The Rescue of Fannie Mae and Freddie Mac – Module A: The Conservatorships[1]

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Abstract

Two government-sponsored enterprises (GSEs), the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), dominated the secondary mortgage market during the U.S. housing crisis, collectively holding or guaranteeing $5.3 trillion in mortgage assets by early 2008. As the crisis escalated the two GSEs began to report substantial losses and doubt grew as to whether they could survive the escalating circumstances on their own. On September 6, 2008, the GSEs' new regulator, the Federal Housing Finance Agency (FHFA), placed the firms into indefinite conservatorships, one step of a four-part government intervention to stabilize the firms. This case, which evaluates the purpose and efficacy of the GSE conservatorships, finds that the conservatorships accomplished their emergency goals of stabilizing the GSEs and allowing them to maintain the secondary mortgage market. However, the FHFA Office of Inspector General concluded that the agency could better accomplish its oversight mission by proactively exerting greater control over its conservator approval process. As of this case's publication, the conservatorship for both companies is ongoing.

Keywords: GSEs, conservatorship, secondary mortgage market, Fannie Mae, Freddie Mac, FHFA, Treasury, liquidity, housing crisis

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[1] The Yale Program on Financial Stability (YPFS) has written 7 case studies that examine in detail the various elements of the government's rescue of the GSEs:

Thompson, Daniel and Rosalind Z. Wiggins. 2019. "The Rescue of Fannie Mae and Freddie Mac, Module A: The Conservatorships."

Thompson, Daniel. 2019. "The Rescue of Fannie Mae and Freddie Mac, Module B: The Senior Preferred Stock Purchase Agreements (SPSPA)."

Vergara, Emily. 2019. "The Rescue of Fannie Mae and Freddie Mac, Module C: GSE Credit Facility."

Zanger-Tishler, Michael and Rosalind Wiggins. 2019. "The Rescue of Fannie Mae and Freddie Mac D: Treasury's GSE MBS Purchase Program."

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Thompson, Daniel. 2019. "The Rescue of Fannie Mae and Freddie Mac, Module F: The Federal Reserve's Large Scale Asset Purchase (LSAP) Program."

Wiggins, Rosalind, Z., Benjamin Henken, Daniel Thompson, and Andrew Metrick. 2019. "The Rescue of Fannie Mae and Freddie Mac, Module Z: Overview."

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The Conservatorships

At a Glance

Concurrent with the U.S. housing market's collapse, the Federal National Mortgage Association (Fannie Mae) and The Federal Home Loan Mortgage Corporation (Freddie Mac) began to post substantial losses in the last two quarters of 2007. These two government-sponsored enterprises (GSEs), which were thought to be backed by an implicit government guarantee, had $5.3 trillion of guaranteed mortgage-backed securities (MBS) and debt outstanding in the summer of 2008. Given their size and importance in the secondary mortgage market, the potential insolvency of either GSE threatened to destabilize the entire housing market and the financial system.

Summary of Key Terms	
Purpose: To prevent the housing GSEs from becoming insolvent and to allow these GSEs to continue to maintain the secondary mortgage market, supporting US mortgage lending.	
Announcement Date	September 7, 2008
Operational Date	September 6, 2008
Expiration Date	Indefinite/None announced
Return to Profitability	FY2012
Legal Authority	HERA §1117
Funder	U.S. Department of the Treasury
Conservator	The Federal Housing Finance Agency (FHFA)
Total Investment	$191.5 billion

Recognizing that Fannie Mae and Freddie Mac might not be able to stabilize on their own, financial officials called for legislation to create a new regulator that could marshal taxpayer funds to rescue the GSEs. On July 30, 2008, the government passed the Housing and Economic Recovery Act (HERA), which created a new GSE regulator, the Federal Housing Finance Agency (FHFA), and provided Treasury with emergency powers to provide funding to rescue the GSEs, should they need it. Confronted with further deterioration of the two GSEs, the FHFA placed them into indefinite conservatorship on September 6, 2008, as part of a four-part rescue plan to stabilize the GSEs.

As conservator, the FHFA immediately suspended dividends on all outstanding stock, replaced both of the GSEs' CEOs and boards, and then managed the firms indirectly, promising to preserve their pre-crisis business operations as much as possible. The Treasury funded the firms while in conservatorship pursuant to Senior Preferred Stock Purchase Agreements, ultimately investing a combined $191.5 billion between 2008 and 2017. While both GSEs remained solvent and continued to maintain a secondary mortgage market throughout the crisis, they reported annual losses until 2012. In February 2012, the FHFA submitted a new plan for conservatorship, which focused more on preparing the GSEs and the secondary mortgage market for operations after conservatorship. As of this case's publication, however, no plan to end the conservatorship has progressed beyond the drafting phase.

Summary Evaluation

Most scholars and evaluators agree that the conservatorship successfully accomplished its short-term emergency goals, as it prevented Fannie Mae and Freddie Mac from declaring insolvency and allowed them to continue purchasing loans and issuing and guaranteeing MBS to the secondary mortgage market during the crisis when private-label securitization all but evaporated. However, the conservatorships have been criticized for poor oversight and for at times prioritizing the GSEs' financial health over the government's broader crisis-fighting goals.

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I. Overview

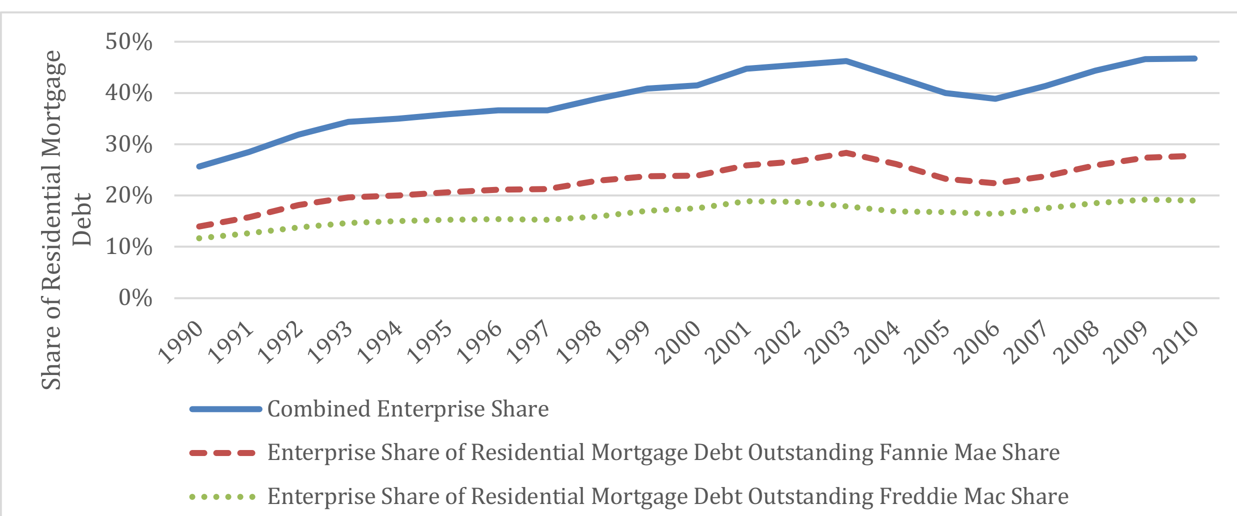
Background

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are large government-sponsored enterprises (GSEs) that are publicly traded and governed, but which were authorized by Congressional mandate and are required to satisfy certain government housing goals (FCIC 2011a, pp38-39). Many investors believed that the GSEs were backed by an implicit guarantee from the federal government. GSE debt and securities were considered safe and were widely held by US and non-US financial and governmental entities (Ibid).

Fannie Mae and Freddie Mac's primary business was to buy from originators whole mortgages that met certain criteria (conforming loans), which they then bundled into mortgage-backed securities (MBS) that they guaranteed and sold. The two GSEs also retained some of these mortgages in their investment portfolios, where they also held agency and non-agency MBS, including nonprime securities (subprime and Alt-A), that they purchased on the open market (Ibid).

Between 1990 and 2003 the percentage of outstanding residential mortgage debt owned or guaranteed by the GSEs grew from 25.7% to 46.3%. After 2003 it began to decline as nonconforming mortgage origination funded by private label mortgage backed securities (PLMBS) increased. As shown in Figure 1, however, the GSE share began to gradually increase again in 2006 after policy changes at the firms reduced underwriting standards, which allowed the GSEs to compete with private firms by buying more non-conforming mortgages, which they could not guarantee as MBS, but which they could hold in their portfolios (FHFA 9/23/2008).

Figure 1: Percentage of Outstanding Residential Mortgage Debt Held by the GSEs



Source:* *Enterprise Share of Residential Mortgage Debt Outstanding

Beginning in mid-2007, private-label residential securitization began to shrink to minimal levels because of the housing correction, increasing the GSEs' market share of new loans to 75.6% by year end, which was double the 38% it had been in 2006 (Congressional Report 04/15/2009). By September 2008, their market share rose to 80%, as the GSEs continued to provide the contracting housing market with much needed liquidity, although the GSEs tightened standards during the 2007-08 market downturn.

As early as mid-2007, the GSEs began to feel the effects of the subprime mortgage crisis as default rates on subprime and nonprime mortgages spiked, causing mortgage lending to slow, the value of mortgage securities to plummet, and private mortgage securitization to evaporate. Compounding the effects of the crisis on the firms was their high leverage, which rendered them especially vulnerable to the market correction. By December 2007, the two companies were highly leveraged—owning and guaranteeing $5.3 trillion of mortgages with capital of less than 2%. (FCIC 2011c). Both GSEs reported billion-dollar losses for FY2007, the first ever for Freddie Mac and the first time in 22 years for Fannie Mae (FHFA Report 04/15/2009).

Deteriorating circumstances made it difficult for the two companies to raise capital and to meet their safety and soundness standards, especially after the near collapse of Bear Stearns in March 2008 due to sudden disruptions in liquidity. By the summer of 2008, after having become increasingly reliant on short-term funding, both GSEs became unable to borrow against their securities to garner enough cash in the repo market (FCIC 2011c, pp316). Market concerns increased on July 7, 2008 when a Lehman Brothers investment analyst released a report speculating that Fannie Mae and Freddie Mac would not be able to raise additional capital in light of weak market conditions for their stock and the possible effect of a new accounting standard that would require the firms to bring their off balance-sheet entities onto the balance sheet (Lehman Report 07/07/2008). The GSEs' common share prices dropped by more than 16% as a result (FHFA Statement 2008).

When Fannie Mae and Freddie Mac posted billion-dollar losses at the end of 2007, the market began to recognize that the firms' weakened condition could destabilize the mortgage market and, by extension, the entire financial system. Government officials escalated efforts to pass legislation that would permit developing a viable plan that would support the firms and prevent their collapse (FCIC 2011c).

On July 13, 2008, the Federal Reserve Board (Fed) invoked its emergency authority under Section 13(13) of the Federal Reserve Act to authorize lending through its discount window to Fannie Mae and Freddie Mac for a period of 90 days or less (Fed 12/16/2008). Section 13(13) allows the Fed to lend to any private entity using government or government-guaranteed debt as collateral.[4] In its statement, the Fed said it was concerned about the systemic risks that the companies' difficulties posed, particularly to the functioning of

[4] Unlike Federal Reserve Act Section 13(3) which the Fed relied on for much of its crisis programs, Section 13(13) does not restrict lending to emergency situations.

residential mortgage markets. The Fed said its authorization was intended to supplement Treasury's authority to lend directly to the GSEs.

The Fed—in connection with officials from the Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), and Treasury—undertook a review of the GSEs' operations, which concluded that both GSEs would soon become insolvent (FCIC 2011c). During this time, Treasury's advisors from Morgan Stanley also reviewed Fannie Mae and Freddie Mac's business operations and their assessment corroborated the Fed and the other government officials' conclusions (Ibid).

Because of these concerns, and at the behest of financial regulators and Treasury, Congress passed the Housing and Economic Recovery Act (HERA)[5] on July 30, 2008. HERA created a new GSE regulator, the Federal Housing Finance Agency (FHFA), with enhanced authorities, provided enhanced resolution options and, importantly, gave the Treasury emergency authority to buy the securities and obligations of the GSEs. Treasury Secretary Paulson hoped that the government's commitment to preserve the GSEs could keep both companies in operation. However, the situation continued to deteriorate (Thompson 2019E).

Program Description

The FHFA took Fannie Mae and Freddie Mac into conservatorship on September 6, 2008—the first step of a four-part rescue program designed to stabilize the GSEs and avoid their likely collapse (FCIC 2011c). Treasury oversaw the other three steps, which were to:

- enter into Senior Preferred Stock Purchase Agreements (SPSPAs) with each GSE
- establish a new secured credit facility that the GSEs could borrow from
- commit to purchase GSE mortgage-backed securities (Frame et al. 2015).[6]

The FHFA stated that:

> The purpose of appointing the Conservator is to preserve and conserve the [Enterprises'] assets and property and to put the [Enterprises] in a sound and solvent condition. The goals of the conservatorship are to help restore confidence in [Fannie Mae and Freddie Mac], enhance [their] capacity to fulfill [their] mission, and mitigate the systemic risk that has contributed directly to the instability in the current market (FHFA Q&A on Conservatorship).

[5] Public Law 110-289. See Thompson 2019E, for a detailed discussion of the relevant provisions of the HERA.

[6] See Thompson 2019B for the SPSPA, Vergara 2019 for the Secured Credit Facility, and Zanger-Tishler 2019 for the GSE MBS Purchase Program. For a discussion of the overall government effort see Wiggins et al. 2019.

To this end, the FHFA would later define the "central goal" of the conservatorship[7] as "minimizing [GSE] credit losses from delinquent mortgages" (DeMarco 2010). It would also guide its decisions about the conservatorship to be consistent with the statutory purpose of the conservator for "reorganizing, rehabilitating, or winding up the affairs of a regulated entity" (HERA). Although the conservatorship did not have an expiration date, the FHFA and Treasury asserted that the conservatorship was intended as a temporary measure, or, as Secretary Paulson called it, "a time out" (Paulson 2010).

When the FHFA became conservator, it assumed all power previously vested in the GSEs' directors, officers, and shareholders and shifted the firms' focus to align with the goals of the conservatorships. (See Figure 2 for an overview of the impact of this shift.) As conservator, the FHFA could govern the companies in any legal capacity to stabilize them and its actions were not subject to judicial review (FHFA-OIG 2015). The FHFA immediately replaced the GSEs' Boards of Directors and CEOs, suspended voting rights, and froze dividends for common and preferred stockholders. Fannie reported in its 2008 10-K that "because we are in conservatorship, we "will no longer be managed with a strategy to maximize common shareholder returns" (Fannie Mae 2008 10-K). The GSEs' stock continued to trade, however. While the FHFA suspended the equity shareholders' rights, it protected rights of preferred and subordinated debtholders (Frame et al. 2015).

With Treasury serving as a financial backstop (discussed below), the FHFA also declared that the existing GSE capital limits were not binding during the conservatorship and then suspended them altogether, although it continued to monitor them (FHFA 11/17/2008).

[7] Fannie Mae and Freddie Mac were put into separate conservatorships. We herein refer to the conservatorships as one due to the similarities across the two structures. Additionally, while the conservatorships are still ongoing, our focus is on the crisis period, therefore we focus on the period through to 2012 when the enterprises returned to profitability.

Figure 2: Changes to Company Focus Under Conservatorship

Topic	Before Conservatorship	As of February 26, 2009
Authority of Board of Directors, management and shareholders	• Board of Directors with right to determine the general policies governing the operations of the corporation and exercise all power and authority of the company, except as vested in shareholders or as the Board chooses to delegate to management • Directors with duties to shareholders • Board of Directors delegated significant authority to management • Shareholders with specified voting rights	• FHFA, as conservator, succeeded to all of the power and authority of the Board of Directors, management and the shareholders • The conservator has delegated authority to a newly constituted Board of Directors. The Board is required to consult with and obtain the consent of the conservator before taking action in specified areas. The conservator may modify or rescind this delegation at any time • Directors do not have any duties to any person or entity except to the conservator. • The conservator has delegated authority to management to conduct day-to-day operations so that the company can continue to operate in the ordinary course of business. The conservator retains overall management authority, including the authority to withdraw its delegations to management at any time • Shareholders have no voting rights
Structure of Board of Directors	• 13 directors: 12 independent plus President and Chief Executive Officer; independent, non-executive Chairman of the Board • Seven standing Board committees, including Audit Committee of which four of the five independent members were "audit committee financial experts"	• 10 directors: 9 independent plus President and Chief Executive Officer; independent, non-executive Chairman of the Board. Up to three additional Board members may be added by the Board subject to approval of the conservator • Four standing Board committees, including Audit Committee of which three of the four independent members are "audit committee financial experts"
Capital	• Statutory and regulatory capital requirements • Capital classifications as to adequacy of capital issued by FHFA on quarterly basis	• Capital requirements not binding • Quarterly capital classifications by FHFA suspended
Net Worth(1)	• Receivership mandatory under Regulatory Reform Act if FHFA makes a written determination that we have net worth deficit for 60 days	• Conservator has directed management to focus, to the extent it does not conflict with our mission, on maintaining positive net worth • Receivership mandatory if FHFA makes a written determination that we have net worth deficit for 60 days(2)
Management Strategy	• Maximize shareholder value over the long-term • Fulfill our mission of providing liquidity, stability and affordability to the mortgage market	• Directed to provide liquidity, stability and affordability in the mortgage market and immediately provide additional assistance to this market and the struggling housing market, and to the extent not in conflict with our mission, to maintain positive net worth • No longer managed with a strategy to maximize common shareholder returns • Focus on foreclosure prevention

Source: *Fannie Mae 10-K 2008*

Treasury Funding

Concomitant with the establishment of the conservatorships, each GSE entered into a Senior Preferred Stock Purchase Agreement (SPSPA) with the Treasury pursuant to which Treasury committed to provide up to $100 billion to each firm in exchange for preferred stock and specified warrants, effectively guaranteeing the solvency of each GSE. Treasury's commitment was later raised to $200 billion, then raised to an unlimited amount for 2010-2012, before reverting to $200 billion thereafter (Thompson 2019B).

For several years, the GSEs ran losses and requested draws pursuant to the SPSPA. In 2012, the SPSPAs were amended to replace the fixed rate divided with a variable dividend, which effectively transferred all of the GSEs' net income to Treasury. Since the beginning of the conservatorship through 4th quarter 2018, the firms have paid a combined $292.3 billion to Treasury in dividends (Ibid).

Commitments. Commitments under the SPSPAs that the FHFA had to ensure the firms adhered to included informing Treasury of any major decisions regarding, and seeking its approval for:

- ending the conservatorships;
- certain executive compensation decisions[8];
- certain transfers or sales of assets (except for fair market value and in the ordinary course of business);
- declaring dividends;
- other matters regarding equity interests, and;
- mergers and acquisitions

Also, pursuant to the SPSPAs, the FHFA capped each GSE's portfolio at $850 billion and required a 10% annual reduction, to begin in 2010 (Ibid). However, reduction below $250 billion was not required (Ibid). The FHFA also capped each GSE's debt limit to 110% of its debt held on June 30, 2008, which was $859.9 billion for Fannie Mae and $956.5 billion for Freddie Mac. The FHFA later raised the debt limit several times (Ibid).

[8]In addition to the requirements under the SPSPA, the FHFA also had to comply with the requirements of Section 110 of the Emergency Economic Stabilization Act (EESA) that obligated it to develop or adopt programs that would minimize foreclosures (FHFA 2/2/2010).

Infrastructure of Conservatorships

To manage the conservatorships, the FHFA established the Office of Conservatorship Operations (OCO). Consisting of six employees, the OCO served as the liaison between the FHFA and the GSEs and sought to ensure that GSE operations were consistent with the goals of preserving their assets, focusing on their missions, and facilitating their emergence from conservatorship. In addition to the Director of the FHFA, staff from the OCO attended the GSEs' Board meetings and many GSE executive management meetings (OIG White Paper).

Under the terms of the conservatorship, however, the agency had some latitude as to how it could manage the firms and it soon eased its direct management style for one that was less direct. On November 28, 2008, the agency delegated authority to the GSEs' new Boards of Directors to oversee management, and to the executive management, including the new CEOs, to oversee day-to-day operations (FHFA-OIG 2012). The FHFA retained authority over certain significant and unusual business decisions as shown in Figure 3, for which the GSEs were required to request agency approval. Despite the delegation, the FHFA also retained authority, at its discretion, to review any delegated decision (Ibid).

Figure 3: GSE: Nondelegated Authorities Requiring Conservator Approval

1. Actions involving capital stock, dividends, the Senior Preferred Stock Purchase Agreements, increases in risk limits, material changes in accounting policy, and reasonably foreseeable material increases in operational risk
2. Creation of any subsidiary or affiliate or any substantial transaction between the Enterprise and any of its subsidiaries or affiliates, except for transactions undertaken in the ordinary course of business
3. Matters that relate to conservatorship, such as the initiation and material actions about significant litigation addressing the actions or authority of the conservator, repudiation of contracts, qualified financial contracts in dispute due to conservatorship status, and counterparties attempting to nullify or amend contracts due to conservatorship status
4. Actions involving hiring, compensation, and termination benefits of directors and officers at the executive vice president level and above
5. Actions involving the retention and termination of external auditors and law firms serving as consultants to the Enterprises' respective boards of directors
6. Settlements in excess of $50 million of litigation, claims, regulatory proceedings, or tax-related matters
7. Any merger with (or purchase or acquisition of) a business involving over $50 million
8. Actions that in the reasonable business judgment of the Enterprises' respective boards of directors are likely to cause significant reputational risk

Source:* *OIG-AUD-2012-008

The FHFA provided three reasons for its style of conservatorship: efficiency, concordant goals, and operational savings. The GSEs and their employees knew their business and were well equipped to continue to carry out normal business operations. The GSEs' objectives in conservatorship were the same as the government's objectives. Additionally, it would have required significant expense (funded by the taxpayers) to create and staff an FHFA unit large enough to oversee the entities' normal operations, and then there was a likelihood of overlap. Moreover, given that the term of the conservatorships was unknown, the efficacy of creating such a unit was questionable (FHFA-OIG 2012).

In July 2009, the FHFA also established a Conservatorship Governance Committee, composed of senior FHFA executives whose goal was to ensure coordination on regulatory or supervisory matters that might need to be brought to the attention of the conservator (OIG White Paper). The committee met weekly to coordinate issues related to the GSEs' operations and decision-making processes and received reports from the OCO (Ibid).

Upon delegation, the FHFA directed the GSEs to implement internal processes for seeking conservator approval for the non-delegated authorities. In 3rd quarter 2009, the FHFA established a formal tracking system to organize the substantial volume of requests and track their resolutions.

In November 2011, the OCO sought to gain more control over the conservatorship by implementing a single flow submission process. Any communications or approvals not following this process (with limited exceptions) were not considered valid. Executive compensation issues and certain legal issues still had to be approved by the FHFA's Office of Policy and General Counsel, respectively (Ibid).

Numerous FHFA employees who were not part of OCO participated in the conservatorship activities through resolving requests for approval and/or providing information to the OCO. In addition to its rights and duties as conservator, the FHFA continued its role as GSE regulator. While the FHFA could request information from Fannie Mae and Freddie Mac as conservator, it continued to gather information and conduct safety and soundness measures using its regulatory apparatuses, particularly the Division of Enterprise Regulation (DER), a unit charged with fulfilling the agency's regulatory responsibilities towards the GSEs (FHFA-OIG 2015).

The relationship between the FHFA's conservatorship and supervision duties was described by the FHFA as follows:

> FHFA's supervision staff does not participate in corporate decision-making or management functions, but maintains a detailed, current understanding of Enterprise business operations and risk management and brings a supervisory perspective to bear in engaging with the Enterprises and FHFA conservatorship staff. FHFA strives to strike a balance so that supervision and conservatorship activities are sufficiently separate to ensure supervisory independence, but Division staff coordinates to an appropriate degree so that there is the benefit of intra-agency collaboration on significant risk matters impacting the Enterprises (FHFA-OIG 2012).

One example of this "intra-agency collaboration" is that the OCO relied on the DER's regulatory review of the GSEs' finances rather than conducting a separate review (Ibid).

On June 20, 2011, the FHFA issued a final rule that clarified its conservatorship and receivership authorities (See 12 C.F.R. Part 1237). It also periodically augmented its directions with letters to the GSE. [Locate].

Despite the FHFAs' efforts to manage the conservatorship, a 2012 FHFA-OIG audit report concluded that the agency "can better accomplish its oversight mission by proactively exerting greater control over its conservator approval process." It criticized the agency for being passive in its oversight, for not ensuring that it reviewed significant matters, that its directives were adhered to, or its processes were followed. For example, Freddie Mac had not established internal procedures for requesting approvals until May 2011, and Fannie Mae had not established any such written procedures by 2012. As a result, requests were funneled from the GSEs in a decentralized manner with no single point of contact at either firm and without sound criteria for which decisions required conservator approval. It also found flaws in the processes that had been established, such as the absence of any controls that the prescribed matters were being brought before it, weak documentation and recordkeeping practices. (FHFA-OIG 2012). Thus, the OIG concluded that the OCO did not have a full grasp of the conservatorship issues being addressed by FHFA and recommended improvements:

> Specifically, FHFA-OIG recommends that the Agency: (1) revisit FHFA's non-delegated authorities to ensure that significant Enterprise business decisions are sent to the conservator for approval; (2) guide the Enterprises to establish processes to ensure that actions requiring conservator approval are properly submitted for consideration; (3) properly analyze, document, and support conservator decisions; and (4) confirm compliance by the Enterprises with conservator decisions. (Ibid).

The FHFA agreed with most of the recommendations and acted to adopt them. (See Appendix A of FHFA-OIG 2012). In 2013, the conservatorship offices were merged into a newly-formed Division of Conservatorship, which employed 25 persons compared to the prior six. (FHFA-OIG 2015).

Operational Emphasis Shifted During Conservatorships

Under the conservatorship, the FHFA directed the GSEs to continue their key business operations and MBS securitizations. No restrictions were placed on the amount of MBS that the GSEs could issue or guarantee (FHFA 11/17/2008). During the early phase of the conservatorship, as expressed in a 2010 letter, the FHFA focused the GSEs on stemming credit losses and reducing their retained portfolios, which many investors thought had become outsized and were a source of significant losses. At all times, the FHFA committed to having the GSEs fulfill their affordable housing goals (FHFA PR 2/20/10). (See Figure 5 for a comparison of how the FHFA's strategic objectives evolved over time).

Some of the steps taken to implement these objectives included, for example, the FHFA tightening GSE underwriting standards, which raised the average FICO credit score of guaranteed mortgages by 35 to 40 points over the next two years (FHFA Report 6/13/2011). The FHFA also shifted guarantee fee calculations from loan volume to underlying loan risk and eliminated preferential underwriting standards for certain entities (MBA 2017). Also, the FHFA requested that Fannie Mae and Freddie Mac "become much more aggressive and innovative in their approaches to loan modification activities to reduce preventable foreclosures" (FHFA 11/17/2008).

Just as the FHFA's conservatorship infrastructure evolved, so too did its theory of operations. In February 2012, the FHFA submitted to Congress a new strategic plan for the conservatorship, which, taking into consideration policy statements that had been circulated by the Obama Administration and Congress, aimed to build a new infrastructure for the secondary mortgage market in contemplation of a significant shrinking of the GSEs' operations and role (See Figure 4) (FHFA Strategic Plan 02/21/2012). Notably, the 2012 strategic plan does not carry over the objective regarding fulfilment of the affordable housing mission.[9]

Figure 4: FHFA Objectives for the Conservatorships of Fannie Mae and Freddie Mac

2010	2012	2014
1. Loan modification and mitigating credit losses from delinquent mortgages	1. Build a new infrastructure for the secondary mortgage market	1. Maintain, in a safe and sound manner, foreclosure prevention activities and credit availability for new and refinanced mortgages to foster liquid, efficient, competitive and resilient national housing finance markets
2. Reduce retained portfolios by ten percent per year, beginning this year from YE2009 maximum allowed balances of $900 billion, per PSPAs	2. Contract the GSEs' dominant presence in the marketplace while simplifying and shrinking their operations	2. Reduce taxpayer risk through increasing the role of private capital in the mortgage market
3. Prohibit new products as inconsistent with the purposes of the conservatorships	3. Maintain GSE foreclosure prevention activities and credit availability for new and refinanced mortgages	3. Build a new single-family securitization infrastructure for use by the Enterprises and adaptable for use by other participants in the secondary market in the future
4. Ensuring fulfillment of the affordable housing mission		

Sources: FHFA PR/LTR 2/20/10; Strategic Plans 2012, 2014

In 2014, with both GSEs having reported profits for several quarters, but with their future still undecided, the FHFA submitted an updated strategic plan that preserved the three key objectives from the 2012 plan, but focused less emphasis on shrinking the GSEs' presence in

[9] This presumably reflects the stance adopted by the Administration in February 2011, when it submitted a report to Congress titled "Reforming America's Housing Finance Market." In the report, the Administration proposes winding down Fannie and Freddie and giving the affordable housing mission to the Federal Housing Administration (FHA). (Treasury Report 02/2011).

the market. The goal of this plan was "overseeing the conservatorships of the Enterprises in their current state and ensuring that the Enterprises' infrastructure meets the needs of their current credit guarantee businesses and other operation" (FHFA Strategic Plan 05/13/2014) (Also see Figure 6).

Outcomes

Due to the conservatorships and the four-part rescue plan, the GSEs continued to operate much as they had immediately prior to the conservatorships and maintained their key role in the secondary mortgage market preventing its sudden collapse. Moreover, as private-label securitization had evaporated, the role of the GSEs became even more critical during the months following September 2008 and the percentage of new mortgages that they purchased increased.

Immediately following the conservatorship announcement, market demand for GSE debt seemed to increase (FOMC Minutes 09/16/2008). However, given the restrictions on dividends and voting rights for common shareholders imposed by the conservatorship, and that the SPSA established a stock class senior to all existing GSE classes of stock, , the common stock of the two GSEs—which had already fallen more than 95% since the previous year—continued to lose value. (Thompson 2019B).

Mortgage yields also fell for a brief period. The Monday following the announcement of the conservatorships, the rate on Fannie Mae's five-year debt and its mortgage backed securities (MBS) dropped about 30 and 50 basis points respectively (using five-year Treasury bond yields as the spread) (Frame et al. 2015). More broadly, mortgage rates fell by 50 basis points (Ibid). Following Lehman Brothers' collapse on September 15; however, mortgage rates rose quickly and dramatically (Ibid). On November 25, 2008, hoping to ease yield levels down, the Fed introduced its strategy of quantitative easing, which enabled it to purchase up to $500 billion in MBS and $100 billion of GSE debt (later raised to $1.25 trillion in MBS and $175 billion of GSE debt) (CBO Report 12/2010). By March 2009, GSE mortgage yields had fallen 150 basis points (FHFA Speech 03/18/2009).

Increased efforts by the GSEs to enforce representations and warranties made by loan originators and to return defaulted mortgages to the originators also strengthened their financial position. This practice led originators to tighten underwriting standards, which was criticized by some as being inconsistent with broader policy (Frame et al. 2015). However, tightened underwriting standards led to an increase in the percentage of mortgages purchased by the GSEs with a loan-to-value ratio of 80% or less—from 76% to 89% from 2007 to 2009. Nevertheless, the GSEs continued to report losses for nearly four years after the conservatorship's implementation, mainly due to continued mortgage defaults (particularly in single family credit guarantees) and to falling housing prices impacting its securitization business and portfolio (Frame et al. 2015).

Overall, as can be seen in Figure 5, since the beginning of the conservatorship, the GSEs have each significantly reduced the size of their portfolios and their outstanding debt. During this period, they also maintained or slightly increased the amount of their MBS issuances, which, given the evaporation of the private-label securitization, significantly increased their prominence in the market. Additional nonmonetary changes occurring under conservatorship are shown in Figure 6.

The year 2012 marked a turning point for Fannie Mae, Freddie Mac, and the FHFA's conservatorship operations. Fannie Mae and Freddie Mac posted annual profits (after paying dividends to Treasury) for the first time since 2007. Pursuant to the 3rd amendment to SPSPA, all profits were paid to Treasury.

In each statement of strategic objectives, the FHFA emphasized that conservatorship was not a long-term strategy for the GSEs. Because the firms were chartered by Congress, the agency was limited in its options for rehabilitation. It could only release the firms from conservatorship back to their previous structure, one which continued to be hotly debated, and one which their financial conditions did not support (Frame et al. 2015). By the time the GSEs began realizing a profit in 2012, they collectively owed the government $189.5 billion (liquidation preference plus initial investment pursuant to the SPSPAs). Although the GSEs have paid Treasury a combined $292.3 billion in dividends (through the 4th quarter 2018) such payments did not reduce their debt but did keep them from retaining earnings and building their capital (Thompson 2019B).

Since the conservatorship began, many individuals and entities, mainly shareholders, have sought damages from the FHFA, and several of these cases remain unresolved (Davidoff Solomon and Zaring 2015). Several governmental and private parties have proposed plans to end the conservatorships and reform the entities, which would require Congressional action. At this time, however, the GSEs remain in conservatorship (Frame et al. 2015).

Figure 5: GSE Sizes ($ in billions)

	Fannie Mae			**Freddie Mac**		
	Portfolio	**MBS/Guarantees**	**Debt**	**Portfolio**	**MBS/Guarantees**	**Debt**
2008	$761.4	$2,559.5	$843.0	$736.9	$1,834.4	$814.9
2010	$802.9	$2,642.8	$830.0	$710.2	$1,763.7	$742.6
2012	$654.3	$2,694.8	$664.1	$568	$1,591.7	$570.3
2014	$438.1	$2,768.2	$479.0	$413.6	$1,646.4	$439.5
2016	$306.5	$2,861.3	$353.6	$308.1	$1,817.9	$381.5

Fannie Mae Sources: Monthly Summaries dated December 2008, 2010, 2012, 2014, 2016
Freddie Mac Sources: Monthly Volume Summaries dated 2008, 2010, 2012, 2014, 2016
Note: Dates reflect GSE size in September of year listed

Figure 6: GSE Programs and Operations Before and After the Conservatorship

GSE Reform: Quick View		
	GSEs Pre-Conservatorship	**GSEs in Conservatorship**
Investor Purpose	Growth stock returns/risks	Conserve assets

Regulatory limitations on pricing	No	Yes
Retained investment portfolio	Large	Reduced
Capital standards	Low capital levels on both retained/guaranteed risk	Reduce capital cushion to zero by 2018
SF risk transfers to private market	Front-end only (MI and lender recourse)	Testing back-end structures in addition to front-end
MF risk transfers to private market	Lender risk share	Lender and capital markets risk share/transfer
Number of entities	Two	Two
New guarantor entrants permitted	No	No
SF lender access	Preferential pricing and underwriting by loan volume	Guarantee fee and underwriting variances restricted
Support for single-family TBA market	Yes	Yes
Support for multifamily finance	Yes	Yes
Preserve operational infrastructures and processes	Yes	Yes
Affordable housing mission	Yes	Yes

***Source:* *Mortgage Bankers Association: GSE Reform* (pp vii)**
Terms: SF (single family), MF (multifamily), TBA (To be announced)

II. Key Design Decisions

1. **The Housing and Economic Recovery Act (HERA) passed in July 2008 constituted an essential step to establish and finance the conservatorship.**

The government passed HERA in July 2008 to provide enhanced resolution alternatives to the GSEs' regulator in light of the severely weakened condition of the firms, their critical role in the stability of the mortgage and housing markets, and the stresses then impacting those markets (among other things). Prior to HERA, OFHEO (Office of Housing Enterprise Oversight, former GSE regulator) could have taken the firms into conservatorship, but there existed no viable funding to support such a move, largely rendering the authority ineffective. Also, the GSEs were exempt from the U.S. bankruptcy code and there was no authority for OFHEO to place them in receivership. HERA created a new regulator, the FHFA, and provided mechanisms for Treasury to fund the firms during an emergency period ensuring their solvency during a conservatorship. HERA also provided the FHFA expanded authority to place the firms into receivership if necessary. (See Thompson 2019E for more information regarding HERA).

2. **Federal officials placed Fannie Mae and Freddie Mac into a conservatorship instead of nationalizing them or placing them into a receivership.**

W. Scott Frame et al. (2015) dismiss the claim that the Treasury could have stabilized the GSEs by simply buying their debt or MBS without a formal apparatus. Noting the amount of capital required to stabilize the GSEs, Frame et al. argue that the Treasury needed a mechanism to ensure that it could continuously fund the GSEs in the needed amounts (which were unknown at the time, but which estimates were in the tens of billions). (Wiggins et al. 2019). As such, Treasury required a government intervention to establish and operate such a mechanism. Operating with the common understanding that the government needed to save the GSEs, Frame et al. identify three options that government officials could have taken.

The first option was nationalization, which Frame defines as purchasing and controlling at least an 80% equity stake in both companies. The government considered this option the least because the government would have been compelled to assume all liability for Fannie Mae and Freddie Mac and to consolidate their operations onto its balance sheet (Frame et al. 2015).

However, the definition of the term "nationalization" is fluid, unlike the definitions of "conservatorship" and "receivership" (which are discussed later). For the purposes of this paper we intend "nationalization" to refer to the government gaining a controlling interest in a company (one that might be much less than 80%) such that it is empowered to make or influence critical decisions about how the company operates. Nationalization often involves a restructuring or resolution of the company. Nationalization can be accomplished in a variety of ways, but does not denote application of a specific, prescribed administrative process, such as conservatorship or receivership, or the FDIC bank resolution process[10], although such processes may be employed. (Herein we sometimes refer to this type of takeover as an "unstructured nationalization.")

In light of this working definition, the government could have nationalized the GSEs by making – via the Treasury – a substantial equity contribution, either by way of a memorandum of understanding (MOU) or stock purchase agreement that laid out the operative terms. This would have sent a clear message that the government had established some level of control over the GSEs. However, operating the GSEs without the benefit of a known and predictable framework would have involved uncertainties and likely would have been messy. (Jester et al. 2018). Moreover, Treasury's ability to operate the companies would still have been subject to management's compliance with the MOU and limited by the need to comply with various regulations regarding preservation of the GSE charters. It is unlikely that the Treasury would have gained as much flexibility as it could have with a wholly private company.

Given these restrictions, it is unclear if a bona fide unstructured nationalization would have been feasible or would have meet the crisis-fighting objectives. As discussed, nationalization

[10] Bankruptcy would not have been a viable solution, as the GSE charter provides an exemption.

shares characteristics with other resolution processes, such as receivership and conservatorship, in that it involves impairment of shareholder interests and some degree of control over the company by the government. However, two significant differences are worth noting. First, in an unstructured nationalization, the Treasury itself would have been in control, rather than the FHFA as conservator. Second, the unstructured nationalization is unscripted and thus is subject to more uncertainty; the rules are not known ahead of time but are devised as the situation progresses. Thus, with more scripted processes available, the government opted for conservatorship, a more predictable process. [11]

Receivership. After the passage of the HERA, receivership was a second viable option. However, there was some concern whether HERA's higher threshold for invoking receivership rather than conservatorship had been satisfied. (Citation). Moreover, the intent of a receivership is to wind down an organization rather than merely stabilize it and have it continue operations. And under HERA, invoking a receivership would mean the application of timelines and the need for a bridge entity since the GSEs could only be dissolved by an act of Congress. And the FHFA would be compelled to reform the firms as they were released from receivership, which would have been required in five years. However, the questionable structure of the GSEs had been debated for years and Congress had yet to resolve those concerns.

Dan Jester et al. (2018), who served in Paulson's Treasury during the rescue, also questioned the feasibility of setting up the receiverships in time to be effective. They doubted the GSEs would acquiesce to such a forceful intervention and worried they would respond by filing lawsuits and drumming up Congressional opposition to it. Moreover, even if the receiverships were put in place, Jester et al. wonder if the FHFA – a new agency with "no institutional experience managing a receivership" – was up to the task of overseeing the successful implementation of one (Jester et al. 2018).

Conservatorship. The final option was conservatorship. Although a conservatorship could last indefinitely, it was seen as a temporary measure that would allow the government to take control of the companies, stabilize them for continued operation and yet avoid solving the more contentious structural aspects of the GSEs' special status. Conservatorship also was

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[11] From a political standpoint, the Bush administration had mixed feelings regarding nationalization. Dan Jester, an official in the Bush administration, wrote later that the Treasury team above all wanted to ensure that the government covered the GSEs' losses. But it was also "imperative to have the market believe this was a nationalization which put the government behind the GSE's while not shocking the political system and the public who would equate the size of the investment with losses and cost to the taxpayer" (Jester et al. 2018). Ultimately, to prevent outright nationalization, the SPSPAs included a warrant for Treasury to purchase up to 79.9% of each GSEs' stock, just below a controlling interest requiring consolidation. Yet, many observers still considered the government's actions to be a nationalization— "The new federal 'conservatorship' is a form of nationalization that puts regulators firmly in control," the Wall Street Journal editorialized the next day, in supporting the government measure. ("Weekend at Henry's"). "We only wish Mr. Paulson had gone further and erased all private equity holders the way the feds do in a typical bank failure."

seen as an option that could be implemented swiftly, which was important given the rising number of concerns at other major financial institutions.

Most importantly, however, conservatorship allowed the GSEs to continue their operations and supply the secondary mortgage market, something critically needed as the private market severely contracted. The efficacy of this option hinged on the Treasury's ability to finance the conservatorship, which was made possible by HERA. Frame et al. note that if the Treasury could not have financed the conservatorship, then receivership would have been the best option. HERA also included a clause that allowed the FHFA to later place the GSEs into receivership from conservatorship (Frame et al. 2015). However, James Lockhart, then Director of the FHFA, stated that this was something that his agency never seriously considered. (Lockhart 2019). See Figure 8 for a comparison of the attribution of the three possible solutions and see Wiggins et al. 2019 for further discussion of the conservatorship decision.

Figure 8: Rescue options (after the passage of HERA)

	Nationalization	Receivership	Conservatorship
Legal Authority	Chapter 11 of Bankruptcy Code	HERA	HERA
Overseer	Secretary of Treasury	FHFA Director[1]	FHFA Director[1]
Agency	Treasury	FHFA	FHFA
Discretionary appointment	Yes	Yes[2]	Yes[2]
Mandatory enactment	No	Yes[3] 1) GSE could not pay back debt (60 calendar days; 30 days if classified "critically undercapitalized") 2) GSE assets were less than outstanding debt (" ")	No
Rights	Complete control of the company	All company operations; subpoena rights	All company operations; subpoena rights
Powers	All powers of shareholders, officers, and directors with respect to the GSE and its assets	All powers of shareholders, officers, and directors with respect to the GSE and its assets	All powers of shareholders, officers, and directors with respect to the GSE and its assets
Main Duties		Prepare for liquidation/restructuring[x]	Maintain the GSEs' solvency and preserve their assets and property
Receivership option	Possible	N/a	Yes
Liquidation option	Yes	Yes	No
Bridge Entity	Possible	Yes; if organizing a new enterprise	No
Rights and claims of stockholders and creditors to GSE assets		Terminates automatically; except for those related to payment, which falls to the FHFA director's discretion	At discretion of FHFA director
Option of parties to net, terminate, or liquidate assets	Possible	Yes (after 5PM the following day)	No
GSE Assets & Liabilities	Government balance sheet	GSE charters, assets in danger of default, and liabilities in danger of default would be transferred to a limited-life entity	Remain on GSE balance sheet
Treasury's emergency authority (expiring December 31, 2009)	N/a	Does not affect	Does not affect
Terminate	At discretion of U.S. Treasury	1) Liquidation 2) 2 years after the creation of the bridge entity (could be extended 3 more years)	1) Receivership 2) At discretion of FHFA and Treasury

[1] In consultation with the Chairman of the Federal Reserve
[2] FHFA director could take either GSE into conservatorship or receivership for any of the following reasons: (A) Assets were less than its obligations (B) Substantial dissipation of assets (C) Unsafe or unsound condition (D) Cease and desist orders (E) Concealment or refusal to provide the books, papers, etc. (F) Inability to pay obligations or meet the demands of creditors (G) Loses losses that would deplete capital, with little chance of recapitalization (H) Any legal violations (I) By request of its board of directors or shareholders (J) Undercapitalization (K) Critical undercapitalization (L) Money laundering
[3] At the discretion of the FHFA director
[x] In order to restructure the GSEs into new entities, the FHFA and Treasury required Congressional approval to revoke the GSEs' charters. Until that point, the charter would remain in the bridge entity.
Compiled by Daniel Thompson
Sources for receivership and conservatorship: HERA, Frame et al. 2015
Sources for nationalization: Elliott 2009, Frame et al. 2015., nationalization of GM

3. Government officials kept the conservatorship decision secret to prevent the agencies from exerting political pressure.

Secretary Paulson identifies secrecy, speed, and timing as the three aspects in the execution of Fannie Mae and Freddie Mac's conservatorship that avoided a protracted battle with the GSEs, news leaks to the public, and a major market swing. After keeping the conservatorship discussion (and later the conservatorship decision) a secret for several weeks, Paulson, FHFA Director Lockhart, and Chairman Bernanke presented the option to Fannie Mae and Freddie Mac's CEOs with no warning (Paulson 2010). These officials knew that the CEOs might fight to keep their positions and thus gave them no time to publicize the conservatorship or solicit assistance from their political contacts on Capitol Hill. Paulson feared that if either CEO decided to resist the conservatorship, they could delay its implementation and instigate panic in the markets (Ibid).

Federal officials also met with Fannie Mae's CEO and executive board first, since they believed that Fannie Mae's team would be more resistant to the idea (they were correct). Federal officials took caution to avoid any press coverage of the event and changed locations for their private meetings with Fannie Mae and Freddie Mac (Ibid). They arranged for the first meeting with Fannie Mae to start at 4:00PM on Friday so that the markets would have closed before the meeting had finished. After each meeting, they informed members of the House Financial Committee and Senate Banking Committee, so that they would not be surprised when the news broke to the public. Lockhart and Paulson announced the conservatorships as part of a four-part rescue plan for the GSEs on Saturday and Sunday, giving the public an opportunity to react before markets reopened on Monday (Paulson 2010).

4. The FHFA replaced the GSEs' Boards of Directors in addition to their CEOs.

When the FHFA placed Fannie Mae and Freddie Mac into conservatorship it also replaced the firms' CEOs and appointed new non-executive Chairmen of the Board. (FHFA PR 09/07/2008). Secretary Paulson pointed to the gravity of the intervention to justify firing the GSEs' CEOs. When asked for his rationale to fire Fannie Mae's CEO, he replied, "I don't think that you could do something this drastic and not change the CEO" (Paulson 2010). FHFA director James Lockhart presented a similar justification for removing the GSE boards, noting that "although it is not necessary in a conservatorship, new boards are being formed as a matter of good governance" (FHFA Speech 2008).

As conservator the FHFA ascended to all authority of the Board and Management but eventually delegated some of that authority back to the Board and management while retaining a right of review. (See discussion at page 7). Even under conservatorship, in exercising their authority the GSE officers remained "subject to the legal responsibility to use sound and prudent business judgment in their stewardship of their companies." (DeMarco 02/02/2010)

5. The FHFA protected all classes of GSE creditors but not shareholders.

The FHFA adopted this approach to save money, to increase public confidence in the two GSEs, and, most importantly, to keep the GSEs operating. After enacting the conservatorship, the FHFA froze the GSEs' dividend payments and shareholder voting rights (except for Treasury's Senior Preferred Stock). The FHFA estimated that freezing dividends would save the GSEs about $2 billion annually (FHFA PR 09/07/2008). The GSE stock remained outstanding and would be restored to its full right when the firms exited the conservatorships.

On the other hand, given Treasury's funding commitment, in essence to provide whatever funds the GSEs needed to remain solvent (up to the stated limits) the GSE bondholders were protected. The SPSPA placed no restrictions on uses of the funds provided by Treasury. Important factors supporting the government's decision included: (i) the sheer size of the GSEs' liabilities, (ii) the nature of the bondholders, and (iii) the GSEs close alignment with the government.

There has long existed an "implied government guarantee" of GSE debt and obligations, which helped them enjoy a robust market with their debt being widely held. Much of this debt was held by foreign central banks and foreign and domestic financial institutions that the government encouraged to buy. Secretary Paulson felt that allowing the international bondholders to suffer losses would undermine the creditworthiness of the United States government and a lack of foreign confidence in the U.S. government's creditworthiness might cause a run on the dollar. (Paulson 2010). Also, many domestic banks, which were already under stress, held GSE debt due to favorable capital rules.

Federal officials recognized that protecting bondholders was critical to minimizing risk to the financial system, and avoiding any questions of the government's ability to support the firms or its own creditworthiness. (CBO Report 12/2010, Paulson 2010).) The government's actions in essence, made the implied guarantee firm, which seems to have increased confidence in the GSEs, which James Lockhart and Frame et al. (2015) argue is evidenced in falling yields—at least before Lehman Brothers collapsed (FHFA Speech 2008). (See also Wiggins et al. 2019 for further discussion of these points.)

6. The FHFA established a limited infrastructure to manage the conservatorships.

To manage the conservatorships, the FHFA established a new infrastructure consisting of the Office of Conservatorship Operations (OCO) and the Conservatorship Governance Committee (CGC). The FHFA also released various processes and reports. The OCO acted as the liaison and administrator between the GSEs and the FHFA, relying on FHFA resources to resolve issues. The CGC was composed of senior FHFA executives whose goal was to ensure coordination on regulatory or supervisory matters that might need to be brought to the attention of the conservator.

During the early years of the conservatorship, the FHFA used strategies that it had inherited from OHFEO to establish goals for the GSEs. Because the OCO only employed six people, the OCO also relied on the regulatory resources throughout the FHFA to evaluate the GSEs' success in achieving these goals and address conservator issues (OIG 2015). One audit report points to the possible tensions that this overlap may have caused to conservator effectiveness specifically, the OIG said that FHFA's role as a supervisor "could become compromised. For example, FHFA could potentially be faced with criticizing its own actions or those of its senior officials." (See OIG White Paper). The OIG also noted that the conflict was partly addressed by the delegation of most management decisions to the Enterprises' boards and managers.

The FHFA, however, defended its structure, specifically stating that given the uncertainty of how long the conservatorship was to last, it was questionable whether expending the resources needed to establish a larger FHFA unit that could take a more hands-on role in the operations of the GSEs would be beneficial. Moreover, the agency had always insisted that its intent was to have the GSEs continue normal operations in conservatorship with a look towards its end (Ibid).

Nevertheless, the FHFA agreed with most of the OIG recommendations and took steps to implement them. As it became more apparent that the GSEs would not soon be exiting the conservatorship, the FHFA refined its strategic plans and evaluation mechanisms by developing a reporting scorecard, establishing an approval tracking and resolution process, and in 2013 consolidating all conservator functions into a Division of Conservatorship, which employed 25 people as compared to the previous six-person OCO. (OIG White Paper).

7. **The FHFA managed the conservatorship indirectly, delegating significant authority to the new Board of Directors and CEOs.**

The FHFA's Inspector General noted that a conservator generally can take one of three approaches: "Actively managing every aspect of an entity's operations; Monitoring the conserved entities' decision-making and stepping in when it feels it is appropriate; or deferring to the conserved entity on most decisions and stepping in only in cases of greater significance." The IG noted that FHFA had taken the latter approach. (OIG White Paper).

> "FHFA has determined to (1) delegate authority for general corporate governance and day-today matters to the Enterprises' boards of directors and executive management, and (2) retain authority for certain significant decisions." (FHFA-OIG 2015).

Within two months of establishing the conservatorship, the FHFA had delegated significant authority to the new Boards of Directors and CEOs. It did this as an efficient way to run the massive businesses consistent with the tenets of the conservatorship − to manage the firms as going concerns, stabilize them financially, and return them to independent operation (OIG

White Paper). However, it's important to the note that the FHFA retained authority over a group of key business decisions, for which it required the GSEs to seek prior approval. These powers were referred to as non-delegated authorities. Among other things, these included capital actions, compensation policies, and other large transactions, including legal settlements, merger activities, and deals with subsidiaries. (See Figure 3 for a run-down of the non-delegated authorities.) In addition to specified non-delegated authorities, the FHFA retained the right to review (and to overturn) any other business decision it deemed important along the way. (OIG-AUD-2012-008).

The FHFA cited three reasons in defense of its style of conservatorship: efficiency, concordant goals, and operational savings (WPR-2012-00, FHFA-OIG, WPR-2015-002, 10). The GSE employees knew the business and were well equipped to continue to carry out normal business operations. The goals of the Enterprises were consistent with those of the conservatorships, i.e., return the firms to stability. "FHFA views part of its "preserve and conserve" mandate to include preserving the entities as private companies with the capacity and responsibility to make business decisions following normal corporate governance procedures." (WPR-2015-002). Further, the FHFA pointed out that without knowing how long the conservatorships might last, it was not immediately apparent that staffing the FHFA to be able to command more of the business decisions of the $5 trillion businesses that employed 12,000 employees would be cost effective. (FHFA-OIG 2012, FHFA-OIG 2015).

Instead, the FHFA communicated with the GSE employees about the conservatorship and tried to maximize retention. The OCO played a liaison and administrative role between the GSEs and the FHFA. The OCO and the CGC worked to ensure that the firms were operating in a manner consistent with their delegations of authority, the stated conservator goals, and the overall objectives of the conservatorship (Ibid).

However, the OIG FHFA-OIG found that the agency's practices were flawed:

> FHFAOIG's reports consistently have revealed two trends: (1) the Agency, in its role as a conservator, does not independently test and validate Enterprise decision-making; and (2) the Agency, in its role as a regulator, is not proactive in its oversight and enforcement. In addition, FHFA may not have enough examiners to meet its oversight responsibilities. (OIG White Paper).

As a result of these procedures, the FHFA was criticized for not overseeing several major decisions that the GSEs had made. These included changes to its Single-Family underwriting standards and its High Touch Servicing Program (whereby it transferred $1.5billion in mortgage servicing rights to third party specialty servicers). It also found that the agency often failed to question decisions that were submitted to it for approval and relied too often on management's decision without an independent proof or business case. (Ibid.)

Additionally, the OIG concluded that the agency could better accomplish its oversight mission by proactively exerting greater control over its conservator approval process.

> Specifically, FHFA-OIG recommends that the Agency: (1) revisit FHFA's non-delegated authorities to ensure that significant Enterprise business decisions are sent

> to the conservator for approval; (2) guide the Enterprises to establish processes to ensure that actions requiring conservator approval are properly submitted for consideration; (3) properly analyze, document, and support conservator decisions; and (4) confirm compliance by the Enterprises with conservator decisions. FHFA agreed with most of FHFAOIG's recommendations." (FHA-OIG 2012).

The FHFA agreed with most of the OIG's recommendations which it worked to adopt. In 2014, the FHFA consolidated the conservatorship units into one and strengthened its processes to address the issues raised by the audit. In 2013, in response to the 2012 audit report it consolidated staff into the DOC, the which had 25 employees compared to the previous six.

8. The FHFA directed the GSEs to continue fulfilling their statutory purposes, including their support for affordable housing.

The GSE intervention was designed to keep the firms in operation so that they could "continue to fulfill their mission of providing stability, liquidity, and affordability to the [mortgage] market." (FHFA 2008 Annual Report to Congress). As a result, under the conservatorship, the FHFA directed the GSEs to continue their key business operations and MBS securitizations and placed no restrictions on the amount of MBS they could issue or guarantee. (Under the SPSPAs, they also were allowed to expand their portfolios for a short time—albeit not to exceed a limit of $850 billion—before having to start reducing them in 2010.) The GSEs' ability to continue operations was especially critical early in the conservatorship; with private-label securitization all but evaporated and the global credit crisis raging, the GSEs assumed a still larger role in the housing market and purchased a greater proportion of new mortgages.

The GSEs' housing mission was also targeted to assist with the government's wider foreclosure prevention efforts. At the end of 2008, FHFA reported the GSEs were "playing an important role in assisting the federal government in foreclosure mitigation activities." These efforts (which continued several years into the conservatorship and included, among other things, the GSEs' participation in the Home Affordable Refinance Program and streamlined modification initiative) were intended to serve the dual goals of limiting GSE credit losses and alleviating wider mortgage market stress, both of which in turn were key to stabilizing the GSEs long-term. (FHFA 2008/2009 Reports to Congress).

Even with the attention being paid to the mortgage crisis, affordable housing goals remained a priority (although they were notably absent from the 2012 Strategic Plan). (FHFA PR 02/2010). As long as the GSE structure remained unchanged, the GSEs were the primary vehicle for achieving these goals, even as the Obama Administration campaigned for their wind-down and the transfer of the mission to the FHA. Through HERA, FHFA was given the the authority to enforce these goals (which had previously rested with HUD) but mandated a change in the way they were structured beginning in 2010. Early in the conservatorship, the FHFA temporarily eased the goals in light of the difficult market situation. However, by the end of 2010, a new structure was in place, and the GSEs were required to meet four core single-family goals, one multifamily "special affordable" goal, and two related sub-goals, on an annual basis. (FHFA 2010 Report to Congress).

9. The FHFA revised the GSEs' executive compensation policies amid barriers to retention and hiring posed by the conservatorship.

Through HERA, the FHFA had the power to review any decision affecting executive compensation, and could amend GSE compensation practices as it saw fit.[12] (FHFA Annual Report to Congress 2008).

During the conservatorship, acting FHFA Acting Director Edward DeMarco (who replaced Lockhart in September 2009) identified enabling the GSEs to retain and recruit talented executives as key to fulfilling his agency's mission as conservator (DeMarco Statement 11/16/2009). Without competent executives, the two firms were at high risk of running into trouble yet again—an operational risk that could result in more losses and potentially add billions of dollars to the steep price taxpayers already had paid.

At a time when other developments at the firms were likely to motivate executives to leave (e.g. calls for the GSEs to be downsized or unchartered put their jobs at risk, and their performance was being scrutinized more than ever given the rising public investment in the firms), the FHFA set out to adjust executive compensation policies to give talented executives more of an incentive to stay. (FHFA Annual Report to Congress 2009).

After consulting with Treasury (including the Special Master for TARP Executive Compensation) and the boards of both firms, and retaining a private consulting firm (Hays Group) to serve as advisor, the FHFA eventually instituted a new three-pronged executive compensation policy at both entities. While the new system was designed to motivate high-performing executives to stay, it also was intended to rein in many of the excesses at the firms pre-conservatorship, for example, by prohibiting golden parachutes promised to outgoing CEOs and other senior executives. And whereas prior executive compensation policies placed an emphasis on company stock, the new GSE system was entirely cash-based, primarily owing to the extremely low value of GSE shares and the resulting risk-taking (upside only) holding these shares would incentivize.

The new system provided for three components of executive compensation—(1) base salary, (2) deferred salary, and (3) performance-based incentives—and was modeled after policies put in place at "institutions receiving exceptional TARP assistance." (DeMarco Statement 11/16/2011). Important aspects of these components are highlighted below:

[12] These broad authorities over executive compensation were granted as part of the arrangement enabling Treasury to purchase GSE obligations. Like Treasury's purchasing authority, these powers were temporary and set to expire December 31, 2009. However, on a permanent basis, HERA gave the FHFA other powers over executive compensation, including the authority to withhold executive compensation and prohibit severance payments. For more information, see Sections 1113, 1114, and 1117 of the HERA. (Public Law 110-289).

- Except for a few top executives, maximum base salaries would be set at $500,00—less than half of what they were prior to conservatorship.
- Performance-based compensation would be determined using only two years of results given the lack of a clear long-term plan for the firms.
- Deferred salary would be paid out a year after the base portion and would be forfeited by officials choosing to leave before the year's deferred payments were due.
- Deferred payments would make up the largest portion of top executives' total compensation package. (Ibid).

In March 2011, the FHFA OIG published a report analyzing the executive compensation policies put in place at both entities and criticized the FHFA for its lack of formal enforcement of the new policies. The report advised the FHFA, among other things, (1) to make information on GSE executive compensation more accessible to the public (and "more user-friendly") and (2) to develop formal control mechanisms to better enforce that the entities' compliance with the new policies. (FHFA OIG Report 2011).

Balancing the need to attract and retain qualified leadership for the firms and the mandated executive compensation restrictions has continued to be challenging for the firms and their conservator. In 2019, audits by the FHFA OIG found that FHFA's approval of senior executive succession planning at both firms had "acted to circumvent the congressionally mandated cap on CEO compensation."[13] The firms disagreed with the auditor's conclusions.

10. After enacting the conservatorship, the FHFA maintained transparency.

The FHFA used plans, reports, and scorecards to disseminate information and increase public transparency regarding the conservatorships. In 2009, the FHFA released its first annual performance plan. The plan outlined the FHFA's FY2009 objectives for the GSEs and detailed how it would use its resources to achieve those objectives (FHFA APP 12/15/2008). Beginning in 2010, the FHFA also released a quarterly conservator's report that summarized the fiscal health of both enterprises under conservatorship; the report lasted until 2013 1Q (FHFA website: Conservator's Report). In 2013, the FHFA began to release an annual scorecard, which was designed to make the FHFA's duties and objectives more transparent for the public (FHFA website). The FHFA also continued the practice of publishing its annual examination results for the GSEs, something which of course bank supervisors don't have to do.

The FHFA identified two reasons for governing the GSEs transparently: to increase public confidence in the GSEs and to inform taxpayers about the FHFA's role as conservator so as to reduce public uncertainty in the GSEs and help the mortgage markets return to their pre-crisis confidence levels more quickly (FHFA Speech 2008). In addition, Edward DeMarco,

[13] See OIG 2019a for the latest report on Fannie Mae and OIG 2019b for the last report on Freddie Mac.

who replaced Lockhart in 2009 as FHFA Director, acknowledged that taxpayer funds kept Fannie Mae and Freddie Mac in operation. For this reason, DeMarco pledged to outline how the FHFA had limited, and would limit, GSE losses (DeMarco 2010). Additionally, as the GSEs by their size were systemic in nature, many investors around the world were paying attention to developments with respect to the conservatorships.

III. Evaluation

W. Scott Frame et al. (2015) argue that the conservatorships succeeded as emergency interventions successfully stabilizing the GSEs. First, the intervention prevented agency debtholders or MBS holders from experiencing losses at a time when such institutions were already being challenged to navigate the worsening crisis, shielding the vast number of counterparties from negative impacts and containing the GSEs' weaknesses from bringing down the entire financial system (2015). In addition, the Congressional Budget Office (CBO) claims that the federal intervention increased the liquidity of GSEs' MBS (CBO Report 12/2010).

Second, the program allowed the GSEs to continue purchasing loans and issuing MBS, which maintained the flow of funding, moderated rates somewhat, and helped to stabilize the mortgage market (Frame et al. 2015). Indeed, the GSEs became more essential to the mortgage funding cycle, as private-label securitization had nearly disappeared.

Frame et al. qualify their approval by noting that the FHFA's focus on the financial health of the GSEs may have limited the overall mortgage supply, as the FHFA urged Fannie Mae and Freddie Mac to return defaulted mortgages to their originators or sellers, leading originators to tighten underwriting standards (Ibid). While the FHFA's decision to facilitate prosecution of originators and to implement stringent underwriting standards helped reduce the GSEs' losses, it also shrank the supply of mortgage credit, which Frame et al. (2015) argue contributed to the market's slow recovery. In contrast, the Mortgage Bankers Association (MBA) contends that the FHFA's stricter underwriting standards, particularly its decision to abolish preferential underwriting standards, made GSE loans more accessible for small lenders (MBA 2017). In addition, Winston Sale finds that the FHFA cut the GSEs' affordable housing goals to stabilize the market during the crisis (Sale 2009).

Some scholars find that FHFA actions have weakened other sectors of the economy. Tara Rice and Johnathan Rose contend that the conservatorship weakened the banking sector. They argue that the FHFA's decision to suspend dividends on preferred shareholders harmed already struggling banks, particularly community banks, which held large quantities of GSE stock. Fifteen banks closed because of this decision and two more were forced to sell themselves (Rice and Rose 2016).

From a governance and operational standpoint, several audits by the FHFA's Office of the Inspector General (OIG) found that the FHFA "can better accomplish its oversight mission by proactively exerting greater control over its conservator approval process." (FHFA-OIG 2012). Specifically, it was also found to have not properly monitored several components of

GSE operations, which resulted in financial losses for both companies. For example, a 2015 audit noted that the FHFA lacked a formal review process for the GSEs' compensatory fee settlements and large mortgaging service transfers (FHFA-OIG 2015). The OIG also found that the FHFA did not have an apparatus to measure properly the GSEs' performance levels or a system to monitor all company operations. In 2014, for instance, the FHFA did not detect that Fannie Mae and Freddie Mac had over-reimbursed their lender-based insurance servicers by approximately $158 million ($88 million for Fannie Mae and $70 million for Freddie Mac) (Ibid).

In addition, the OIG noted that the enterprises were in the unique position of having satisfy its housing policy goals, which cane with much outside attention. Other factors cited by the OIG or the FHFA that impacted the efficacy of the conservatorship:

- the unique size of the GSEs, which were factors larger than any other entity to have been previously resolved by the government;
- the unique nature of Fannie Mae and Freddie Mac as GSEs, which presented operational challenges and limited the conservator's exit strategies;
- the fact that the FHFA was a newly established agency, which at the time of the conservatorship was forming itself;
- despite retention efforts, there was significant turnover of GSE personnel, particularly at the management levels, and;
- tensions between the FHFA's role as regulator and conservator. (Cite).

Scholars generally find that the conservatorship has been unsatisfactory with respect to the longer-term objective of resolving the GSEs' structural issues and removing them from conservatorship. Despite the government's intention to use the conservatorship temporarily, they remain in effect ten years later. Fame et al. argue that the FHFA should have transitioned the conservatorships to receiverships, as the firms were technically insolvent (absent the Treasury commitment). Lockhart, however, states this option was not seriously considered. (Lockhart 2019).

While the conservatorships have kept the companies in business, Congress has yet to resolve the longer-term question of how to terminate the conservatorships or on a new form for the entities (Fame et al. 2015). The FHFA cannot discharge the GSEs from conservatorship without Treasury's approval and all parties seem to agree that releasing the GSEs from the conservatorship in their current form, with their quasi-public/private hybridity and implicit government guarantee intact, would not be ideal (OIG White Paper). It is unlikely that the conservatorships will end until Congress agrees on what form the entities should have upon release from the FHFA's supervision (FHFA-OIG 2015).

Despite these views, Jester et al. are of the opinion that enacting the conservatorships without developing a plan to exit them was entirely appropriate at the time, as the Treasury was focused on stemming the crisis rather than solving the broader policy issues that had helped to instigate their demise (Jester et al. 2018).

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IV. Key Program Documents

Summary of Program

- Christopher Dickerson to James B. Lockhart: Proposed Appointment of the Federal Housing Finance Agency as Conservator for Fannie Mae (09/06/2008) - *memo from Christopher Dickinson to James Lockhart that includes reasons for conservatorship and the background of the case.* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-09-06_FHFA_Fannie_Mae_Conservatorship_Memo_from_Dickerson_to_Lackhart_Re_Proposed_Appointment_of_the_Federal_Housing_Finance_Agency_as_Conservator_for_the_FederalNational_Martgage_Association.pdf

- Christopher Dickerson to Daniel Mudd (09/04/2008) – Mid-year report that classifies Fannie Mae as critically undercapitalized, which would give the FHFA director Lockhart discretion to take Fannie Mae into receivership (see Key Design Decision no. 2 for more information). http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-09-04%20FHFA%20Dickerson%20ltr%20to%20Fannie%20Mae%20Mudd%20-%20Mid-year%20letter.pdf

- Christopher Dickerson to Richard Syron (09/04/2008) – Mid-year report that classifies Freddie Mac as critically undercapitalized, which would give the FHFA director Lockhart discretion to take Freddie Mac into receivership (see Key Design Decision no. 2 for more information). http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-09-04%20FHFA%20Dickerson%20ltr%20to%20Freddie%20Mac%20Syron%20-%20Mid-year%20letter.pdf

- Fact Sheet: Federal Housing Finance Agency Conservatorship (09/07/2008) – *defines conservator, its function, goals, and other generally asked questions.*

https://www.treasury.gov/press-center/press-releases/Documents/fhfa_consrv_faq_090708hp1128.pdf

Implementation Documents

- Conservatorship Strategic Plan 2012 –*focuses on shrinking the GSEs' role in the mortgage market while continuing to provide an adequate supply to the market.* https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/20120221_StrategicPlanConservatorships_508.pdf
- Conservatorship Strategic Plan 2014 – *focuses less attention on reducing the size of Fannie and Freddie's market share.* https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2014StrategicPlan05132014Final.pdf
- Letter: Edward DeMarco to Committee on Banking, Housing and Urban Affairs and Committee on Financial Services (FHFA 02/02/2010) - *outlines the FHFA's commitment to scale back the GSEs portfolios and establish a new process for product review* https://www.fhfa.gov/Media/PublicAffairs/Documents/Letter_to_Dodd_Frank_Shelby_Bachus-02-02-2010_n508.pdf

Legal/Regulatory Guidance

- Emergency Economic Stabilization Act, (§1424) – *mandates that the FHFA act to prevent foreclosures.* https://www.gpo.gov/fdsys/pkg/PLAW-110publ343/pdf/PLAW-110publ343.pdf
- Housing and Economic Recovery Act of 2008 (§1117) – *legally authorizes the FHFA to take Fannie and Freddie into a conservatorship.* https://www.fhfa.gov/Government/Documents/GPO_Authenticated%20HERA.pdf

Press Releases/Announcements

- Meeting the Challenges of the Financial Crisis (03/18/2009) – outlines actions taken by the FHFA, Treasury, and the Fed in the first 6 months of conservatorship. https://www.fhfa.gov/Media/PublicAffairs/Pages/Women-in-Housing-and-Finance-Symposium.aspx
- Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (09/07/2008) – *Treasury press release that announces the four-part rescue plan for the GSEs, including the conservatorship.* https://www.treasury.gov/press-center/press-releases/Pages/hp1129.aspx
- Statement Regarding Contracts of Enterprises in Conservatorship (FHFA 09/07/2008) – *asserts that both GSEs will honor existing contracts and are able to enter new*

contracts. https://www.fhfa.gov/Media/PublicAffairs/Pages/Statement-of-FHFA-Regarding-Contracts-of-Enterprises-in-Conservatorship.aspx

- The Appointment of FHFA as Conservator for Fannie Mae and Freddie Mac (FHFA 09/23/2008) – *outlines the weaknesses of OFHEO (former GSE regulator) and explains why the FHFA decided to enter Fannie and Freddie into a conservatorship.* https://www.fhfa.gov/Media/PublicAffairs/Pages/Statement-of-James-B-Lockhart-III-Director-FHFA-Before-The-US-Senate-Committee-on-Banking-Housing-and-Urban-Affairs.aspx

Media Stories

- As Crisis Grew, a Few Options Shrank to One (09/07/2008) - *generally represents the media reaction and level of public understanding just after the conservatorship was enacted.* https://www.nytimes.com/2008/09/08/business/08takeover.html?_r=2&hp=&pagewanted=all&oref=slogin

- In Rescue to Stabilize Lending, U.S. Takes Over Mortgage Finance Titans (Stephen Labaton and Edmund L. Andrews (09/08/2008) - *generally represents the media reaction and level of public understanding just after the conservatorship was enacted.* https://www.nytimes.com/2008/09/08/business/08fannie.html

Key Academic Papers

- After the Deal: Fannie, Freddie, and the Financial Crisis Aftermath (Davidoff Solomon and Zaring 2015) - *explains the legal ramifications of the conservatorship, with particular emphasis on the 2012 amendment*. http://scholarship.law.berkeley.edu/facpubs/2477

- Effect of the Conservatorship of Fannie Mae and Freddie Mac on Affordable Housing (Sale 2009) - *explains how the conservatorship affected the GSEs' affordable housing goals.* http://www.jstor.org/stable/25782848

- The Rescue of Fannie Mae and Freddie Mac (Frame, Fuster, Tracy, and Vickery 2015) – *addresses the causes of the conservatorship and evaluates the program's efficacy in the short-run and the long-run.* http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.29.2.25

- When good investments go bad: The contraction in community bank lending after the 2008 GSE takeover (Rice and Rose 2016) - *examines and evaluates the effects the conservatorship, mainly from the perspective of banks.* http://www.sciencedirect.com/science/article/pii/S1042957316000127

Reports/Assessments

- 2008 Annual Report to Congress (FHFA 04/15/2008) – *covers basic operations, market contractions, financial health of the GSEs', and risk. See subsequent years below.*

https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/OFHEO_Report_Congress-2008.pdf

- 2008 (revised)
https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2008_AnnualReportToCongress_N508.pdf

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- 2016
https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/FHFA_2016_Report-to-Congress.pdf

- 2008 Performance and Accountability Report (FHFA 11/17/2008) – *describes factors leading up to conservatorship, operations of the FHFA, goals of the FHFA, and management strategies. See subsequent years below.*
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- 2016 https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/FHFA-2016-PAR.pdf
- 2012 Annual Scorecard: A Progress Report (FHFA 03/09/2012) - *establishes objectives and schedules to meet the goals outlined in the FHFA's strategic plans. See subsequent years below.* https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/ExecComp3912F.pdf
- 2013 https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2013EnterpriseScorecard_508.pdf
- 2014 *https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2014Scorecard051314FINAL.pdf*
- 2015 *https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2015-Scorecard.pdf*
- 2016 https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2016-Scorecard.pdf
- Fannie Mae, Freddie Mac, and the Federal Role in the Secondary Mortgage Market (CBO 12/2010) – analyzes reasons for Federal involvement in the secondary mortgage market and provides alternative approaches for the future of the secondary mortgage market. https://www.cbo.gov/sites/default/files/111th-congress-2009-2010/reports/12-23-fanniefreddie.pdf

- GSE Reform: Creating a Sustainable, More Vibrant Secondary Mortgage Market (MBA 04/2017) – develops a new GSE structure that could be sustainable for the GSEs after the conservatorship. https://www.mba.org/Documents/Policy/17305_MBA_GSE_Reform_Paper.pdf
- Housing Finance at a Glance: A Monthly Chartbook [sic] (Urban Institute 01/2016) – includes annualized data on market indicators, GSE portfolios limits, mortgage originations, et cetera. http://www.urban.org/research/publication/housing-finance-glance-monthly-chartbook-january-2016/view/full_report