INDUSTRY PERSPECTIVES

GSE Re-privatization

Will Washington Scare Off Private Capital?

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Introduction

The two government-sponsored enterprises (GSEs) Freddie Mac and Fannie Mae have just entered into their thirteenth year of conservatorship, despite its originally having been designed as a temporary "time-out." In September 2019, the Trump administration began the process of ending the conservatorships and recapitalizing the two companies by "administrative means" – that is, without the need for any new legislation. This requires the Federal Housing Finance Agency (FHFA), their regulator and conservator, and the US Treasury to both separately and together make decisions and take actions involving extremely large amounts of money in a very complex, never-tried-before process with many political sensitivities. To implement such an unprecedented undertaking of this scale and scope, the FHFA and Treasury are mostly going to have to just figure out how to do it as they go along.[1] To date, even though the implementation of this "administrative means" plan began a little over a year ago, it has really only scratched the surface – and so it likely has years to go, with many tough and complex decisions still to be analyzed, made and implemented.

As part of this implementation, the two GSEs will need to build up an immense amount of capital. The current proposal by the FHFA for a new capital rule would require over $240 billion; even alternatives that are less strict are at $150 billion or more. This capital will be produced by a combination of retained earnings (which could easily require a decade or more to build up if they alone provide the capital) and new equity issues. To put this amount of capital in perspective: the largest IPO in history of an American company in US securities markets was just under $18 billion.[2] So, unless the policymakers are going to be extremely patient and wait many years for retained earnings to accumulate, there are likely going to have to be several record-setting common equity issues, and very possibly more than one for each company.

The two GSEs will therefore have to become very attractive to equity investors. And that means attractive not just to one or two types of investors, but to the clear majority of all large institutional equity investors globally if the record-setting amounts required are to be successfully raised at a reasonable, rather than fire-sale, price.

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[1] The most relevant precedent would likely be the actions taken by the government to release AIG from its control, following the 2008 Financial Crisis. As I was appointed by Treasury to be a board member of AIG during part of that time (2010-12), and then immediately afterwards served as CEO of Freddie Mac for seven years, I can say based upon those first-hand experiences that the GSE recapitalization is far more difficult and complex.

[2] Specifically, $17.9 billion for VISA in March 2008. There have been a small number of non-IPO equity issues from American companies that have been modestly larger.

This paper starts by describing exactly what the companies today represent as an investment opportunity, as it is fundamentally different than what existed prior to conservatorship. Then it will review four issues where the government – in the form of the FHFA, Treasury, or Congress – is already acting or has a real risk of acting contrary to this need for the GSEs to be significantly attractive to equity investors. These are examples of a level of government policy instability with respect to the GSEs that is just much higher than investors get from owning the equities of other companies, whether they be large financial institutions, regulated public utilities or even other mortgage-market companies. If this policy instability is not significantly reduced over the next few years or, even worse, if enough investor-unfriendly actions pile up on top of each other as the modus operandi of the post-conservatorship GSEs is built, then it is going to be almost impossible to raise the record amounts needed, except of course via retained earnings. Unfortunately, I have found that people who play a key role in housing finance activities generally have a "build it and they will come" attitude about raising the required capital.[3] That is, they assume that the record-setting amounts will just somehow be available when needed.[4]

However, the reality is that if "it" is not built right, they will absolutely not come.

Additionally, depending upon the outcome of this November's elections, it is possible the current Trump administration plan will be stopped in quick order by an incoming Biden administration via its immediate control of Treasury after the inauguration.[5] (If a current Supreme Court case is decided as expected, the Biden administration would also be able to replace the existing Trump-nominated FHFA Director within about six months, cementing its total control of the exit and recapitalization process.) If

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[3] In my experience, those active in housing finance activities in Washington have little, if any, expertise in equity markets or understanding of the needs of equity investors. An exception would be any Treasury officials who get involved in housing finance, as they clearly have market expertise, although it is concentrated in debt more than equity markets.

[4] This attitude is exemplified by Adam J. Levitin and Susan M. Wachter, *The Great American Housing Bubble: What Went Wrong and How We Can Protect Ourselves in the Future* (Cambridge, MA: Harvard University Press, 2020). It recommends a revised GSE structure, which it calls "Franny Meg," in which the government would set the credit criteria, pricing of guarantee fees, and many other restrictions on how to operate (including the structure of credit risk transfer transactions). The book does not ever address or understand that this structure would not be attractive to equity investors: who, for example, would invest in a lending institution that can't even control its own credit criteria? Their argument just assumes that investors will show up to invest record amounts in what is in essence a government agency with almost no ability to operate as a private-sector corporation, and which would thus always be subject to the government's pursuing policy goals at the expense of the shareholders earning a full return.

[5] The business model of the GSEs requires that there be government support to its guarantee of credit risk to the investors in the mortgage-based securities they issue. Since 2008, this support takes the form of the PSPA, i.e. the preferred stock purchase agreement, which gives Treasury various rights in exchange for its support to the GSEs. Among those rights is the requirement that Treasury approve many GSE actions, including their removal from conservatorship by the FHFA.

the Biden administration at some point then were to choose a particular exit and recapitalization path, there is also a good chance that this requirement for raising such large amounts of equity would be part of it.

Thus, the need for government officials to shape their actions to support a high degree of investor attractiveness by reducing today's undue policy instability and building a post-conservatorship GSE "business model" that is designed to support private-market ownership is seemingly bipartisan: both the Republicans and the Democrats need to keep this goal front and center when it comes to their policy choices if they want the GSEs to become fully capitalized in some reasonable timeframe as part of exiting conservatorship and becoming "normal" (or as normal as a GSE can ever be).

Not Your Father's (i.e., Pre-conservatorship) GSEs Anymore

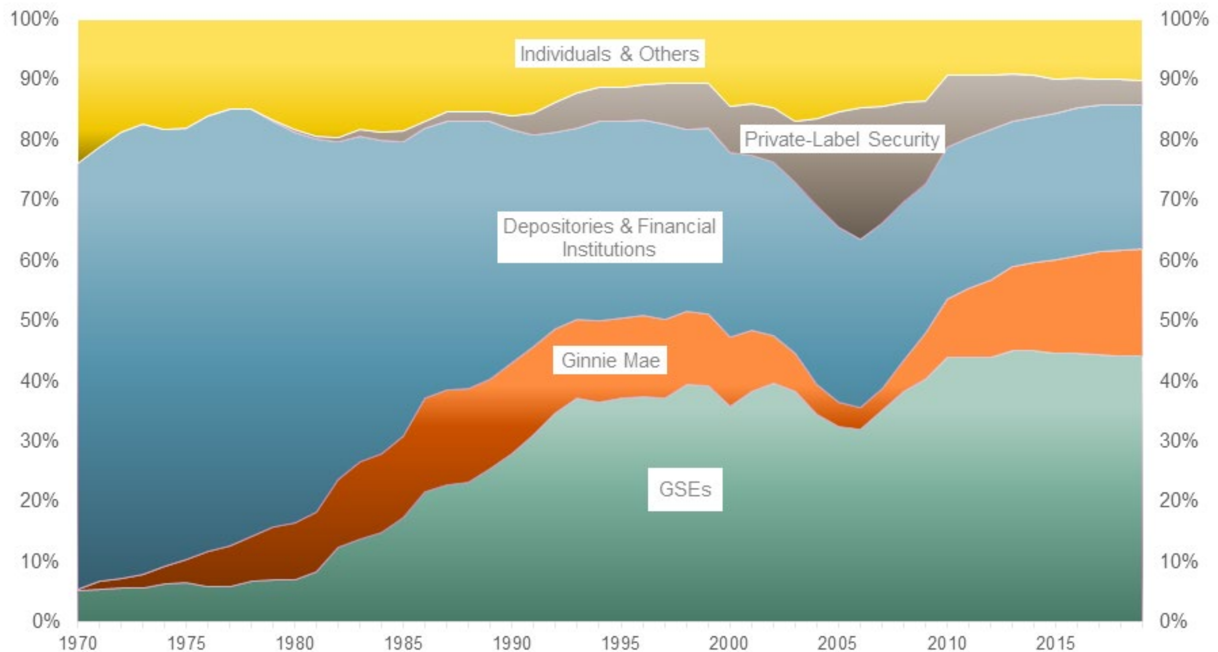
Following World War II, the GSEs were very small organizations and a minor part of the housing finance system (i.e., well less than 10 percent market share).[6] Their role changed in the 1970s and early 1980s, however, when the country's system of thrifts (savings & loans and mutual savings banks) came under major stresses, culminating in the Thrift Crisis (or S&L Crisis) of 1989 and its aftermath. At that point, there was a tremendous shift away from mortgage loans being financed by balance sheet lending (mostly by the thrifts) and towards the government-supported securitization model.[7] At first, beginning in the 1970s, the shift was towards government lending units, such as the Federal Housing Administration; in the 1980s, the shift was towards the two GSEs. This government-supported securitization model has accounted for about two-thirds of all single-family mortgages outstanding in recent years.[8] (**Figure 1** shows these shifting shares by year since 1970, with thrifts included in the "Depositories and Financial Institutions" category.)

[6] At first, Fannie Mae was the only GSE; it was joined by Freddie Mac in 1970.

[7] These government programs were not in the early years based upon securitization, but did transition to it starting in the late 1960s and through the early 1980s.

[8] This government-supported securitization model is comprised of the two GSEs plus the direct government units that securitize their mortgages through Ginnie Mae (e.g., the Federal Housing Administration).

Figure 1: Single-Family Mortgage Debt Outstanding



Source: Federal Reserve (data through Q319), Compass Point

As part of this major shift in the sources of mortgage financing, the two GSEs, being shareholder owned, became very successful investments for their shareholders.

The stock price of Fannie Mae, the older firm, was $1.30 on January 1, 1977 but had gone virtually nowhere for years afterwards: it was only $1.36 on January 1, 1985. Then, with the pressures growing on the thrifts and mortgage financing volume heavily shifting to the GSEs, its stock price began to take off: by January 1, 1990, at the height of the Thrift Crisis, it was $8.59, and in the next ten years it climbed to $56.56 by January 1, 2000. After that, the company's performance kept the stock price in a range near that high level, mostly between $50 and $70 a share, until into 2007, when the Financial Crisis began to manifest itself and the company collapsed into conservatorship. For Freddie Mac, the pattern is similar. On December 1, 1988 its share price was $4.21 (and then $5.08 on January 1, 1990), and it rose in the next decade-plus to $50.19 by January 1, 2000. It, too, then stayed in a high range, mostly between $50 and $60, until the Financial Crisis.

For investors in the common stock of the two companies, this was an excellent value-creation track record: in the key decade of the 1990s, when the overall market went up by almost five-and-a-half

times, the share price of Fannie Mae went up by six-and-a-half times; for Freddie Mac, it went up by almost ten times![9]

But what exactly was creating this value? What business model were investors actually investing in?

Certainly, it included the mortgage purchase-securitization-guarantee business of the two companies that fulfilled the mission given to them in their congressional charters. I will call this business their "core mortgage business," which includes both single-family and multi-family (i.e., apartment house) mortgages. However, one reason the GSEs became so politically controversial is that their most profitable, value-creating activity was something other than this core business: over time, the two companies had become heavyweight political organizations seeking to monetize (i.e., generate revenues and profits from) defects in the design of the GSEs' charters, and also defects in their regulation, into billions of dollars of hidden subsidies. These hidden subsidies came to drive the majority of their profits and share price.[10]

This characterization may sound harsh, but it was unfortunately the reality.[11]

The biggest obvious hidden subsidy to the GSEs was the ability to grow their investment portfolios without limitation, mainly investing in their own mortgage-backed securities (MBS) and funding that investment with debt that was highly subsidized – i.e. inordinately low-cost, with an interest rate just above what Treasury securities pay investors – because it carried the implied guarantee of the government. This subsidy had not historically been intended by the design of the GSEs, but once the loophole was discovered, it was exploited massively by the two companies: by about 2005,

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[9] The five-and-a-half-fold increase in the overall market is as measured by the S&P 500 index.

[10] The two GSEs have what is known as the "mission" in their congressionally-established charters, and no one expects or is pushing for this mission to dramatically change. Much of the mission is delivered by the fundamental business model of the two companies: they enable most primary mortgage lenders to make inexpensive thirty-year fixed rate mortgages readily available to LMI (low- to moderate-income) households. In addition, they have some other specific obligations; historically, the most prominent are the "affordable lending goals." For decades, the two companies' lobbying efforts, which were core to their political operations and sought to protect and expand their hidden subsidies, appealed to the desire to expand LMI families' ability to qualify for mortgages (often referred to as "access to credit") so as to get the well-documented benefits of homeownership. This goal, historically, has been very important to many Democratic Party-aligned interest groups, but also was important to the Republican administration of George W. Bush. The challenge, of course, has been to expand access to credit consistent with safety-and-soundness and proper consumer protections; with respect to this particular challenge, the GSEs' historic track record is decidedly mixed.

[11] To free-market housing finance specialists, pre-conservatorship, this all looked like a system whereby the GSEs, members of Congress, and various housing groups (like mortgage bankers, realtors and homebuilders) came together politically to create a mechanism to produce large amounts of cheap mortgage credit, and which allowed the GSEs to obtain unduly large hidden subsidies as part of the package. As a viewpoint, I find it had a lot of validity.

their investment portfolios totaled over $1.5 trillion between them – about double the Federal Reserve's balance sheet at the time.[12] It accounted for the majority of their profits (a situation which ended at Freddie Mac only well into conservatorship).[13] I was also able to ascertain, upon arrival as CEO of Freddie Mac, that the large historic investment profits were basically completely due to the cheapness of the funding rather than to any actual value-creation from the investing: it was virtually all due to the hidden subsidy.

The second big source of hidden subsidy was the inordinately low capital requirement on the core mortgage business – just 45 basis points per dollar on securitized/guaranteed mortgages. Even by the lax financial institution capital standards of the time, this requirement was extremely low.[14] It came about because Congress itself intervened and set the capital requirement. Congress also set up the GSEs' pre-Financial Crisis regulators in such a way that that their independence was compromised, making them subject to influence via special interest lobbying by the GSEs and other housing interests, which are always interested in cheap mortgage credit.[15] This situation turned the core mortgage businesses of the GSEs into high-ROE (return on equity) ones, as the equity was so understated.[16] That high ROE, along with the subsidized investment portfolio profits, allowed the share prices to grow, enriching the shareholders and generally enabling the GSE management teams to falsely portray themselves as highly effective financial institution managers deserving of very large compensation.[17]

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[12] In January 2006, this balance was $744 billion, as reported by the Federal Reserve Economic Data (FRED) system, produced by the Federal Reserve Bank of St. Louis.

[13] An attempt during 2005-06 by Alan Greenspan, then chair of the Federal Reserve, and the administration of George W. Bush to restrain this activity was defeated in Congress.

[14] One can never be sure of what the right capital level would have been at that time, given that the standards among bank regulators and others were generally low, but I would estimate at least double to triple the 45 basis points.

[15] The GSEs, prior to the establishment of the FHFA in 2008, were regulated over the years by a series of organizations, starting with the Federal Home Loan Bank Board and ending with the Office of Federal Housing Enterprise Oversight. These organizations lacked independence because Congress controlled their budgets. Lobbyists therefore targeted members of the relevant House and Senate committees to argue for the laxest regulation, with significant success. In this case, Congress not only itself directly specified the inordinately-low 45 basis points, but it also did not allow the regulator to increase it in the routine regulation of the companies. For more on this, see the testimony of Armando Falcon, the former GSE regulator, in front of the Congressional Financial Crisis Inquiry Commission, April 9, 2010, https://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0409-Falcon.pdf.

[16] Return on equity is the most important benchmark measure of the success and efficiency of a financial institution, and thus a big driver of its share price.

[17] Normally, creditors and others would be very concerned if an organization carried unduly low capital versus its risks. Such a situation would generate very low credit ratings, for example. But because the GSEs then carried the implied guarantee of the US Government, creditors only saw or cared about the AAA then given to the companies by the rating agencies based upon that implied support. In fact, this inflated credit rating allowed the companies to operate virtually free from market discipline. The only one at risk because of the low capital requirement was the

As best as I could determine some years later from my perch as a GSE CEO, the actual performance of the core mortgage business was quite mediocre.[18] In the pre-2008 politics around the GSEs, the policy antagonists of the two companies had claimed – in my view, with considerable justification – that the GSEs were more highly effective political organizations that extracted subsidies from the government than they were effective managers of the core mortgage business. This reality was hidden behind the GSEs' investing some of their massive subsidies to protect and expand those subsidies via extensive lobbying and other opinion-influencing activities, including brand image advertising. However, when the two companies were placed into conservatorship and their influence with Congress and the industry then effectively evaporated, the harsh reality finally came into public view and gained broader acceptance.[19]

And so there emerged a consensus, bipartisan as it was supported by both the Bush and Obama administrations during the critical years of 2008 to 2009, that conservatorship would be designed to eliminate these two major sources of subsidy and return the companies to their actual core mortgage businesses, and nothing else.[20] The support agreement put in place immediately upon their entering conservatorship in 2008 took a first step towards this goal by requiring a massive reduction of the size of their investment portfolios.[21] The portfolios are now down by over 75 percent (some portion still being needed to support the core mortgage businesses). A second step is the development of a full, post-2008 capital requirement that would no longer be intentionally understated. While the companies are in conservatorship, this requirement is called the "conservatorship capital framework" (CCF). Under it, the GSEs can operate as if they had a full level of capital required when making decisions about their risks;

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taxpayer, who was more likely to have to make good on the implied guarantee. This is, of course, exactly what happened in 2008.

[18] The indicators of the historic mediocre performance of the core mortgage business, at least at Freddie Mac, were things such as (1) antiquated technology, (2) returns on the risk being taken that were substandard (but optically looked good because of the inordinately low regulatory capital requirements), (3) an overreliance upon a limited number of price-sensitive large lender customers rather than on truly serving the full national market, and (4) no standard risk-adjusting of guarantee fees according to the riskiness of the borrower (until the mid-2000s), which is absolutely a standard practice for large financial institutions. More qualitatively, I also found a low level of innovation and competitiveness compared to private-sector financial institutions.

[19] The testimony of Armando Falcon (see note 15), their former regulator, was particularly enlightening on this point.

[20] This consensus about the conservatorship did not mean the corporate structure housing the core mortgage business would be unchanged. In particular, the Obama administration initially supported a "wind down" of the existing GSEs, which were to be replaced by something else that would do the core mortgage business in some to-be-determined fashion.

[21] This support agreement is most often called the PSPA (preferred stock purchase agreement). It required the shrinkage of the investment portfolios to under $250 billion each for the two companies. As conservator, the FHFA has required additional shrinkage.

the CCF's requirement is between three and five times as high as the previous requirement of 45 bp. For post-conservatorship, a capital rule is under development by the FHFA; as of now, the latest version of this rule requires a considerably higher level of capital even than the CCF.

The import of all this is that, in raising equity post-conservatorship, the GSEs will be able to point only to their core mortgage business as the driver of revenues, profits and ROE; importantly, the ROE will no longer be inflated by a too-low level of required capital.[22] Thus, the two big pre-2008 subsidies will have been substantively stripped away from the two companies. In effect, the value proposition to potential new investors in any new common stock issue will in no way resemble what existed prior to 2008 – they are really very different investment theses.[23]

These new policies will also raise the bar in that equity investors will be looking carefully at that core mortgage business, and not assuming that any profit-reducing burdens placed on the companies by Congress or others (i.e., placing on them what are in essence unfunded mandates or hidden taxes) will somehow be more than compensated for by hidden subsidies received by the companies, as the latter have been eliminated. In these circumstances, it is crucial that the political actors in Washington (primarily the FHFA, White House, Treasury, and Congress) both (1) set up clear and stable rules under which that core mortgage businesses will operate going forward, and (2) not produce (or appear likely to produce) a stream of unfunded mandates, taxes or other special burdens upon the GSEs that will reduce ROE below what investors require. If these conditions, needed for the two companies to operate as reasonable commercial enterprises, are not put into place, then equity investors just won't know enough or have the confidence to ever get comfortable with any reasonable valuation of their shares.[24]

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[22] Some would point to a third source of subsidy: the fact that, due to government support (implicit in the pre-conservatorship era, but explicit via the PSPA since), the MBS and unsecured debt of the two companies are treated by the marketplace as "almost as good as US Treasury" debt – that is, with interest rates at a level below what a normal large financial institution would be required to pay. This government support is a very real source of subsidy; however, by the market structure of how the GSEs' core mortgage businesses actually operate, the benefit of this subsidy, instead of accruing to the GSEs' bottom lines, is passed almost wholly on to primary market mortgage lenders, with the hope that through competition among those lenders that it then gets substantively passed through to homeowning borrowers in the form of lower mortgage interest rates.

[23] The pre-2008 investment thesis in reality was something like "heavyweight political operator that, based upon its core mortgage business having high policy and political value to the public and thus elected officials, extracts far more in hidden subsidies than it is required to pay out to maintain the needed political support." The post-conservatorship investment thesis will be something like "the core mortgage business is well-run, producing a proper return on the risk taken while meeting its charter-required mission."

[24] Unease in such a situation can conceptually be addressed by lowering the share price in an offering to the point of its being little more than a "give-away." But such a move would have major negative implications, such as driving a large increase in required guarantee fees. I am therefore assuming in this article that the government wants to get a reasonable price for the shares of the company in any type of common equity issuance.

Possible Sources of Business Model Volatility and Burdens

I have identified five "risk factors" (as they are known in the securities underwriting business) that present real challenges to the process of raising extremely large amounts of common equity. Four relate to what I deem to be "business model volatility" – that is, investors will be subject to an unusually large degree of uncertainty about how revenues, expense and ROE are going to be produced in the future. The fifth is an example (currently discussed among more progressive Democrats) of a burden (i.e., an unfunded mandate) that would distort the operations of the companies, increasing risk and reducing revenues and profits.

Government Policy Instability

With such extensive government involvement in housing finance, the GSEs are subject to policy changes that can emanate from Congress, from the FHFA (temporarily as conservator, permanently as regulator) and from the presidential administration to some degree (usually through Treasury). It is obviously important for investors to have policy stability: they need to know what business model they are investing in. If the model is changing continually, it presents a risk well above what is usual for commercial enterprises, even regulated ones.

Unfortunately, right now, the odds of an outsized risk of continuing policy changes and instability are high. Consider these two examples.

FHFA Single Directorship

The FHFA is currently led by a single director, nominated by the president and confirmed by the Senate. The position is designed to be independent in the same way as the leadership at other regulatory agencies, which means that the director's term is fixed and he or she is removable only "for cause." Even putting aside a current Supreme Court case about that position (which could end its independence), the single-director model is more unstable in terms of policy than the more common "commission" model (such as used by the Securities & Exchange Commission, the Commodities Futures Trading Commission, and the Board of the Federal Reserve System). We have already seen that instability with the current director, a strong libertarian and Republican partisan by background, pushing many policies in the direction he feels warranted, but which are quite different from those of his predecessor, who was a long-time Democratic member of Congress.

With the director having the power of being the conservator, the two GSEs are even more subject to policies that zig-zag (i.e., materially change) with each new FHFA director

appointed. A great example of this zig-zagging is the development of a regulatory capital requirement to apply to the GSEs: the current proposal from a Republican-appointed director is about 80 percent higher than the one from the preceding Democratic-appointed director.

This instability is an obvious risk factor for investors. They are accustomed to more stable policies that reflect the commission structure, with respect to which the FHFA is now a high-risk outlier. One can hope that Congress, seeing the problem and the outcome of a relevant Supreme Court case, will shift the FHFA to a commission structure; unfortunately, no such effort seems to be in the works currently.

Congress and the Administration

The simple reality is that the history of the two GSEs, as explained above, was dominated by a political bargain: the two companies got massive hidden subsidies, and then Congress, with presidential administration involvement, intervened in their affairs to direct the spending of some of those subsidies.[25] Sometimes, this intervention took place through formal legislation (such as the affordable housing goals, later joined by the "duty to serve" obligation), and at other times through various congressional or administration influencing tactics, including individual members of Congress threatening legislation if the GSEs or the FHFA did not head in some desired direction.

However, as explained above, this historic political bargain is no more – the conservatorship and most plans to release the two GSEs from conservatorship do not include receiving such hidden subsidies anymore. They are gone, presumably not to return. But who says Congress or some future presidential administration "got the memo" – why should investors expect such political actors to cease putting unfunded mandates or other burdens either formally or informally upon the two GSEs, when they have become habituated to doing so over decades? In fact, for the politicians dedicated to expanding access to LMI households, as one observer put it to me, "using the GSEs is too tempting to not meddle," and so expecting congressional self-discipline now that the hidden subsidies are gone is perhaps too big a leap of faith.

A great example of such meddling occurred in 2011, when Congress passed the Temporary Payroll Tax Cut Continuation Act. In this act, Congress cut payroll taxes and included various mechanisms to help pay for it. One of those mechanisms, which financed just months of

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[25] The net result was for Congress to direct spending that was "off budget" (i.e., it appeared nowhere in the federal budget) because it was housed in the shareholder-owned GSEs.

the tax cut, required the GSEs to add 10 basis points to their guarantee fees for the next ten years and then remit the amount directly to Treasury.[26] This clause was inserted, according to those in Washington at the time, "in the dead of night," so that housing industry lobbyists had no time to attempt to counter it. It is considered a great example of how Congress treats the GSEs differently than it does normal private-sector companies.

While this example might be dismissed because it occurred almost a decade ago, when many views about the GSEs were different than they are today, right now there is a push by progressives looking to convince a potential Biden administration and Democrats in Congress to dramatically raise a fee charged to the two GSEs to increase the funding of a government affordable housing trust fund.[27] Where are the GSEs to get the money to pay the increased fees, as there are no more hidden subsidies to generate the cash to pay for them? The only answer is some combination of higher guarantee fees to homeowners or lower returns to investors. And if guarantee fees are to be set by the FHFA, as is possible in many future scenarios, then why should investors believe there won't be political pressure on the FHFA that results in a bias to finance the increased fees disproportionately by lowering the returns to investors?[28]

At a more strategic level, investors buying the equity of the two GSEs as part of a plan for their exit from conservatorship by administrative means run the risk that there will be legislation that could disrupt the entire GSE system. Maybe the two companies will be "wound down" and replaced by something else (which was the policy of the Obama administration); maybe new ones will be created so there are four or five or six of them (which was the basis for many proposals from 2009 through about 2016). It is unclear how an administrative-means program of GSE reform can eliminate this risk.

[26] This means that Congress raised taxes on homeowners by the dollars collected through the 10 bp requirement, but did so in a very disguised manner: homeowners don't really know that their mortgage rate is a bit higher than it might have been. In that sense, this form of tax increase is quite clever. It is also arguably, in a good government sense, low-rent because Congress is intentionally misleading the voters.

[27] See Andrew Ackerman, "Where Trump and Biden Stand on Mortgage Finance," *Wall Street Journal*, October 8, 2020, https://www.wsj.com/articles/where-trump-and-biden-stand-on-mortgage-finance-11602158413?mod=politics_lead_pos10. The article references an increase of $20 billion, presumably over the ten-year horizon of Federal budget calculations – thus about $2 billion per year. This is the equivalent of increasing the corporate tax rate on the GSEs by between 5 and 10 percentage points.

[28] It is clear that the people making this proposal are working under the habits developed over the decades before conservatorship ended, when there were large hidden subsidies from which such payments could come while not impacting either borrowers with higher guarantee fees or investors with lower returns.

The net result is that investors are looking at policy instability that is, in my view, materially higher than is usual for regulated industries like banks or insurance companies or electric utilities. The risk that this policy instability will come at their expense, reducing returns, is considerable.

Unstable Capital Requirement

The general concept of policy instability, just described above, is front and center in the regulatory capital requirement to be placed on the GSEs by their regulator, the FHFA. The simple reality is that for a regulated financial institution, the regulatory capital requirement's details matter tremendously in driving its business model.

A regulatory capital requirement has two key features it should strive to "get right." The first is the overall level of the capital required, which should – according to post-2008 best practice – allow it to survive a "severe adverse" economic scenario and *still* have enough capital left over to maintain the confidence of the marketplace. The GSEs have guarantee fees that are currently designed to produce an acceptable return (or "a fair return" in the parlance of utility-style regulation) of about 9 percent to the shareholders based upon the CCF (the capital requirement utilized by the FHFA under its previous director). If the current director, Mark Calabria, finalizes a new capital rule without significant revision to what he proposed earlier this year, which requires capital about 80 percent higher, then the ROE produced will drop well below 9 percent. It will then take years for higher guarantee fees to finally get the ROE of the company back up to the 9 percent range – maybe five or more years.[29] Until that point, the company will be "earning less than its cost of capital," which for a financial institution is a very big negative to shareholders. That is going to be a large barrier to successfully raising equity at a reasonable price for years to come.

The current regulatory proposal, however, is highly controversial, and it has been widely criticized as outside the mainstream of financial regulatory thinking (a criticism with which I agree). That controversy leaves great uncertainty, as the first time a Democratic president gets to appoint a new FHFA Director, the capital proposal will likely get revamped as one of the first orders of business. That revamping could return it to something more in the mainstream, or perhaps go to the opposite extreme,

[29] Since the GSEs can't re-price old mortgages, they simply price up new ones and then have to wait years for the portfolio to turn over, with the older mortgages at lower G-fees slowly replaced by newer ones with higher G-fees.

pushing the capital requirement down unduly to "help homeownership," a practice last seen in the years prior to 2008. Such zig-zagging would be a tremendously impactful source of policy uncertainty.[30]

The second of the two key features a regulatory capital requirement has to get right is in the microeconomics: it must incent incremental risk-versus-reward decision-making that is consistent with the actual economics and not falsely distorted. Historically, the classic failure to do this has been found in capital regimes that are based upon an accounting leverage ratio, which treats high-, medium- and low-risk assets all the same, generating an incentive for lenders to load up on high-risk assets.[31]

The current FHFA proposal gets this feature of a regulatory capital requirement almost wholly wrong. Its anti-CRT bias is one example (as described below). Its usage of floors and ceilings and buffers is a mish-mosh that makes it almost impossible to cleanly figure out what the incremental capital requirement actually is on any particular proposed transaction, with all sorts of discontinuities possible. And its purposeful design to have the accounting-based leverage ratio be not just a back-stop but actually binding upon the companies is also problematic. In other words, the actual incremental economics is substantively lost in the complexity of the proposal.

Thus, the regulatory capital requirement is likely to immediately go into revision, with probably large changes, the first time there is a new director of the FHFA appointed by a Democratic president. And these changes are both about the total level of capital and also the incremental economics that drives decision-making. How, in such an unstable environment, are the managements of the two companies to pursue long-term shareholder value?

This instability will present potential equity investors with more risk than they are used to in regulated industries, a definite negative for raising equity in the record-setting amounts required.

Which Business Model: CRT or "Buy and Hold"?

The GSEs, prior to conservatorship, had a business model known as "buy and hold." In their case, they passed-through interest rate and liquidity risk on their securitized mortgages by issuing their MBS (excluding the large amount they bought back and put in their own investment portfolios) but held on to

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[30] Barring a reconfiguration of the FHFA to be run by a commission (which would require legislation), we can only hope that a Democrat-appointed FHFA director, to attain the kind of policy stability any regulated industry deserves from its regulator, will propose a capital requirement that is mainstream rather than controversial for being too low.

[31] Randal Quarles, vice chairman for supervision at the Federal Reserve, has made several speeches which assert that risk-based measures should be dominant, with a leverage ratio requirement as only a "backstop" to them. See, for example, his speech "Refining the Stress Capital Buffer," September 5, 2019, https://www.federalreserve.gov/newsevents/speech/quarles20190905a.htm.

all the mortgage credit risk – immense amounts of it. At the time they went into conservatorship, over $4 trillion of mortgage credit risk was concentrated in the two companies; such an extreme level of concentration is counter to normal large financial institution regulation and even to smart financial institution management.

With the advent of credit risk transfer in 2013, and its later evolution, the business model has changed. The GSEs now largely have a "pass-through" business model: passing through most credit risk to broadly diversified investors, along with passing through almost all interest rate and liquidity risk. This model is attractive to equity investors, because it means that the profits of the companies are materially less subject to cyclical downturns in the mortgage credit cycle, and certainly much less critically exposed to some severe crisis situation such as 2008 – and equity investors highly prize earnings stability.

However, this is now all in flux. The FHFA's recent capital proposal has been heavily criticized for revealing a strong and unexpected anti-CRT bias, seemingly eliminating almost all the benefit of CRT in terms of the capital required on the underlying mortgages.[32] The impact of this proposal would likely be to eliminate CRT as being economically viable. (In other words, it falsely distorts the economics so that CRT becomes unattractive to do.) If this proposal is allowed to stand in the final capital rule, the business model would likely revert to mostly "buy and hold," which is a much less investor-attractive proposition.

So, as of now, it is unclear what business model investors would be looking at: buy and hold, or CRT-driven pass-through? Investors will clearly have less appetite for the former than for the latter.

I also note that this result reflects a somewhat extreme view that is not broadly shared in the financial community. If the anti-CRT bias is left in the proposed capital rule now being finalized by the FHFA, it will not only create an impediment to raising large equity amounts in the capital markets, but it will also likely be reversed the first time a Democratic-appointed FHFA director (or even, potentially, a different Republican-appointed one) is put into office. This all muddies the ability of investors to figure out exactly what business model, with what economics, they are investing in.

[32] The criticism comes from both Democrat and Republican officials, among many others.

Utility-Style Regulation: If So, How?

There is currently an unresolved contradiction in the plan of the current administration to eventually have the two GSEs exit conservatorship and become fully capitalized: as a duopoly with limited competition, what will prevent them from raising their guarantee fees inordinately?[33]

The Trump administration, in its September 2019 plan addressing GSE reform via legislation, indicated it wanted to have more than two GSEs competing, although there were no specifics about how such additional firms would come about.[34] The idea was that competition among a larger number of firms (perhaps five or six were hoped for all together) would provide market discipline to keep guarantee fees in line.[35]

But with administrative reform, such new firms cannot be created, as doing so would require legislation. Thus, many industry observers have supported the idea of the FHFA's regulating guarantee fees, much as a state-level public service commission regulates electric utility rates. However, the current administration has not come out and said it supports such an approach in its administrative reform program. We thus have a policy vacuum and contradiction on the issue.

Until the issue is decided, investors again won't know what business model they are investing in.

If the administration does begin to support utility-style regulation, how would it work and how can investors be assured it will be run with due regard for their interests? Even advocates of utility-style regulation of the GSEs have never specified how it would work. Just looking at state-level infrastructure for regulation of utility rates, there would be a lot of formal administrative process to build. Will there be a clear (and not easily changed) policy, as is usually embedded in the legislation governing a state-level public service commission, that investors must get a "fair return"? How will that allowed "fair" rate of return on the equity needed to support the business be determined? How often will rates get revised? Who will measure and establish how much mortgages with more or less risk will be priced up or down to reflect that risk – the companies or the FHFA? At the state level, public hearings and a long

[33] This rise in fees would happen via "implicit collusion," a well-observed phenomenon, as overt collusion is illegal. By its nature, a duopoly will either head towards high pricing via implicit collusion, or very low pricing via a fight for market share; it is impossible to tell ahead of time which will result.

[34] For a new entrant, competing with the two large, entrenched incumbents would be daunting. Raising large amounts of equity to do so would be even more daunting, as it is not obvious how the new firms would become profitable in any reasonable time frame. In the aftermath of the failure of the Corker-Warner proposal in 2014, I heard quite a few of its supporters then realizing that the assumption of new firms showing up to compete (as assumed in that bill) was in fact quite questionable. For more on this topic, see my earlier paper from September 2019, "How Deep Is the GSE 'Economic Moat'?," https://www.jchs.harvard.edu/blog/how-deep-is-the-gse-economic-moat.

[35] FHFA Director Calabria has repeatedly asked Congress to give his agency the ability to issue new charters for additional GSEs. It is, however, unclear whether any firms would actually seek out these charters.

body of precedents give investors comfort that their interests will be reasonably respected. Will the same be true at the FHFA level when no one has specified any details of how it will all work?[36]

In other words, there's a lot of business model uncertainty that needs to be filled in for investors to know what they are investing in.

Lobbying Restriction: The Unlevel Washington Playing Field

America's housing finance system is dominated by the government, which supports the credit of two out of every three dollars of single-family first mortgages in the country. And government support goes beyond that – for example, it also supports the liquidity of owning mortgages via the Federal Home Loan Banks (FHLBs) on about another $1 trillion.

As a result, politics and lobbying play an outsized role throughout all of housing finance. Every type of firm involved in mortgages – the mortgage insurers, the banks that originate and/or service mortgages, the non-banks that originate and/or service mortgages, and so on – has historically had its own lobbying group (and sometimes more than one) in Washington, angling to increase revenues and decrease costs and risks for their members. This lobbying happens within a larger and thus more politically influential housing ecosystem of interest groups, including realtors and homebuyers most prominently, that is almost always willing to support efforts to increase the availability or cheapness of mortgage credit.

Prior to 2008, the two GSEs may well have been the most powerful lobbying group among all those in the mortgage industry. The stories of how they influenced Congress to an uncomfortable degree, and of how they were able to stymie attempts at more intrusive regulation, are legend inside the Beltway. One ex-congressman told me they were just "bullies".

This all came to a screeching halt in 2008, when the government put the GSEs into conservatorship and prohibited them from lobbying.

Unfortunately, this change became a form of what politicians sometimes call "unliteral disarmament," for while the GSEs were prohibited from lobbying, every other group in housing finance continued to do so. Not unexpectedly, some of that lobbying became focused on taking the revenues

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[36] For investors to feel their interests are protected, and thus be comfortable investing in a regulated utility, the state public service commission regulation process is grounded in specific laws (e.g., promising a "fair return") and substantial required administrative processes. In contrast to these relatively transparent and required processes, decisions that might affect investors at the GSEs currently happen merely at the FHFA's discretion, and especially at the discretion of its single director. This approach would, in my view, not be adequately attractive to investors. A commission approach would be an improvement, and lots of policy infrastructure would also have to be built.

and profits of the GSEs and redirecting them to other industry groups.[37] The FHFA, as conservator of the two companies, to fend off such attempts then had to educate the relevant members of Congress about the real facts of the situation (in contrast to the claims of special interest lobbyists) so that it all did not get out of hand.

With the GSEs exiting conservatorship in the future, what will be the fate of all this? Will Freddie Mac and Fannie Mae get right back into massive lobbying, not just defensively to counter attempts to capture their revenues and profits, but also offensively to push for unfair advantages for themselves? Fearing the latter, some proposals for GSE reform would, even after conservatorship ends, prohibit the GSEs from lobbying – leaving the "unilateral disarmament" in place but without even the FHFA, as conservator, to act in their stead to balance things out.

It's a tough tradeoff. If the GSEs are prohibited from lobbying, then the attractiveness of investing in the two companies goes down: there could be a steady drain on revenues and profits as other groups in the industry, still doing extensive lobbying, eventually chalk up several "wins" for themselves. On the other hand, if the GSEs are not prohibited from lobbying, there is a risk that they will become "bullies" again, gaining unfair advantages for themselves.

Whichever way it goes, investors need to know about lobbying restrictions beforehand to be able to judge the value of the shares of the two companies. And right now they don't. That's more uncertainty and volatility in their business model.[38]

Mandated Cross-Subsidies versus Market Share

In purchasing mortgage loans, the two GSEs – as shareholder-owned companies, even if currently in conservatorship – naturally try to risk-adjust their pricing: that is, they charge appropriately more for higher-risk mortgages and appropriately less for lower-risk ones. All large financial institutions do so – and they would be criticized by their regulators if they did not![39]

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[37] I once heard a colloquial phrase in Washington about this type of situation (which builds upon the observation that, in a poker game, if you don't know who the sucker is, it is you): "If you are not sitting at the table when the lobbyists get together for lunch, you are the lunch."

[38] Personally, I view the utility model as the one most likely to allow the GSEs to lobby to defend themselves without causing a repeat of the pre-2008 years, when they were rightly considered to gain unfair advantage via their lobbying efforts. This balance could be achieved because the FHFA, as the utility regulator, would have tools to dampen excessive lobbying (e.g., disallowing the expenses of lobbying from being recouped in guarantee fees).

[39] Because of the unusual policy and political background of the GSEs, they did not do significant risk-adjusting until the mid-2000s, just before the Financial Crisis of 2008. They now do so thoroughly, just as any private-sector lender would.

In conservatorship, however, the FHFA (as conservator) controls the amounts of risk-adjusting, and it has set these amounts to create a series of internal cross-subsidies that fit a policy objective of expanding access to mortgage credit to a certain degree. First, the GSEs overcharge for mortgages with low mission-value, such as cash-out re-financings, investment properties and second properties. Second, they also overcharge modestly for lower-risk mortgages (i.e., the rates on such mortgages are lower than average, but not as much as the historical statistics of losses would justify); the benefit of these overcharges then goes to reducing the amount by which high-risk loans are charged extra (versus what the historical statistics of losses would justify).[40]

These cross-subsidies accommodate the political environment around the GSEs, although it is troubling that the cross-subsidies are not authorized by Congress and not at all transparent to the public.[41]

It is unclear what would happen to these cross-subsidies upon exit from conservatorship. If the FHFA acts as a utilities-style regulator and sets guarantee fee pricing, then at least the cross-subsidies that they approve would presumably become transparent to the public. If the FHFA does not act as a price regulator, then it would be normal practice in a competitive market for the GSEs to adjust guarantee fees based strictly on the economics, rather than on someone's notion of what is a good social policy. There would likely be a lot of politics about such a happening, as left-leaning groups do not want to see the existing cross-subsidies reduced.[42]

In fact, there are proposals among some progressive members of the housing finance policy community to mandate that the GSEs use not just today's level of cross-subsidization but a greater level, even potentially mandating "flat pricing" – that is, there would be *no* risk-adjusting of mortgage interest rates.[43] Such flat pricing already exists at the Federal Housing Administration, which of course is a unit of

[40] The overcharging of loans with low mission-value is not particularly controversial. The cross-subsidy from low-risk borrowers to high-risk ones is.

[41] In fact, it takes an immense amount of analytical calculation power to even estimate who is paying more than the economics say and who less. See Michael Stegman and Richard Cooperstein, "A Missing Piece of the Administrative Reform Puzzle: How the GSEs Generate Cross-Subsidies," Joint Center for Housing Studies of Harvard University, October 2019, https://www.jchs.harvard.edu/sites/default/files/media/imp/harvard_jchs_gse_cross_subsidies_stegman_cooperstein_2019.pdf.

[42] For those who believe higher-risk borrowers should be subsidized given the undisputed social benefits of homeownership, the proper (i.e., "good government") policy would be an on-budget subsidy from the taxpayer administered through the two GSEs. This would ensure the subsidy was transparent and that it came about from a democratic process (i.e., a vote in Congress). Hidden cross-subsidies rarely, if ever, meet a "good government" test.

[43] See for example Adam Levitin, "How to Start Closing the Racial Wealth Gap," *The American Prospect*, June 17, 2020, https://prospect.org/economy/how-to-start-closing-the-racial-wealth-gap/; and Michelle Aronowitz, Edward

the Department of Housing and Urban Development, and as such does not need to adhere to competitive private-market practices.

Putting aside whether the existing cross-subsidies are a good thing in terms of public policy, or whether more cross-subsidies up to and including a flat guarantee fee would be better or worse, this practice is counter to what a normal, shareholder-owned financial institution would do. More than a minimal level of cross-subsidies would mean that the GSEs would gain market share in high-risk loans (which they would be pricing lower than economically justified) and losing market share in low-risk loans (which they would be over-pricing).[44] Since the increased market share in high-risk loans would be underpriced, this would in particular be something that equity investors would not be happy with as it will generate poor risk-adjusted returns for shareholders.

These dilemmas arising from cross-subsidies reflect the GSEs' history as hybrids: partly shareholder-owned companies and partly government agencies. These roles don't always mix well: a flat guarantee fee requirement (or an unduly large cross-subsidy from low-risk to high-risk loans) might well be appropriate for a government agency, but is absolutely not for a shareholder-owned company. Thus, the more the situation seems to smack of the government forcing cross-subsidies as if the GSEs were just part of the government itself, the more investors will not be interested.[45]

So, this is another issue that needs clarification – and not just for a moment in time but for the long term – if it is to avoid being yet another a major risk factor that scares away private capital.

Conclusion: A Bias Towards Retained Earnings Is Warranted

The above list of "risk factors" makes clear that the GSEs' ability to raise equity from new issues, rather than patiently allowing retained earnings to accumulate, is today heavily burdened by very significant

L. Golding, and Jung Hyun Choi, "The Unequal Costs of Black Homeownership," forthcoming in the National Association of Real Estate Brokers "2020 State of Black Housing in America Report," and available at http://gcfp.mit.edu/wp-content/uploads/2020/10/Mortgage-Cost-for-Black-Homeowners-10.1.pdf.

[44] The expectation is that the high-risk loan market share would increase at the expense of the FHA and VA and of the PLS markets, and that the low-risk loan market share would be lost mainly to banks holding them in portfolio.

[45] Just prior to publication of this paper, the FHFA announced that it was looking to create a new rule (which updates an earlier, less stringent one) that any broadly defined new products or activity must be reviewed by the FHFA as a regulator (i.e., the rule will survive after conservatorship) to determine whether the activity merits a "formal public notice and comment period," which can easily take six months or more (see https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Proposes-Rule-for-New-Enterprise-Products-and-Activities.aspx). Such a lengthy period for review is of course appropriate for government agencies but not for a private-sector company: it would hamstring the GSEs' ability to innovate and move fast, and it would give every special interest in the housing finance community an opportunity to stop anything that would hurt their revenues and profits. This rule would therefore be another detriment to the GSEs' ability to raise capital.

business model and policy uncertainties. The simple fact is that it could be some years before the "new" (meaning post-conservatorship) GSEs have settled in, with all the aspects of their business model being known with certainty enough for global equity investors to understand – and hopefully like – what they are being asked to buy into. Right now, by comparison, the uncertainties just seem too great – and they are exacerbated by the zig-zagging that results from having a single FHFA director rather than the more stable commission model. Furthermore, it is quite unknown when these uncertainties might be adequately resolved.

An additional problem arises from the "secondary" sales of GSE common shares by Treasury.[46] This paper, like almost all on the topic, focuses on the GSEs' building up their capital (known as a primary capital raise). What is left unsaid is that, no matter how primary capital raising is planned and executed, the reality is that Treasury will end up owning a large share of the two GSEs, as it currently has a warrant to purchase 79.9 percent of each, and may end up with additional shares depending upon the resolution of the treatment of the $200 billion-plus of senior preferred stock that Treasury also owns. At some point, Treasury needs to sell all those common shares, thus competing with the primary capital raising of the two GSEs indirectly if not directly. These secondary sale amounts are also immense, dwarfing what would be the normal size of such transactions.

Thus, it might seem that the complexities of raising sufficient equity for the GSEs add up to an almost insoluble dilemma.[47] It may very well be, but only if we restrict ourselves to focusing on raising equity primarily, even in the early years of the recapitalization process, through new securities issues. If, instead, we focus more on relying upon retained earnings, especially in the early years, a more likely-to-succeed path does emerge.[48]

A primary capital-raising strategy based heavily upon retaining earnings continually for as long as needed, which of course has actually been underway for over a year now, is simpler and more reliable, and would hopefully allow many of the business model uncertainties listed above to be put to bed over the next three to five years (which is the minimum it will take). Then, some years out, when

[46] In the equity markets, "primary" equity issues are those from which the money raised goes to the company, thereby increasing its net worth, while in "secondary" equity issues, an existing shareholder sells the shares, so that the money raised goes from new shareholders to old, with none "sticking" to the company.
[47] A further complication is that there are, of course, two companies that need to raise equity. Coordinating the two, so that the success of the primary capital raising of one doesn't come at the expense of the other, is also an unprecedented challenge.
[48] The present focus is so much on new issue equity for a few reasons: the desire by many to get it all done as quickly as possible; the push by Wall Street firms to earn what may very well be record underwriting fees; and the media's focus on potential record-setting new issues. By comparison, a strategy based upon retained earnings is simply boring.

the picture is clearer because the major "risk factors" would have been significantly reduced and a track record of the "new" GSEs' performance established, a decision can be made about how to further proceed. Perhaps then Treasury will use the public markets to sell its shares on a secondary basis while the GSEs continue to exclusively utilize retained earnings to build capital. Or perhaps each of the GSEs will then be in a position to do a single new issue of equity that can "put them over the top" (i.e., have enough capital to meet all regulatory requirements); Treasury would then afterwards have an all-clear to sell its shares on a secondary basis without competing with the GSEs' need to raise further equity as well.[49]

The biggest objection I have heard to this approach is that it would take many years for retained earnings to build up – maybe even a whole decade.[50] That does indeed seem like a long time. But the GSEs have already been in conservatorship for over twelve years, and any exit – due to complexity, as well as other reasons – is already looking like a long affair. Letting today's earnings retention continue into the future while Washington tries to figure out GSE re-privatization (or maybe even starts the whole thing over in a Biden administration) just reduces the burden of capital that would eventually need to be raised through new issues. In fact, continuing today's earnings retention would tend to simplify the whole process of the GSEs' exit from conservatorship.[51] An emphasis on retained earnings thus begins to look better than the alternatives – more consistent with having a stable and well-functioning mortgage system during the first years of conservatorship exit.

And as a way to build up the GSEs' capital, earnings retention will work! Simply put, while many things can delay or make impossible equity raising through some IPO-like mega-sized issuances, few things can derail a strategy heavily based on retained-earnings.

[49] One specialist who has studied how the GSEs can recapitalize recently told me that it will take several equity issuances per company to get to fully capitalized status. Only by having earnings retained for many years first (at least five) would it therefore be possible that a single equity issue could "put them over the top".
[50] It is impossible to predict how long with any accuracy. Beyond general uncertainty in forecasting profits many years out, until there is a decision about what fee the GSEs will pay to Treasury for PSPA support going forward, earnings just can't be predicted with any confidence at all.
[51] The current limit of $45 billion for the retention of earnings ($25 billion for Fannie Mae, $20 billion for Freddie Mac) should therefore absolutely be eliminated, allowing the long-term buildup of equity.