TREASURY, THE CONSERVATORSHIPS AND MORTGAGE REFORM

By Timothy Howard

There are two competing approaches to setting up a secondary mortgage market mechanism to succeed the one in place prior to the 2008 financial crisis: (a) legislative reform that would replace Fannie Mae and Freddie Mac with a de novo system, such as the one proposed by Senators Johnson and Crapo, and (b) administrative reform that would make structural and regulatory changes to Fannie Mae and Freddie Mac but keep them as the centerpieces of conventional secondary mortgage market financing.

The main argument for legislative mortgage reform is that Fannie Mae and Freddie Mac are a "failed business model" that needs to be replaced with a more reliable mechanism. But many proponents of this alternative, in defending it, badly distort the history of the financial crisis. In this paper we briefly discuss three important issues that are widely misunderstood or mischaracterized in the reform debate:

- Treasury's actions to place Fannie Mae and Freddie Mac into conservatorship were fundamentally different from Treasury and Federal Reserve interventions in support of commercial and investment banks during the financial crisis. Intervention in support of banks was done in response to sudden and uncontrollable liquidity crises that required immediate government assistance to keep the companies from failing, and involved actions and tools intended to achieve that result (not always successfully). The act of placing Fannie Mae and Freddie Mac into conservatorship was not a response to any imminent threat of failure but rather a policy decision initiated at a time of Treasury's choosing, and involved actions and tools intended to make and keep the companies insolvent.

- Convincing evidence exists that the conservatorships of Fannie Mae and Freddie Mac were planned well in advance, and that they were intended to remove the companies permanently from private ownership. There also is clear prior history of OFHEO and its successor agency FHFA following the dictates of Treasury in its dealings with Fannie Mae and Freddie Mac.

- The motive behind the third amendment to the Treasury-FHFA senior preferred stock agreement was made evident by its timing, coming as it did just ten days after Fannie Mae announced sufficient second quarter 2012 earnings not only to pay its $2.9 billion quarterly senior preferred stock dividend but also to add $2.5 billion to its capital. Coupled with strong and growing revenues, rising home prices in the first half of 2012 meant that the pessimistic assumptions that had driven earlier decisions to write down assets, add huge amounts to the loss reserve, and establish a valuation reserve for deferred taxes no longer were supportable. Treasury and FHFA entered into to the third amendment to ensure that when many of these write-downs were reversed it would be the government, and not Fannie Mae's shareholders, that would benefit.

The Fannie Mae takeover was unlike any other financial institution rescue

All of the individual financial institution rescues (or failures) during the 2008 crisis—including that of AIG—had similar profiles: market perceptions of a sharp decline in the value of a company's mortgage-related assets led to rapid outflows of consumer deposits or an inability to roll over maturing short-term obligations. Depressed asset prices made it impossible for these highly leveraged companies to replace lost deposits or maturing short-term debt by selling assets without taking losses that would have exhausted their capital. The Federal Reserve and Treasury were faced with the need either to take immediate steps to save them—whether through assisted mergers, massive provisions of liquidity, asset guarantees or other measures—or to allow them to fail.

In their respective books, *On the Brink* and *Stress Test*, then-Treasury secretary Paulson and then-New York Federal Reserve president Geithner both discuss how the Fed and Treasury evaluated a financial institution in the throes of a liquidity crisis. If the long-term value of that company's assets was too low to allow it to repay its outstanding debts, the company was insolvent and could not be saved without a permanent infusion of capital (typically by the government). If, on the other hand, the Fed and Treasury judged that the values of the company's assets were only temporarily depressed—because, for example, markets had become illiquid—the Fed or Treasury could maintain its solvency by providing short-term loans or guarantying a floor value for their assets until their prices could recover.

Fannie Mae's situation was totally different. In the winter of 2000, it had agreed with Treasury, and pledged publicly, to maintain sufficient liquidity to enable it to survive at least three months without access to the debt markets. As a consequence of this pledge—to which it had adhered—unlike all of the other companies rescued by the Fed or the Treasury during the crisis, Fannie Mae never experienced a threat to its solvency because of difficulty rolling over its maturing debt, nor did it need to sell assets at depressed prices to survive. The company never experienced a market crisis. At the time it was put into conservatorship, Fannie Mae's capital significantly exceeded its regulatory minimum. Fannie Mae's "rescue" was a policy choice by Treasury, with its timing determined by Paulson. As he said in *On The Brink,* he wanted to put Fannie Mae and Freddie Mac in conservatorship before Lehman Brothers announced a "dreadful loss" for the second quarter of 2008.

After the companies were placed in conservatorship, the mechanism Treasury used to extend credit to them—"draws" of non-repayable senior preferred stock to make up for book capital shortfalls—was one developed specifically for Fannie Mae and Freddie Mac. No other regulator in the world, at any time or under any set of circumstances, ever had used non-repayable senior preferred stock, paid with after-tax dollars, as a vehicle for rescuing a financial institution in crisis (or for any other purpose). The goal of this instrument was not to aid the two companies, but to push them into insolvency and keep them there.

The contrast between Treasury's treatment of Fannie Mae and the banks during the financial crisis could not have been more striking. At the exact time the Fed and Treasury were making extraordinary efforts to overcome banks' lack of liquidity by providing them with virtually unlimited assistance to bridge what they claimed was a period of temporarily depressed asset prices, Treasury was working with FHFA to make Fannie Mae's superior liquidity irrelevant, by forcing it to mark down almost all of its assets, and change its accounting policies, to levels that reflected the same temporarily depressed values it was seeking to help the banks ride out through government assistance. Treasury then effectively made Fannie Mae's temporarily depressed values permanent—foreclosing any chance of recovery, at any time—by requiring it to take draws of non-repayable senior preferred stock, at a 10 percent after-tax dividend, to fill the hole that Treasury and FHFA themselves had created.

It is difficult to look objectively at how Treasury responded to the real liquidity crises of the banks (and AIG) and at the same time created both the problems Fannie Mae (and Freddie Mac) faced and the unique "solution" to those problems, and conclude anything other than that Treasury took advantage of the 2008 financial crisis to advance their long-held policy objective of removing the two companies as the centerpieces of the U.S. mortgage finance system.

<u>Treasury's September 7, 2008 nationalization of Fannie Mae and Freddie Mac was planned well in advance</u>

Treasury Secretary Paulson has said repeatedly that Treasury made its decision to place Fannie Mae and Freddie Mac under government control after the Housing and Economic Recovery Act (HERA) was signed on July 29, 2008, and only shortly before their conservatorships were announced. The facts, however, do not support that contention.

In late 2007, private-label securitization—which Treasury and the Federal Reserve had promoted aggressively since the early 2000s as superior to securitization by Fannie Mae and Freddie Mac for financing single-family mortgages—collapsed amidst an explosion of delinquencies and defaults. The result was in a huge fall-off in the supply of mortgage credit, to which Congress responded in February of 2008 by nearly doubling the Fannie Mae-Freddie Mac loan limit. That gave the companies access to the largest share of new residential mortgage loans in their history.

Within a month, in early March of 2008, a paper titled "Fannie Mae Insolvency and Its Consequences" was circulating among senior officials at the National Economic Council and the Treasury. This paper, which was provided to *Barron's* as the basis for a negative article on Fannie Mae published on March 8, claimed that because of risky loan acquisitions and four accounting treatments it questioned—for deferred tax assets, low-income housing tax credits, and the valuation of both the company's private-label security holdings and its guaranty obligations for mortgage-backed securities—Fannie Mae was in danger of failing and might have to be nationalized. Whatever one might have thought about the merits of the paper's analysis, its prescription for Fannie Mae insolvency—writing down many of the company's assets and greatly boosting its loss reserves—was a blueprint for what Treasury and FHFA would do six months later.

Barely a week after the *Barron's* article, and on the eve of the announcement of the government-assisted acquisition of Bear Stearns by JP Morgan, Paulson overrode the strong objections of FHFA director Lockhart and agreed to allow Fannie Mae and Freddie Mac to reduce their surplus capital percentage with no firm commitment from either company to raise additional capital. This was significant on two levels—first as a clear example of Treasury's dominance of FHFA, and second as a strong indication that Paulson at that early date already was thinking of Fannie Mae and Freddie Mac as instruments of the federal government. (Two years later, Paulson would tell the Financial Crisis Inquiry Commission, "[Fannie Mae and Freddie Mac], more than anyone, were the engine *we* needed to get through the problem." [Emphasis added])

On July 11, the *New York Times* published a front-page article saying, "Senior Bush administration officials are considering a plan to have the government take over one or both of [Fannie Mae and Freddie Mac] and place them in a conservatorship if their problems worsen." Shares of the companies plunged, and in response Paulson publicly pledged support for them on July 13, saying, "Fannie Mae and Freddie Mac play a central role in our housing finance system and must continue to do so in their current form as shareholder-owned companies." Yet he had a very different private message for Wall Street insiders. As reported by Bloomberg in November of 2011, Paulson met with a select group of hedge fund managers at Eaton Park Capital Management on July 21, where he told them that Treasury was considering a plan to put Fannie Mae and Freddie Mac into conservatorship, which would effectively wipe out common and preferred shareholders. This, of course, is precisely what happened six weeks later.

When HERA was signed into law on July 29, it created a new regulator for Fannie Mae and Freddie Mac, FHFA (effectively, OFHEO renamed), and gave it expanded powers to put both companies into receivership or conservatorship. HERA also contained a clause not present in any other regulatory statute: "The members of the board of directors of a regulated entity shall not be liable to the shareholders or creditors of the regulated entity for acquiescing in or consenting in good faith to the appointment of the agency [FHFA] as conservator or receiver for that regulated entity." The rationale for this clause became evident within a matter of weeks. When Paulson met with the directors of Fannie Mae and Freddie Mac to inform them of his intent to take over their companies, neither entity met any of the twelve conditions for conservatorship spelled out in the newly passed HERA legislation.

Paulson since has admitted that he took the companies over by threat. Absent the unique provision in HERA exempting Fannie Mae's and Freddie Mac's directors from shareholder lawsuits for acquiescing in conservatorship, they may well have balked at Treasury's demand that they allow the companies whose shareholders they represented to be taken over by the government without statutory cause.

Following the passage of HERA, Treasury asked the Fed, the Controller of the Currency and a Wall Street firm, Morgan Stanley, to assess Fannie Mae's and Freddie Mac's financial health. The weaknesses Treasury said they found in the companies' capital and financial statements were nearly identical to the ones contained in the "Fannie Mae Insolvency and its Consequences" paper circulated six months earlier. Treasury, however, lacked authority to put the two companies into conservatorship; only the new regulator, FHFA could do that. And Treasury had kept neither the old OFHEO nor the new FHFA apprised of its nationalization intentions. Paulson was unaware that on August 22 FHFA had sent both Fannie Mae and Freddie Mac letters saying the companies were safe and sound and exceeded their regulatory capital requirements. Paulson told Lockhart that he had to change his agency's posture on the two companies, and FHFA did exactly that. On September 4, FHFA sent each company an extremely harsh mid-year review letter, and two days later, Paulson, Lockhart and Fed chairman Bernanke met with the companies' CEOs and directors to tell them they had no choice but to agree to conservatorship.

On the day Fannie Mae and Freddie Mac were put into conservatorship, Treasury and the conservator, FHFA, "agreed" to a one-sided and punitive senior preferred stock agreement that wiped out nearly all of the value of shareholder investments in the companies' common and preferred stock. Shortly thereafter, FHFA as conservator implemented the accounting write-downs identified in the "Fannie Mae Insolvency and its Consequences" paper, along with others, to exhaust Fannie Mae's capital and create a need to take non-repayable senior preferred stock from Treasury, at a 10 percent dividend. Cumulative borrowings of this stock ultimately reached $117.1 billion before the company could return to profitability in 2012.

<u>The third amendment to the senior preferred stock agreement was adopted to prevent Fannie Mae from benefiting from the reversal of extremely conservative accounting decisions made earlier</u>

At a surface level, it appeared that Fannie Mae had no chance at any time in the foreseeable future of paying an $11.7 billion annual after-tax senior preferred stock dividend to Treasury and having anything left over as retained earnings. Doing so would have required pre-tax earnings of more than $18 billion, and the most pre-tax net income the company ever earned had been $11.4 billion, in 2003. Moreover, as part of the 2008 senior preferred stock agreement Fannie Mae had been required to shrink its mortgage portfolio—the source of a majority of the company's earnings—by ten percent per year. Yet the strategy devised by Treasury to push Fannie Mae into insolvency contained the seeds of its own undoing, giving rise to the need for a third amendment to the senior preferred stock agreement in 2012.

To understand what happened, it is useful to think of Fannie Mae's earnings as having three basic components: (a) revenues from the company's two businesses, portfolio investments and credit guarantees, (b) annual expenses, principally administrative costs and credit losses, and (c) accounting gains or losses.

During the eight years between 2003 and 2011, the combined revenues from Fannie Mae's portfolio investments and credit guarantees grew irregularly but strongly, rising by almost 60 percent. The $162 billion in losses the company recorded from 2008 through 2011 was not due to a lack of revenue. Indeed, the $74 billion Fannie Mae booked in combined net interest income from its mortgage portfolio and guarantee fees from its mortgage-backed securities during the 2008- 2011 period was more than enough to cover not only the huge $62 billion spike in its actual credit losses (charge-offs net of recoveries, plus foreclosed property expense) but also its cumulative $9 billion in administrative expenses during that time. Put another way, <u>all</u> of Fannie Mae's GAAP losses from 2008 through 2011 stemmed from accounting entries and judgments: principally the exceptionally large $70 billion increase in its reserve for future loan losses, and significant write-downs of a number of items on the company's balance sheet (which are not possible to calculate precisely because of the complexity of Fannie Mae's GAAP accounting).

Many of the write-downs were made near the low points of asset values and were subject to upward revision in future periods, while the loss reserve similarly was predicated on pessimistic projections of future home prices, loan defaults and loss severities. The turning point for both sets of accounting decisions came during the first half of 2012. After falling by almost 24 percent from the third quarter of 2006 to the first quarter of 2012, Fannie Mae's index of home prices rose by 3.2 percent in the second quarter of 2012. This jump in home prices, together with a sharp rise in the prices received for sales of foreclosed homes and a further decrease in Fannie Mae's single-family serious delinquency rate, convinced the company that it could begin to use its ample loss reserve to absorb current-period credit losses. Doing so meant that nearly all of Fannie Mae's $5.8 billion in pre-tax revenues reached its bottom line in the second quarter, since tax loss carry-forwards made its federal income tax liability zero. The company was able to make its $2.9 billion quarterly dividend payment to Treasury and still add $2.5 billion to its net worth.

With a positive net worth, strong revenues, a declining loss reserve, the tax loss carry-forward, and the likelihood of upward asset price revaluations and the successful resolution of loan repurchase claims over the next several quarters, it suddenly became apparent that Fannie Mae would not need any further draws from Treasury for quite a long period of time. And if that were the case, the decision Treasury and FHFA had made in 2008 to establish a valuation reserve for Fannie Mae's deferred tax assets soon would be reversed, adding even further to the company's profits, retained earnings and capital.

Treasury, of course, knew all this; it was the one that had engineered Fannie Mae's accounting losses and excessive loss reserving in the first place, following the roadmap of the March 2008 paper, "Fannie Mae Insolvency and its Consequences." Treasury and FHFA agreed to the third amendment to the senior preferred stock agreement—in which Fannie Mae and Freddie Mac would be required to give all of their future profits to Treasury instead of paying a quarterly preferred stock dividend—so that the government, and not the company's shareholders, would reap the benefits of the now-imminent reversal of many of the earlier accounting-related write-downs.

It was even less difficult for Treasury to get FHFA to agree to the third amendment in 2012 than it had been in 2008 getting director Lockhart to agree to reduce Fannie Mae and Freddie Mac's surplus capital percentage, or to reverse his previous public position that the companies were safe and sound and adequately capitalized. In 2012 the acting director of FHFA was Ed DeMarco, who from 1993 to 2003 had worked at Treasury as director of the Office of Financial Institutions Policy.

Treasury insists that the third amendment was essential to prevent the companies from having to undertake an endless cycle of borrowing in order to continue to make their dividend payments. But with the third amendment coming only <u>after</u> Fannie Mae had begun to rebuild its capital—and with the reversal of its reserve for deferred tax assets having become a virtual certainty—this rationale crumbles in the face of the factual record.

<u>A way forward</u>

The argument for bringing Fannie Mae and Freddie Mac out of conservatorship and using an amended version them as the basis of the future mortgage finance system is extremely straightforward: their credit guaranty mechanism is low-cost, efficient and effective, and has a proven track record of success. **There is no credible basis for the oft-repeated contention that they are a "failed business model."** Even after Fannie Mae and Freddie Mac made unwise decisions to lower their underwriting standards to try to compete with private-label securitization, their loans acquired between 2005 and 2008 still performed four times as well as loans from that period financed through private-label securities, and more than twice as well as loans made and retained by commercial banks during that time.

The false narrative about the two companies' problems and the government's role in intervening in their affairs now hampers the effort to design a robust system for the future. Each of the major legislative reform proposals—the Hensarling bill in the House, and the Corker-Warner and Johnson-Crapo bills in the Senate—starts with the assumption that the system of the future should look nothing like the "failed" Fannie Mae and Freddie Mac did in the past. That has led drafters of these efforts to rule out structures, techniques and elements that have demonstrated records of success, in exchange for more complex and unproven approaches. There is an understandable reluctance on the part of Congress to risk the functioning of a $10 trillion credit market crucial to the nation's economy on an untested alternative.

The remaining objection to preserving Fannie Mae and Freddie Mac is political, but even that political argument weakens when examined closely. The companies' longstanding critics, including the Treasury and the Federal Reserve, based their historical opposition on the portfolio business, and the agency debt that funded it. Right up until the time the mortgage finance system imploded, there was very little criticism of Fannie Mae and Freddie Mac's credit guaranty activities.

Ironically, Treasury now holds the key to administrative reform of the system. FHFA cannot release Fannie Mae and Freddie Mac from conservatorship as long as the third amendment remains in force, because with Treasury keeping all of their earnings the two never could be viable as private companies.

There is a simple solution that will break the impasse. Treasury should declare victory in their battle against the "old" Fannie Mae and Freddie Mac. No one is arguing for the restoration of the companies' on-balance sheet portfolio business, funded by agency debt, while their credit guaranty business helps banks originate fixed-rate mortgages without taking on unmanageable interest rate risk. Treasury's insistence on "killing the ghosts" of two companies that no longer exist is the single biggest impediment to mortgage reform. Treasury needs to accept the fact that they have beaten the Fannie Mae and Freddie Mac they once found so objectionable, put that fight behind them, and turn their attention to helping to build a mortgage finance system for the twenty-first century. This would include replacing the third amendment to the senior preferred stock agreement—which was designed to keep Fannie Mae and Freddie Mac insolvent—with a fourth amendment designed to allow them to be released from conservatorship and returned to private ownership, limited to the credit guaranty business, with more capital and stronger oversight, and with the proven ability to provide the volumes of fixed-rate mortgages homebuyers require, at a cost they can afford.

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Timothy Howard was a senior executive at Fannie Mae for 23 years, starting as chief economist in March 1982 and holding a number of positions until leaving as vice chairman and chief financial officer in December 2004. His book on the financial crisis, *The Mortgage Wars,* was published in November 2013.

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