The Rescue of Fannie Mae and Freddie Mac – Module E: The Housing and Economic Recovery Act of 2008

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I. Summary

As the United States housing crisis worsened in 2007 and through 2008, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) headed towards insolvency. Contractions in the private market increased these two Government Sponsored Enterprises’ (GSEs’) share of the secondary mortgage market to nearly half by 2008. The government passed the Housing and Economic Recovery Act of 2008 (HERA) on July 30, 2008, to address three interrelated concerns about Fannie Mae and Freddie Mac: the ability of their regulator to oversee them, their potential insolvency, and public uncertainty regarding whether the federal government would back their assets and liabilities. HERA provided Treasury and the newly formed Federal Housing Finance Agency (FHFA) with the requisite legislative framework to manage the distressed firms, which they did after placing the GSEs into conservatorship on September 6, 2008. The steps taken by the government pursuant to HERA are perceived to have avoided the collapse of the GSEs and the concomitant collapse of the U.S. housing market, but not to have addressed the longer-term issues inherent in the GSEs’ blended structure, which remain unresolved as the firms remain in conservatorship.

Note: This article addresses how HERA changed the government’s relationship with GSEs (specifically Fannie Mae and Freddie Mac) leading up to the crisis. It briefly mentions the Federal Home Loan Banks and does not discuss HERA’s other functions.

1The 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. 2017. “The Rescue of Fannie Mae and Freddie Mac, Module B: The Senior Preferred Stock Purchase Agreements (SPSPA).”


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II. GSE Regulation before July 2008

Several prominent federal officials expressed concerns about the efficacy of GSE regulators at least two decades before the crisis (Bernanke Lecture 03/27/2012). In 2004, Chairman Alan Greenspan argued that the GSEs’ private interests and public duties often conflicted, which created a systemic risk in the market (Greenspan Report 2004). During his tenure as Chairman, Ben Bernanke echoed Greenspan’s concerns, adding that Fannie Mae and Freddie Mac’s low capital limits posed a risk for the housing market and the economy (Paulson 2010, Bernanke 2015).

Prior to HERA, Congress had tried and failed to pass legislation to strengthen the GSEs’ regulators or create a stronger regulatory agency (Frame and White 2004). From the passage of the Federal Housing Enterprises Financial Soundness and Safety Act (1992) until the passage of HERA (2008), Fannie Mae and Freddie Mac were regulated using a two-tiered system composed of two bodies: The Department of Housing and Urban Development (HUD) and the Office of Federal Housing Enterprise Oversight (OFHEO), which operated as an independent agency within HUD (Ibid).

HUD monitored the GSEs’ commitment to the mission stated in their charter—i.e. whether they had adequately supplied the secondary mortgage market with loans, particularly for lower-income families (and underserved areas) (Fishbein 2003). HUD, which reviewed new mortgage program proposals from the GSEs, was required to authorize the programs within 45 days of their submission. Given the quick turnaround in this formal approval process, and the complexity of some new financial products, HUD occasionally did not formally review new GSE programs. For instance, HUD did not review the GSEs’ decision to begin purchasing subprime mortgages for their portfolios (Ibid).

OFHEO regulated the safety and soundness of Fannie Mae and Freddie Mac. As part of its duties, OFHEO examined the GSEs’ financial health, established risk-based capital standards, and ensured the GSEs’ compliance with the capital standards. OFHEO used three capital standards to evaluate the GSEs: a risk-based standard, a minimum capital standard, and a critical capital standard. The risk-based standard was intended to consist of enough capital to cover the interest, credit default, and operational risks plus an additional 30% of capital surplus. The established minimum capital standard was 2.5% of assets on the balance sheet and 0.45% of off-balance-sheet assets. The critical capital standard was set to 0.25% of on balance sheet and off-balance-sheet assets. OFHEO could seek disciplinary action if the GSEs violated capital standards or the law, which the agency did following the discovery of accounting errors in the early 2000s (Frame and White 2004).

OFHEO’s decision to conduct an intervention depended on the GSEs’ ability to meet the three aforementioned capital standards. Based on this capital assessment, Fannie Mae and Freddie Mac fell into four categories of increasing risk: adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized (Frame and White 2004). If a GSE met all three criteria it was classified as “adequately capitalized” and required no further action. If the GSE could not meet the risk-based standard, it was considered “undercapitalized.” In this case, the GSE had to submit a capital restoration plan.
to OFHEO and could not distribute more capital in the short-term. If the GSE failed to meet both the risk-based and minimum capital standards it was “significantly undercapitalized.” Here, the GSE would face the same restrictions as the undercapitalized classification along with additional growth restrictions. If the GSE met none of the three capital standards it was considered “critically undercapitalized.” OFHEO could then place the GSE into conservatorship (Ibid). Prior to HERA, however, conservatorship was not considered a viable option because OFHEO lacked a mechanism to finance a conservatorship and had no power to delegate losses between debtors and creditors (Frame et al. 2015). In addition, OFHEO was not authorized to initiate a receivership (Ibid).

As the mortgage market contracted, OFHEO changed capital regulations to ensure that the GSEs continued to provide the market with liquidity and retain sufficient capital. OFHEO raised the GSEs’ investment portfolio cap from approximately $728 billion to $735 billion in September 2007 and abolished the cap altogether in March 2008. It lowered the capital surplus requirement from 30% to 20% in March 2008 (and from 20% to 15% for Fannie Mae in June 2008), with an understanding that the GSEs would use these loosened restrictions to raise capital (FCIC 2011). While Fannie Mae was able to raise $7.4 billion in capital in May, Freddie Mac failed to do so (Ibid).

Despite OFHEO’s efforts to mitigate the GSEs’ losses, many observers believed that OFHEO’s existing structure and regulatory practices rendered it unable to handle the full extent of the crisis. OFHEO could not adjust minimum capital requirements, as the 1992 statute mandated that they remain at 2.5% and 0.45% of on-balance-sheet and off-balance-sheet assets respectively (Frame et al. 2015). OFHEO required annual Congressional appropriations to function, which subjected the regulator to political interests, particularly because Fannie Mae and Freddie Mac had substantial Congressional lobbying teams. OFHEO also lacked tools to regulate enterprise-wide risk (Frame and White 2004).

Even if OFHEO discovered risks outside of capital requirements, it did not always seek action. For instance, every agency report from 2005 to 2008 recognized the risk inherent in subprime and nonprime loans, but OFHEO did not ask Fannie Mae and Freddie Mac to curb their risky purchases (FCIC 2011).


When Fannie Mae and Freddie Mac began to post billion-dollar loses at the end of 2007, it became more apparent that the firms’ decision to purchase (and to continue to purchase) risky loans could destabilize the GSEs and, by extension, the entire financial system. Fannie Mae and Freddie Mac’s worsening health increased public concerns about whether the federal government would guarantee their assets. In the words of Tim Geithner (then President of the Federal Reserve Bank of New York [FRBNY]), “just about everyone except their captured regulator [OFHEO] agreed [Fannie Mae and Freddie Mac] were woefully undercapitalized” (Geithner 2014). Market concerns increased on July 7, 2008, when an analyst released a report speculating that Fannie and Freddie would not be able to raise the required 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 (Lockhart Testimony 09/23/2008).

In July 2008, at Treasury Secretary Paulson’s request, the Federal Reserve Board invoked section 13(13) of the Federal Reserve Act, enabling the FRBNY to extend a provisional line of credit to Fannie Mae and Freddie Mac (Fed 12/16/2008). This also allowed the Fed—in cooperation with the Office of the Comptroller of the Currency (OCC)—to conduct its own investigation into the GSEs for the first time (FCIC 2011). The review revealed that the GSEs were more financially unstable than previously suspected and might soon become insolvent. Treasury also hired a team from Morgan Stanley to review Fannie Mae and Freddie Mac’s business operations; their assessment corroborated the Fed and OCC’s conclusions (Ibid).

Paulson, Chairman Bernanke, and OFHEO director James Lockhart increased their lobbying efforts for legislation to create a new regulator that could rescue the GSEs from insolvency, stabilize them, resolve their regulatory issues, and quell general uncertainty in the market. On July 13, 2008, Secretary Paulson testified before Congress, requesting “GSE reform legislation [...] to have a strong independent regulator that will inject confidence into those institutions and into the markets” (Paulson C-Span 08/13/2008). Paulson stressed that the new regulator should have the financial capacity—with the backing of Treasury—to stabilize the GSEs. Offering an analogy to support his request, Paulson argued that Treasury required a “bazooka” that it could use to increase confidence in the stability of the agencies (FCIC 2011).

IV. The Housing and Economic Recovery Act (HERA): The Federal Housing Finance Agency (FHFA) and Treasury

On July 30, 2008, the government passed the Housing and Economic Recovery Act (HERA). The bill replaced OFHEO and HUD with the Federal Housing Finance Agency (FHFA) and enabled the FHFA and its new director, James Lockhart, to exercise significantly increased authority over Fannie Mae and Freddie Mac. Like OFHEO, the FHFA could restrict asset growth if it found a GSE to be undercapitalized. However, the FHFA could also adjust minimum and risk-based capital standards. The FHFA could use cease and desist authority and remove company officers. It was given power to review and approve the GSEs’ new products (previously the authority of HUD) (HERA). The FHFA no longer needed Congressional approval for its budget, providing it increased latitude (Frame 2009).

Based on the severity of the GSEs’ undercapitalization, the FHFA could restrict their capital distributions, force them to change their leadership, or—in the most severe cases of undercapitalization—place them in a conservatorship or a receivership (FHFA summary). After enacting a conservatorship, the FHFA could stabilize Fannie Mae and Freddie Mac by any means necessary and could access funds from the Treasury if needed. The conservatorship provision in HERA was intended to be similar to the power of the FDIC
over insolvent depository institutions, but unlike bank regulators, the FHFA did not need to resolve the insolvency at the lowest possible cost (Jickling 2008).

After passage of HERA, even though the FHFA was more powerful than its predecessor, it continued to use statutory capital requirements to analyze the health of Fannie Mae and Freddie Mac. Secretary Paulson claims that this approach left the FHFA unable to assess the capital needs of the market (Paulson 2010). Bernanke concurred with Paulson, adding that Federal Reserve officials had warned the regulator that the GSEs' capital limits were too low (Bernanke 2015). During this time, the GSEs capital levels were less than 2% (FCIC 2011).

While the FHFA was the GSEs’ regulator, HERA enabled Treasury to serve as a potential financial stopgap for Fannie Mae or Freddie Mac during conservatorship. Under Section 1117 of the act, Treasury could exercise its broad emergency powers once it determined that its actions were necessary to:

(i) provide stability to the financial markets;

(ii) prevent disruptions in the availability of mortgage finance; and

(iii) protect the taxpayer (HERA).

In this circumstance the Treasury could inject the GSEs with capital by purchasing an unlimited amount of their securities or debt, provided that such authority was exercised prior to December 31, 2009 (Ibid). This was a compromise of design, unlimited authority but limited as to time, which made the bill palatable to legislators, who were thought unlikely to grant a total blank check without any limits (Jester et al. 2018). However, while it recognized that it was to be a temporary authority to address the emergency situation at hand, it also acknowledged that the true scope of what might be needed to stabilize the GSEs was unknown (Paulson 2010). Concurrent with the passage of HERA, the federal debt ceiling was also expanded by $800 billion to $10.6 trillion to accommodate any emergency financing (Ibid).

Fannie Mae and Freddie Mac were also subject to additional guidelines, most prominently conforming loan limits. HERA also established a new formula for calculating the GSEs' conforming loan limit. HERA stipulated that the conforming loan limit would not exceed $417,000 for single-family units, and could be adjusted annually based on housing prices. The conforming loan limit could not be reduced; only increased (HERA).

HERA also designated the FHFA director to serve as director of the Federal Home Loan Banks (FHLBs). The FHLBs are a collection of 11 banks that lend to institutions, mainly commercial banks and thrifts, for purposes related to housing. The FHLBs experienced financial difficulties as the result of contractions in the housing markets, but not to the
same severity as Fannie Mae and Freddie Mac. HERA provided Treasury with the same emergency capability to stabilize the FHLBs that it allowed for the GSEs. Treasury never exercised its emergency authority related to the FHLBs (HERA).

V. Intervention

On September 7, with the two GSEs near insolvency and facing liquidity difficulties, Treasury and the FHFA (with the Fed in consultation as required) announced a four-part rescue plan to stabilize the firms: to place the GSEs into conservatorship\(^3\); to enter into senior preferred stock agreement with each GSE; to establish a secured credit facility with each GSE; and to purchase GSE MBS (See Figure 1 on following page).

Figure 1

<table>
<thead>
<tr>
<th>Programs developed using the HERA</th>
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<tbody>
<tr>
<td><strong>Name of intervention</strong></td>
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<tr>
<td>Conservatorship</td>
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<td>SPSPA</td>
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<td>Credit Facility</td>
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<td>MBS Purchase Program</td>
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The second and third components permitted the Treasury to inject funding into the GSEs to ensure that they remained solvent. Pursuant to the senior preferred stock purchase agreements (SPSPAs), the Treasury received GSE preferred stock (paying a 10% dividend) and the option to acquire 79.9% of the firms’ common stock for a nominal price in return for providing draws to maintain a positive net worth for the GSEs. The final part allowed Treasury to purchase GSE MBS, which would help sustain Fannie Mae and Freddie Mac in their key role as issuers (Frame et al. 2015).

\(^3\) The FHFA took Fannie Mae and Freddie Mac under separate conservatorships. We herein discuss the two conservatorships as one due to the similarities between the two structures.
While Fannie Mae and Freddie Mac faced different problems (e.g. Freddie Mac had a larger capital hole), the government decided to adopt the same approach to resolve both GSEs. In defense of treating Fannie Mae and Freddie Mac the same, Paulson argued that the market saw them as the same, as the market believed both had the implicit guarantee of the U.S. government (Paulson 2010).

Beginning in August 2008 and continuing during the first three months of the conservatorship, the newly formed FHFA absorbed employees from OFHEO, HUD, and FHFB (Federal Housing Finance Board), which interfered with its ability to act as conservator (FHFA PAR 11/17/2008). Under HERA, OFHEO and FHFB had a year to wind down their operations and to integrate into the FHFA (HUD’s non-GSE related duties would remain operational) (Ibid). However, the FHFA’s decision to enact a GSE conservatorship seems to have accelerated this process to less than three months. The FHFA absorbed all OFHEO and FHFB employees and operations by October 27, 2008 (Ibid). The FHFA would later report that overseeing the GSEs as conservator while simultaneously managing a major reorganization integrating new employees and operations had created “administrative and cultural challenges in merging information technologies and systems, financial and human resources functions, and operational differences” (FHFA Strategic Plan 07/09/2009). In effect, the FHFA was stressed with creating itself at the same time that it was charged with managing the two-trillion dollar GSEs and stabilizing the US mortgage market.

Fannie Mae and Freddie Mac continued to sustain significant losses until 2012, and often had to borrow from the Treasury to fund the dividend payments it made to the agency. Prior to 2012, Treasury invested $187.5 billion in draws pursuant to the SPSPA. It also purchased $225 billion GSE MBS (Thompson 2017 b). The Fed invested an additional $1,270.4 billion: $134.5 billion in GSE debt and $1,135.9 billion of GSE MBS purchased (FHFA Table 4a, 5).

In August 2012 the SPSPA was amended to require that, in lieu of dividend payments, the GSEs would pay all realized profits after a stated capital buffer to the Treasury. The payments did not reduce the GSEs’ debt to Treasury. Beginning in 2012 and continuing each year to this case’s publication, the GSEs posted annual profits. As of 4th quarter 2018, Fannie Mae and Freddie Mac have paid a composite $292.3 billion to Treasury in dividends and have received $191.5 billion in draws (Ibid).

Over the course of the conservatorship, GSE shareholders have filed several lawsuits challenging the government’s sweep of profits; lawsuits are still pending as of this case’s publication. Also, some critics have claimed that the continuing conservatorships have created uncertainty causing lenders to tighten their underwriting standards (Frame et al. 2015). There have been several proposals for reforming the GSEs by various constituencies but no resolution has yet taken hold. As of date of this memo, the firms continue to operate under conservatorship and the amended SPSPAs.
References


