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Portfolio

[tag] Checks and Balances

[hed] The GSE conservatorship should end now

[dek] After 15 years, the federal government should end its conservatorship of Fannie Mae and Freddie Mac. The conservatorship prevents these government-sponsored enterprises from operating like a privately run corporate entity.

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A lot has changed since Fannie Mae and Freddie Mac entered into a federal conservatorship. What hasn’t changed is the need for the federal government to follow established law and ensure its conservatorship of Fannie and Freddie is temporary.

After a 15-year conservatorship that has subjected Fannie and Freddie to political influence and compromised their founding purpose of expanding the secondary mortgage market, the time has come to end what was intended to be a short-term timeout for the enterprises.

[subhed] The road to conservatorship

On Sept. 6, 2008, the real estate market was cratering, property values were deteriorating and foreclosures were rising rapidly. By the end of the month, Lehman Brothers, Bear Sterns and Washington Mutual would fail due to their involvement in subprime mortgage lending.

Fannie Mae and Freddie Mac were experiencing rising defaults as lax underwriting and overvalued properties proved to be a toxic mix. The government-sponsored enterprises (GSEs) were seeing their stock prices tumble as their losses rose, and GSE investors in mortgage-backed securities began to exit the market, pushing mortgage rates up further and crippling the housing market in the process.

To calm the housing market, the Treasury and the newly formed Federal Housing Finance Agency (FHFA)—announced the conservatorship, saying it would be a short-term “timeout.” This move would reassure investors, help stabilize the mortgage market and provide a lifeline of equity to the GSEs to support their operations and help them work through their mounting defaults and losses. Once they were stable, they would be released from conservatorship.

The strategy worked. The housing market stabilized, with the GSEs eventually drawing $180 billion from the Treasury between 2008 and 2012. The U.S. government would end up with a like amount of senior preferred stock warrants from the two companies, granting the government 80% ownership of Fannie and Freddie, which they still have today.

[subhed] The return to profitability

In late 2012, both companies returned to profitability, and in 2013 they began to repay their debt to the Treasury. By 2017, the GSEs had completely repaid all the aid they received plus a 10% dividend.

Initially there were calls from policymakers and others to “reform” the GSEs through legislative action. Congress debated but never voted. The reason was simple—the market was working well, and no one wanted to ruin it.

Moreover, the government had discovered that the GSEs were a great source of cash for various initiatives that could not get funded through the normal appropriations process. In fact, when the FHFA and Treasury realized the GSEs would soon return to profitability in 2012, they changed the terms of the GSEs’ bailout agreement to require them to sweep all excess earnings to the Treasury, preventing the rebuilding of equity capital.

This contract is still in place and has only temporarily been paused until the GSEs are fully recapitalized. Then the net-worth sweep resumes in perpetuity.

[subhed] Fifteen years is enough

After 15 years of a resilient housing market, it’s time for the FHFA and Treasury to return the GSEs to private ownership and control, as required by the 2007 Housing and Economic Recovery Act.

First, ending the conservatorship will ensure Fannie and Freddie focus on their founding purpose of expanding the secondary mortgage market. The GSEs currently serve as cash machines subject to political influence, sending revenue to the Treasury to pay for things unrelated to housing—such as the 2021 infrastructure bill. And because the FHFA director effectively runs both companies and answers to the president, the GSEs serve as a de facto arm of the administration to further its policy agenda.

As conservator and regulator, the FHFA can also dictate credit, pricing and operational policy, in addition to its customary safety and soundness responsibilities. This type of control can have unintended consequences, destabilize the mortgage market and put taxpayers at risk.

Meanwhile, the GSEs cannot access the capital markets to raise outside equity. So, they remain in a netherworld between being able to operate like any other federally chartered, shareholder-owned, privately run corporate entity (which they are) and a government agency run by political appointees, similar to the Department of Housing and Urban Development or Ginnie Mae.

[subhed] The road ahead

It has been 15 years since the GSEs were placed into conservatorship. Based on current earnings, it will be at least another 10 years until they are fully recapitalized per the GSEs’ capital framework. Unless something changes, the net worth sweep will then resume.

At the Hotel California, you can check out anytime you like, but you can never leave. FHFA and Treasury need to follow HERA, resolve the Treasury’s ownership, acknowledge it’s paid in full and release the GSEs from conservatorship. If not, they too will never leave.

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