage backed security (MBS). The owners of the MBS are entitled to only the interest and principal repayments that borrowers pay to servicers, which in turn send the funds to the GSEs, which are then forwarded on to the MBS investors (that's why they are called "pass-throughs"). On that 90 percent of the balance sheet, then, there is no material liquidity risk – no possibility of a "run," no ability to take down funds under lines of

[8] The exception is a joint-venture between the two GSEs, called Common Securitization Solutions, that does certain back-office processing operations only (i.e., it has no role in balance sheet risks such as credit or liquidity). Its role in a living will is therefore de minimis. The two companies also have individual trusts for each pool of mortgages placed into a particular mortgage-backed security; those are not separately capitalized operating entities, however, but just legal constructs needed for certain securitization purposes. Otherwise, all activities occur in the congressionally chartered legal entities Freddie Mac (formally, the Federal Home Loan Mortgage Corporation) and Fannie Mae (formally, the Federal National Mortgage Association).

credit (the GSEs do no lines of credit), and no need to roll over funds to carry existing assets.[9] The liquidity risk is centered in the remaining 10 percent of the balance sheet, and that's it. No large bank comes within a country mile of having such a favorable liquidity picture inherent in its business model.

So, given the ultra-simple legal structure of the GSEs and the pass-through nature of 90 percent of their balance sheets, their need for a living will is minimal compared to that of large banks.

On top of that, the GSEs are privately owned companies with a public mission – in practice, hybrids of a government agency and a privately owned mortgage securitizer-guarantor. The housing market – which accounts for about 15 percent of GDP – is unduly dependent upon the GSEs' staying in business to keep purchasing new loans, as they account for almost half of all single-family mortgage loans currently outstanding. If one or both GSEs went out of business, then, the economy would take a real hit, as there are not another five or ten GSEs ready to step in to replace them. (The situation for banks is very different, since there are many other competitors to take business away from a faltering large bank.)

If one or both GSEs were to get into distress in the future, then, the government could adopt several alternative approaches to minimize any damage to the economy.

First, it could try to resolve the problem while the GSEs continue to operate without change in their legal status. It could do so by putting in some additional credit support to supplement the preferred stock purchase agreement (PSPA) or whatever might exist in the future, to reduce market fear.[10] This approach has the least risk of disruption to the economy.

Second, it could put them, once again, into conservatorship. For policymakers, this is an attractive option: provided that something like the PSPA is put into place to regain market confidence, conservatorship relieves market distress while allowing the housing finance system to continue operating as normally as possible. Conservatorship allows the government to call the shots, but also allows it to take the time to work things out with no statutory deadlines and with a wide range of options: from winding down the GSEs (the Obama administration's official policy, though it was never implemented) to reinvigorating them (the policy since). All in all,

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[9] If the GSEs wished to continue purchasing new mortgage loans from primary market vendors, then they would need access to new funds. They also need some liquidity to operationally facilitate the passing-through of funds from servicers to MBS investors, but the amount in question is modest in the context of the GSEs' multitrillion dollar balance sheets.

[10] This was done in 2008 for the FHLB system, which was under distress in the Financial Crisis, while they kept their existing legal status, i.e. there was no conservatorship or receivership. While it is impossible to predict what proper such additional support would make most sense in a future stress scenario, the Treasury buying credit risk transfer bonds – reducing the GSEs exposure to defaults and credit losses - directly from the GSEs would be an example of such a possible action.

while the conservatorships put together in 2008 have lasted far longer than expected, the result has been quite positive: the mortgage markets have continued to work well, in some ways even better than previously, and meanwhile the GSEs have undertaken major operating reforms (e.g., the development and implementation of credit risk transfer). Overall, it has been quite a success.

Third, it could put them into receivership. This is what the living will proposal is about, as it applies only when receivership is being pursued. When a GSE is in distress, by definition the overall financial markets are likely to also be in distress (as was clearly true in 2008); even a unique event like a successful cyberattack on a specific GSE, if just that GSE were placed into receivership, would shake market confidence since the GSEs play so large a role in the world's second-largest debt market. As a rule, policymakers in such circumstance will try to calm market distress, not exacerbate it. Placing even one GSE into receivership, or more likely both, would absolutely exacerbate market distress because the resulting resolution would require the sale of a large amount of mortgage assets on a forced basis; that sale of assets would in turn drive mortgage rates up, maybe even considerably so.[11] Receivership for a GSE is therefore a highly unlikely policy choice: other alternatives, such as conservatorship, will be much more attractive because they will be so much less likely to spread market distress.[12]

The living will rule to plan for a receivership thus seems like a lot of work for little benefit. There is nothing wrong with a living will being put into place as a regulatory housekeeping requirement, but it should be done without fatal flaws and in a manner proportionate to its utility – which is really not much at all.

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[11] In 2008, the government faced this same issue of avoiding a large-scale sale of mortgage assets by the GSEs when they entered conservatorship. In that case, the sale of those assets – about $1 trillion worth in their investment portfolios – was engineered to take place gradually, over a decade. Such a gradual resolution is not obviously possible in receivership, which is designed to end in, at most, five years.

[12] In the history of distressed banks, for example, receivership has been pursued only for smaller and perhaps medium-sized institutions, because a systemically important bank going into receivership would spread market distress, which is the last thing that government policymakers would want at the time. Larger banks have thus been rescued in some fashion (e.g. sale to another institution, possibly aided by government support to the transaction) to minimize market distress. The GSE equivalent of such a rescue would be conservatorship, which not only minimizes spreading market distress but helps to maintain the economy by preserving the flow of housing mortgage credit.

The Fatal Flaws

The first fatal flaw relates to the preferred stock purchase agreement (PSPA), the agreement by which the Treasury supports the GSEs' creditworthiness since they were placed into conservatorship in 2008. The FHFA's proposed rule inexplicably treats the PSPA as somehow unavailable to the two companies even though it most assuredly is. I will call this flaw "PSPA denial."

This flaw is evident in two key passages of the rule proposal. First, the proposal makes it sound, falsely, as if the government does not in fact support the GSEs, and as if the PSPAs are mistakenly perceived as government support:

> Despite statutory provisions clarifying that neither the Enterprises nor their securities or obligations are backed by the United States, investors, creditors and others doing business with the Enterprises may *perceive* that the Enterprises have implicit United States government support. Financial support from the Treasury Department provided through the PSPAs, which continues today, could encourage that *perception*. (16, my emphasis)

There is a grain of truth in the fallacy of this passage: it is true that the GSEs are not "backed" by the US government in the narrow sense that they do not have a full-faith-and-credit guarantee. Yet the government (like any company or individual) can offer a wide range of support to a borrower, from very strong (like a guarantee) to very weak (like a handshake). The government currently supports the GSEs through the PSPAs, which are absolutely not full-faith-and-credit guarantees but are nevertheless quite strong.

The PSPAs support for the GSEs is neither implicit nor a mere matter of perception. Their support is explicit and legally binding: the PSPAs were, in fact, specifically designed by the government to acquire and keep investor confidence in government support by actually providing that support. The PSPAs, at their core, currently obligate the government to invest up to a *further* $140.2 billion in the equity of Freddie Mac and $113.9 billion in the equity of Fannie Mae to ensure that the net worth of each company does not drop below zero. The PSPAs are, to be sure, weaker than a full-faith-and-credit guarantee because (1) the amounts they commit towards each company have a limit (although they are rather high), and (2) their support to the companies is tied to an accounting-based net worth calculation, as opposed to the direct need for cash to pay off their liabilities, which means creditors might conceivably receive their cash later than scheduled. The marketplace has accurately registered the PSPAs' strength.[13] Investors have been relying upon the non-cancellable PSPA to stand behind GSE

[13] The rule proposal claims that "because of the Enterprises' federal statutory charters and some federally conferred business privileges, pricing of Enterprise obligations has reflected investor perception of a full faith and credit guarantee" (8). Actually, that is not true. The investor perception was and continues to be of government

creditworthiness for over a dozen years now, and given that the PSPA is a legally binding contract, they have every right to.[14]

In spite of the PSPAs' very real support, in a second key passage, the rule proposal requires the GSEs to plan for a resolution in which that support would be unavailable:

> Because Enterprise obligations and securities are not backed by the full faith and credit of the United States… resolution of an Enterprise by FHFA necessarily would involve only the Enterprise's resources available to absorb losses and satisfy investor and creditor claims. (10)

This PSPA denial is simply not grounded in reality. The PSPA is legally binding upon the federal government, and proceeds from it should be included in the resolution planning. The FHFA's requirement not to include those proceeds would make the resolution planning's results wholly misleading.

The rule proposal's PSPA denial leads to a second fatal flaw: its requirement of what I will call a "business model impossibility." The FHFA press release describing the rule proposal usefully sums up this impossible requirement:

> Under the proposed rule, the Enterprises must demonstrate how core or important business lines would be maintained to ensure continued support for mortgage finance and stabilize the housing finance system without extraordinary government support to prevent an Enterprise from being placed in receivership, indemnify investors against losses, or fund the resolution of an Enterprise.[15]

As the rule proposal itself and my discussion above make clear, "extraordinary government support" includes the PSPA. As this passage from the press release explains, the rule requires the GSEs to show how, without the PSPA or any other government support, they would continue to perform their core functions (e.g., buying mortgage loans from primary lenders) in receivership.[16]

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support, but not at the strength of a full guarantee; for example, investors in MBS from the GSEs demand a higher rate of interest than they do on similar MBS from Ginnie Mae, which do carry the full faith and credit of the government.

[14] The PSPA is non-cancellable with respect to existing debt instruments; the agreement could, at some point, be terminated as no longer applying to future issuances of debt instruments.

[15] See FHFA, "FHFA Issues Notice of Proposed Rulemaking on Enterprise Resolution Plans" (News Release), December 22, 2020, https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Issues-Notice-of-Proposed-Rulemaking-on-Enterprise-Resolution-Plans.aspx. The proposed rule states that the living will "[m]inimizes disruption in the national housing finance markets by providing for the continued operation of the core business lines of an Enterprise in receivership by a newly constituted limited-life regulated entity" (67).

[16] The receivership specified in legislation applying to the GSEs is rather unusual. It calls for the assets and liabilities of the GSE to be split: those that are "core and important" go to a limited-life regulated entity (LLRE) – a term I have never heard used by regulators other than the FHFA – that will continue to operate under the existing congressional charters; the remaining assets and liabilities will be left behind in a bankruptcy estate for disposition. Given that there are no obvious precedents for such an LLRE vehicle to be deployed in a receivership, it is not clear how well it will all work.

This requirement is a business model impossibility: no government support to the GSEs means virtually no GSE support to the housing finance system, period. The business model of the GSEs, from the very first day that Fannie Mae was privatized back in 1968, has required government support: investors in the GSE's liabilities must see a level of support sufficient for them to believe that those liabilities are near-Treasury quality (i.e., that they have nil credit risk). With the later creation of Freddie Mac and the development of securitization, this reliance upon government support continued – and the business can't operate without it. (See the Appendix for a fuller description of this support.)

In other words, the day that the government successfully disavows the PSPA (or whatever form of necessary government support may exist in the future) will be the day that mortgage debt investors basically stop buying the MBS of the two GSEs, and so it will also be the day the GSEs almost totally have to stop buying mortgages from primary lenders.[17] In the rule proposal, which ignores this reality, the FHFA specifies that somehow the assets and businesses that get transferred to the limited-life regulated entity (LLRE), which will house the "core and important" assets of the GSE after receivership is established, will continue to operate in support of the housing finance system – which is simply impossible. It's like a Venn diagram with two circles – one is that GSE support to housing continues via its purchases of mortgages from primary market lenders, and the other is that there is no government support to the GSEs – that have near-zero overlap. The FHFA's requirement, in other words, is just plain impossible.

Interestingly, everyone in the mortgage industry understands this – lenders, servicers, debt investors, the GSEs, mortgage securities dealers, credit rating agencies, and so on. So do all the relevant people in Washington – except, as I observed during my seven years as Freddie Mac CEO, for a narrow group of very conservative think tank specialists and certain politicians ideologically aligned with them. (I also saw more broadly that interest groups in Washington, on both right and left, often claim to believe in non-realities when realities are inconvenient for their ideologically or economically driven policy positions, at least with respect to matters of housing finance.) FHFA Director Calabria showed himself to be part of that small conservative group when, in 2019, he told a meeting of MBS investors that if the GSEs were well capitalized and engaged in quality underwriting, they should not need government support anymore. The investor reaction was swift, and highly negative. Not only did they tell Director Calabria he was wrong, their industry association shortly afterwards publicly announced

[17] It is possible some small percentage of investors might buy MBS from the two GSEs under those circumstances, but at rates that would be so much higher and in volumes that would be so much lower that they would not obviate the substantial disappearance of the GSE guarantee businesses.

that it no longer supported any GSE exit from conservatorship without a full-faith-and-credit guarantee of GSE MBS, which requires legislation by Congress.[18] Privately, I was told that after hearing Director Calabria's comments, the investors simply no longer trusted the FHFA to ensure that the PSPA (despite being a legally binding contract) or any successor government support mechanism, short of a full-faith-and-credit guarantee, would be properly applied to their benefit.

This second fatal flaw of business model impossibility means the analysis and plan for resolution is doubly defective. Together, these two flaws render the entire proposal meaningless.[19]

The Political Background

As I have written many times before, with the role of government in housing finance being so large (e.g., it supports the credit of about 65 percent of all single-family first mortgages in the country, among other things), every aspect of it is highly politicized. The narrow group of very conservative think tank specialists (and their political supporters) who are very noisily opposed to such a major government role in financing mortgages has over the years developed some beliefs I view as just plainly counter to reality. At their purest, I have found these beliefs reflecting the underlying conviction that nothing the GSEs can ever do is right or beneficial, that anything that shrinks them is a good idea, and that total elimination would be an even better one. Here are five of those views:

1. The credit quality of the GSE mortgage portfolio is always bad, period, even going into the pandemic after years of enjoying a very favorable credit market; GSE credit quality is "a dumpster fire."[20]

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[18] See the letter from the Securities Industry Financial Markets Association (SIFMA) to Secretary Mnuchin, Secretary Carson, and Director Calabria, July 11, 2019, https://www.sifma.org/resources/submissions/presidential-memorandum-on-federal-housing-finance-reform/. Prior to that incident, the PSPA's continuation was usually assumed to be sufficient to keep market confidence. It might still do so (despite the press release), but given the comments by Director Calabria, the investor community is, at least, stating that it isn't agreeing to that assumption ahead of time.

[19] Contradictorily, the proposed rule states that somehow the living will "[m]inimizes disruption in the national housing finance markets by providing for the continued operation of the core business lines of an Enterprise in receivership by a newly constituted limited-life regulated entity" (67). This is impossible: no government support means virtually immediate full run-off and no new loan purchases by the GSEs; if the national housing finance markets are to be continued without disruption, then government support, likely in the form of a continuation of the PSPAs, will be required.

[20] See the Senate Banking Committee hearings on "Housing Finance Reform: Next Steps," September 10, 2019, https://www.banking.senate.gov/hearings/housing-finance-reform-next-steps. Referring to the credit quality of the mortgages financed by the GSEs, Senator Kennedy (R-LA) says, "This whole thing is a car wreck. It's a dumpster fire. We spent $190 billion of taxpayer money and we're in worse shape." Director Calabria responds, "Agreed."

2. Credit risk transfer (CRT) doesn't work.[21]
3. The private capital markets, especially the private label securitization (PLS) business, can replace most or all of the volume done by the GSEs in a smooth manner with no significant increase in mortgage rates or acceptable credit terms.
4. The product range of the GSEs is way too broad – the companies should not be buying mortgage loans that fund investor properties, second homes or cash-out refinancings, for example.[22] (Some purists even argue they should exclude all refinancings, and maybe even finance only purchase mortgages for first-time homebuyers.)
5. In 2008, the GSEs should have been put into receivership, which would have been more likely than conservatorship to have resulted in their major shrinkage – and maybe even their full wind-down; the government's choice of conservatorship was a mistake

The first three items are just plain wrong as a matter of reality. The last two are opinions, but not surprisingly have as their underlying objective that the GSEs should be shrunk if not eliminated. This is the policy and political background of current FHFA Director Mark Calabria, who apparently agrees with most or all of the beliefs listed above. This background is particularly valuable to understand in examining the unacceptable vagueness of several components of the living will proposal.

Unusually Vague

In addition to its two fatal flaws, the proposed living will rule is incredibly vague on several key points, leaving the public with little idea of how it would work in practice, which might not become known until years after the rule's approval. This vagueness, as described below, will allow the FHFA, if it chooses, to pursue a conservative policy direction via the living will to significantly "shrink the footprint" of the GSEs in some backdoor fashion, without any congressional authorization.

I have selected three areas of unusual vagueness that could have such an effect. These show how the living will rule proposal is really more a vehicle for policy implementation than a technical document specifying how resolution, i.e. the sale or run-down of assets, will occur.

[21] Mark Calabria has said this more than once, including in my hearing.
[22] See the US Department of the Treasury, "Housing Reform Plan," September 2019, p. A2, item 11, https://home.treasury.gov/system/files/136/Treasury-Housing-Finance-Reform-Plan.pdf.

Identification of "core business lines"

The living will proposal calls for the GSEs to propose, and then for the FHFA to choose – entirely as it wishes[23] – what are the "core business lines" of the companies, which will in turn get put into the "limited life regulated entity"(LLRE) that will continue to operate under the existing charters, with the rest of the GSEs' operations put into a bankruptcy estate of some sort.[24] But the GSEs are very simple businesses in terms of their breadth – they are called "monolines" because their core function, as designed into their charters, is quite limited: the secondary-market purchase from primary-market lenders of residential mortgages on single-family and multifamily properties. The identification of "core business lines" may make sense for a bank, which has a broad-ranging charter that allows it to pursue activities as varied as trading foreign currencies, acting as trustee for a corporate bond, taking deposits from individuals, making credit card loans, and much more; it is not at all clear, however, why identifying core business lines makes sense for the GSEs.

The proposal seems to admit that the GSEs' core businesses are quite obvious, acknowledging that "application of the concept [of "core business line"] may result in identification of two core business lines for each Enterprise, a single-family business line and a multifamily business line" (20). But then it puts the whole matter up in the air, calling for each GSE to evaluate "the Enterprise's participation in activities and markets that are critical to fostering liquidity, efficiency, resilience, stability and competition in the national housing finance markets" (25). This can mean virtually anything the FHFA wants it to mean. So, why the vagueness? Why not just say, "In the case of the GSEs, since they do activities only as per their Congressional charters, we will define all their activities, divided up between the single-family and multifamily businesses, to be core."

In fact, the GSEs' congressional charters, which are extremely narrow compared to bank charters, do not recognize any concept of "core" activities. For decades, the regulatory and legal framework has been about which activities are "charter compliant" versus not. This section of the living will may have the purpose, then, of allowing the FHFA to override Congress's intent by creating a first-class category of charter-compliant activities separate from a second-class category, and then jettisoning (at least in the context of a living will plan) the latter, while supposedly intending to keep the

[23] The rule proposal says that "FHFA would not be required to utilize any particular methodology for identifying any core business line … FHFA would be able to consider any other factor it deemed appropriate" (26).

[24] The LLRE is supposedly designed to be a "bridge bank" of sorts, in which operations of the GSEs would be placed with the expectation that someday in some fashion they would emerge to operate "normally" (or as normally as a GSE can ever operate) again. The remaining assets and liabilities would remain behind in a bankruptcy estate, to be liquidated down to zero in some fashion with no assumption that any related operations would continue into the future.

former operating on a routine basis. If the FHFA were to create these categories in line with the views of conservative advocates who wish to shrink the GSEs' footprint, it could define products like mortgages on second-home properties, investor properties and cash-out financings as "non-core."[25] Then, even if the living will is never activated, the FHFA could use the status of these products as non-core in the living will to somehow restrict or eliminate their eligibility for GSE purchase at all times.

The vagueness about core business lines also creates a troubling lack of transparency about what would happen to the GSEs' assets in the event of a resolution. The rule would allow the FHFA to determine, based on criteria of its own choosing, which core activities would go in the LLREs. The public therefore really has no idea what percentage of the GSEs' assets would stay in the bankruptcy estates for liquidation or what percentage would go into the LLREs for continuation. Are we talking 5 percent? Twenty percent? Fifty percent? As the GSEs are not two out of thousands of banks, but two specialty companies executing upon a quasi-governmental mission, accounting for almost half of the $11 trillion of single-family mortgages outstanding, it really is poor policy to leave the public in the dark about such matters.

LLRE in action: What exactly will happen?

The living will proposal says that "each Enterprise… should… detail how, in practice, the Enterprise could be resolved through FHFA's receivership authority by liquidating assets or by transferring them to an LLRE, which would continue to operate the Enterprises' core business lines" (33).

The notion of the LLRE – the name seems to be unique to the FHFA – is in fact somewhat confusing. It is supposedly patterned on the concept of a "bridge bank," according to ex-FHFA officials, enabling the GSE activities placed in it to somehow return to operating normally, as would a company emerging from bankruptcy.[26] How this is to occur is rather muddy, though, when the LLRE has a maximum life of two years (which can be extended in one-year increments to five years). Since we're in the thirteenth year of the current conservatorship, it is not at all clear that a GSE could be resuscitated to private-sector ownership in five years, much less two. For example, if the PSPA is not (as per the proposal) available to the GSE operations in the LLRE, then it has no going-forward business at all, and will be in run-off mode until it is fully liquidated. Furthermore, it would be almost impossible to do such

[25] The debate as to whether the GSEs should be purchasing any of these three categories of loans is entirely legitimate. However, that debate should happen "through the front door" via legislation in Congress or, at the least, a rule dedicated to the specific issue, and not determined via the back door of a living will.
[26] The FDIC does use a bridge bank from time to time, but on institutions that are much smaller than the GSEs, as that smaller size can accommodate a sale to another bank or the disposition of assets in a routine manner.

a liquidation in five years without massive asset sales (as opposed to natural run-off) that will depress the prices of mortgage assets, thus raising mortgage interest rates, possibly by a lot, and hurting the economy and homeownership.

The proposal's discussion of the sales of ongoing business operations is also unclear. Assuming that the PSPA remains in place (so that there actually is an ongoing business), who might be in a position to buy a GSE when that would require on the order of at least $50 billion to $75 billion in capital?[27] The answer is that there is no organization obviously able and willing to do so; even the concept of re-floating the company via a stock sale to the public is highly questionable, as the largest-ever American IPO was about $18 billion.

The result is that, in real life, putting a GSE's "core" assets into an LLRE will not be a smooth process, with the marketplace assuming that operations will somehow, within the LLRE's two-to-five year limit,[28] readily return to normal. Instead, the marketplace is just as likely to assume the only feasible outcome is for the LLRE to act as a vehicle for liquidation of the assets. In reality, the LLRE looks as much like a liquidation vehicle as it does a bridge-bank-style resuscitation vehicle. If a GSE were to fail and be put into an LLRE, it would therefore create tremendous stress in the second-largest global debt market; the expectation of a corporate liquidation would only exacerbate this stress.

In other words, the LLRE concept in the legislation is actually not well-considered, and it is not at all obvious that it would work smoothly or successfully as a bridge bank. (My view is that Congress got this one very wrong.) The living will rule proposal is, in fact, unusually vague about just about every aspect of how an LLRE and its companion bankrupt estate would actually deal with the trillions of dollars of assets and liabilities from each GSE; it has no obviously relevant precedents of which I am aware, and the proposal seems impractical in too many ways. My own prediction is that its execution, if ever attempted, would be a giant mess.

A second bite at the capital apple?

A third problematic vagueness in the proposal lies in its call for the GSEs to establish in their living wills that the LLREs will be "well capitalized" (31). This requirement is surprising: to say the least, a vehicle

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[27] This number, based upon the just-approved capital rule from the FHFA, is an estimate of what would be required for Freddie Mac, as the smaller of the two companies, assuming most but not all of its assets were transferred to the LLRE.

[28] In fact, one year extensions allowed three times (after the initial two year life for the LLRE), would themselves create market uncertainty as each year, after the first two, the market would be waiting for the FHFA to announce its decision which would have a major impact on the likely forced sale of mortgage assets. This would be another source of market uncertainty, potentially quite large.

like the LLRE would not normally be well capitalized, since the whole point is that the two companies somehow used up enough of their capital that they have to be put into receivership.

The living will proposal is incredibly vague about how this capital requirement will work. The proposal makes reference to having capital to “bail in” to meet the LLRE’s needs (13). For example, it mentions subordinated debt, which would be left behind in the bankrupt estate and thus create equity (i.e., assets outweighing liabilities) in the LLRE. In theory, this idea is totally legitimate, but the proposal gives no further specifics. How much bail-in capital will be required? What would be the target level of capitalization for the LLRE – a full amount (i.e. equal to the regulatory requirement on the pre-receivership GSEs) or something less? How long would the LLRE have to raise the amount that is required? These are core unanswered questions.

Since these questions are unanswered, it appears that the requirement for the LLRE to be “well capitalized” is a way for the FHFA to take a second bite, and maybe a major one, at the capital rule which was just approved. The proposal mentions that the FHFA may put out a separate rule related to “bail in” capital – but that really should have been done in the just-approved capital rule. Since that capital rule was already criticized widely as calling for an excessively large requirement (which will very likely cause guarantee fees to go up over time), it is clear that a second bite will just create more disadvantage for the GSEs. With a higher capital requirement, they would have to raise guarantee fee pricing again to show a proper return on the higher capital level; higher fees would shrink the GSEs’ footprint, as they would then lose market share.[29] That footprint shrinkage is a key policy objective of Director Calabria does not seem to be coincidental.

Conclusion: A Major Revision is Needed

A proposal for the GSEs to have a living will rule is, in theory, a perfectly reasonable thing. It is, however, not of great significance, as described above.

In the FHFA’s actual proposal, though, we find the two fatal flaws, PSPA denial and business model impossibility, both of which are obviously based upon incorrect beliefs. Add in its vagueness as to how certain things will work, as identified above, and the concerns about it become even larger. It is just not designed to be the kind of technical document required for a living will – in fact, it gives almost no specific information about how assets will be disposed of through sale or run-off.

[29] A material increase in GSE guarantee fees means that the GSE will lose market share on low-risk loans to mainly commercial banks and on high-risk loans to mainly the FHA.

One is then left with the unfortunate conclusion that this exercise is indeed dominated by the conservative policy agenda of Director Calabria to shrink the footprint of the GSEs, and to be consistent with his vision of many smaller GSEs which no longer enjoy much, if any, government support. This living will proposal is thus reminiscent of the recently approved capital rule, which I regard as decidedly outside the mainstream.

Unless the living will rule proposal is revised to make it a clearly defined and more conventional regulatory rule, grounded in the reality that the PSPA as government support does exist and needs to be considered even inside a receivership, the proposal will not be accepted as credible or appropriate, either broadly in the industry or by future GSE directors. I would therefore expect it to be replaced most likely through an entire rewrite by a Biden-appointed FHFA director, who will probably show up during 2021.

APPENDIX

Why government support *is* necessary to the GSE business model and always has been

The GSEs long had a paradox at the heart of their business model: they are officially not guaranteed by the US government, as stated in legislation, but the market assumed since the original privatization of Fannie Mae back in 1968 that, regardless, they would not be allowed to go under by that same US government. That's because the government has long played a two-faced game: tell the federal budget experts that the two companies are not guaranteed, allowing the GSEs to escape disciplines associated with the federal budget, but then tell the market through various mechanisms that (wink, wink) they really are strongly supported by the government, although not to the extent of a full-faith-and-credit guarantee.[30]

Until 2008's conservatorship was established, this market confidence was created via what became known as the "implied guarantee." Because of the GSEs' congressional charters, statements by government officials over time, the government's naming one-third of the members of the Boards of Directors,[31] and special lines of credit ($2.25 billion each) from the US Treasury, investors felt comfortable believing in the "implied guarantee." Perhaps the greatest reason the market believed in it was that the GSEs' role was so large and central to homeownership and homebuilding – housing today accounts for about 15 percent of GDP, and the percentage was higher in 1968 – that it would make sense for the government to rescue them; letting them go under would just be economically too painful. As a result, investors were willing to buy GSE liabilities at near-Treasury rates. It turned out that, when push came to shove, the government did in fact intend to support the GSEs, despite there being no full-faith-and-credit guarantee, and thus conservatorship was instituted in 2008 to rescue the companies. The result was that the owners of the GSEs' liabilities were kept whole, just as the implied guarantee promised that they would be.[32]

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[30] When Fannie Mae was privatized in 1968, one of the main reasons for the action by the federal government was to relieve pressure on the federal budget, which was straining under Vietnam War-era "guns and butter" spending pressures. With the privatization, Fannie Mae's borrowings to fund the ownership of mortgage assets (as this was before there was securitization of those assets) were taken off the federal balance sheet. However, to keep the cost of funds to Fannie Mae low so it could still perform its core function, the government put in place many mechanisms (listed in the second paragraph of the appendix) to provide the market with confidence that it was supported by the government, if not at the level of a full-faith-and-credit guarantee.

[31] This authority still exists, although it was declined to be used by President George W. Bush, and has remained dormant since. Additionally, the Boards still have requirements that certain directors represent different interest groups (e.g. homebuilders), which once again reflects how much the GSEs are creatures of the Federal government.

[32] The greatest reason the GSEs were placed into conservatorship, rather than being liquidated through receivership, is that their collapse would hurt the economy too much – they are simply expected to help support

I should note that, during those decades prior to 2008, the credit rating agencies baldly stated, for all the public to see, that the AAA ratings given to the two companies were based upon the government's implied guarantee – there was nothing hidden about it, and everyone in housing finance knew all about it.[33]

The business model of the two GSEs had long been, in fact, built upon that implied government support. Focusing on single-family loans, which comprise most of their balance sheet, the GSEs purchase mortgage loans and then issue mortgage-backed securities (MBS) against them. This leaves the purchasers of the MBS with both interest rate risk (which is quite complex given that free prepayment is allowed at any time) and credit risk (i.e., the risk of non-payment, or even late payment, of amounts owed). The GSEs then guarantee the MBS investors against that credit risk. The result is that the MBS investors are intending to purchase pure "interest rate risk" instruments (i.e., having near-US Treasury quality): they take on the complex interest rate risk of the American mortgage [34] and have no interest in taking on the credit risk of the underlying loans.[35]

This mechanism, however, works only if the GSEs' guarantee of the credit risk has, itself, near-Treasury quality, and the only way the market will believe that is if the government does indeed stand behind that guarantee.[36] Even if the GSEs were much more highly capitalized than an official regulatory minimum "well capitalized" level, the market would not, absent government support, accept their guarantee to be of near-Treasury quality, as it is, after all, being relied on for up to thirty years, a timeframe during which any heavily capitalized private-sector company can lose its capital strength. Prior to 2008, government support came in the form of the implied guarantee. When the stress of the 2008 financial crisis reduced the market's willingness to believe in the implied guarantee, the government, in its rescue of the GSEs, had to offer something stronger. Hence was born the preferred stock purchase agreement. Under the PSPA, Treasury promises to spend up to a specified level of dollars (currently, $140.2 billion for Freddie Mac and $113.9 billion for Fannie Mae) to not let the net worth of

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the economy in the worst of times, not to "run for the hills" as the PLS markets and bank lenders tend to do. With the addition of FHA and VA lending, the result is that the economy is less cyclical because housing finance is so stable – as enabled by government support. This proved true again when the pandemic hit in early 2020.

[33] As a matter of interest, the Federal Home Loan Bank System, with about $1 trillion of assets, is today supported by the same implied guarantee. Ditto for several smaller agencies. And the credit rating agencies still say so very publicly: in fact, the rating agencies currently also say what the credit ratings would be (i.e., significantly lower) if there were no such government support.

[34] The "American" mortgage has a 30-year fixed rate, is fully self-amortizing over its life, allows free prepayment at any time for any reason, and can even have its rate locked up some months ahead of being taken down to facilitate a home purchase.

[35] Later, credit risk transfer (CRT) transactions were developed to separately sell off credit risk.

[36] The letter from SIFMA cited above (n. 18) exemplifies this investor viewpoint.

either GSE drop below zero; that promise, though not as strong as a full-faith-and-credit guarantee, ensures in turn that GSE liabilities will almost certainly get paid off.[37]

In other words, government support can take one of a range of forms: from the strongest (the full-faith-and-credit guarantee) to adequately strong (the PSPA) to minimally adequate (the implied guarantee). The situation is by no means binary, in which there must be a full guarantee or no support at all. The PSPA has been accepted by the MBS investor marketplace as "good enough," at least while the two companies are in conservatorship, since its inception in 2008.[38]

To sum up, the business model of the GSEs requires support from the government that the market believes is strong enough so that investors in their MBS have no discernible credit risk, just interest rate risk. In practical terms, then, if one day the government were to successfully disavow its support of the GSEs, the issuance of new MBS would almost totally stop cold, and therefore GSE purchases of loans from primary-market lenders would similarly almost totally stop cold. Additionally, all existing outstanding MBS would become instantly worth materially less. Such an action, given that there are over $5 trillion of such securities outstanding, would all by itself trigger at least a mild financial crisis as the world's second-largest debt market would have been thrown into disarray and investors in it would be suffering losses of probably hundreds of billions of dollars (e.g., a reduction in value of just 5 percent would generate a $250 billion loss in value).

It was to avoid just such a disruption, both in the financial markets and in the financing of homeowners purchasing their homes, that the government rescued the two companies back in 2008.

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[37] This promise has, in terms of the legal documentation, limits to it based upon the unused but available amounts under the PSPAs for each company, as listed above in the text. However, there is still a lot of good reason for investors to believe, just as was true in the implied guarantee days pre-2008, that the government would rescue the two companies in some fashion to protect the owners of all their debt from incurring losses, even if not required by contract, in the interest of avoiding a major collapse of homebuilding and homeownership – and the knock-on impact of falling house prices reducing family net worth and thus consumption spending.

[38] The PSPA was accepted as sufficient even when the GSEs had almost no capital for many years during conservatorship. In a sense, then, the PSPAs are a mechanism for GSE liability holders to see, as capital backing their investments, the total of the capital on the books of the GSEs *plus* the capital held at Treasury, which can be accessed if needed through the PSPA agreement. As the latter amounts are quite large, the market has maintained its confidence in the two companies.