

RESPONDING to the GLOBAL FINANCIAL CRISIS What We Did and Why We Did It

Rescuing the Mortgage Giants

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Note: The views expressed in this draft are strictly those of the author(s).

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Introduction

From the day Henry M. Paulson Jr. was sworn in as Treasury Secretary in July 2006, Fannie Mae and Freddie Mac were at the top of our list of policy priorities. We shared Secretary Paulson's concerns that these companies posed a major risk and might someday threaten the United States financial system and broader economy.

Fannie Mae and Freddie Mac were known as government-sponsored enterprises (GSEs) because they were chartered by Congress, required to support the mortgage market and called on to satisfy certain government housing policies. At the same time, they were publicly traded and managed for the benefit of their shareholders (who received significant profits over time) and their senior executives (who enjoyed Wall Street-level compensation). The government and taxpayers were not protected from the risk inherent in their business or compensated for the implicit obligation they had assumed.

The primary business of Fannie and Freddie was to buy mortgages that met defined criteria, which they then bundled into mortgage-backed securities (MBS) guaranteed by the GSEs and sold to investors. The mortgage companies also purchased and held their own portfolios of MBS, some guaranteed by the GSEs and others that were not.

All of this made the GSEs a dominant force in the secondary mortgage market. In 2006, as the housing market was peaking, they owned or guaranteed more than \$5 trillion in residential mortgages and mortgage-backed securities, or almost half of the country's home loans. They purchased about 80 percent of all new home mortgages.² They were also among the biggest creditors and counterparties in the global capital markets. To finance their operations, they issued a total of more than \$1.7 trillion of debt³—much of it sold not only to U.S. investors, but also to China, Japan, Russia, and Saudi Arabia among other foreign governments. In the summer of 2008, foreign investors held \$800 billion in debt issued by the GSEs.

Given their Congressional charter and government sponsorship, many investors, particularly foreign governments, viewed the GSE debt securities as if they were backed by the full faith and credit of the United States. As a consequence, the GSEs enjoyed an enormous funding advantage. They could borrow money at lower costs than similarly rated corporations without setting aside much capital to protect against losses, and use the proceeds to build an investment portfolio of MBS. Together, their investment portfolios totaled \$1.5 trillion, adding significant interest rate and credit risk.

Fannie and Freddie were powerful institutions in Washington, with an unparalleled lobbying and political giving operation and roots that ran deep into communities across the nation. Despite the widely understood risk they posed, no legislation to reform the GSEs was able to obtain Congressional approval.

²On *The Brink*, p. 3. As the housing market teetered, Fannie and Freddie's role would grow to fund three out of every four new mortgages. See FCIC, pp 312.

³Stress Test, p. 169.

But as housing prices declined and the economy weakened, the dangers of the GSEs became painfully evident. In 2007, Fannie and Freddie reported combined losses of more than \$5 billion. In the first quarter of 2008, the companies reported a combined loss of more than \$2 billion.

Investors began to lose confidence in both companies as losses ballooned. By the end of June 2008, the stock prices of both companies had declined more than 70 percent over the prior year. In the first two weeks of July, their share prices declined another 50 percent, reacting, in part, to a Wall Street research report that suggested they might need to raise as much as \$75 billion in additional capital.

With one mortgage broker after another toppling like so many dominos, Secretary Paulson believed strongly that we could not let the overall housing finance system collapse, especially given the underlying economic and market fragility. He decided to seek Congressional approval for a new set of tools to prevent a destabilizing insolvency that could pose a threat not just to the housing market and the broader economy but to the standing of the United States on the global stage and the status of the American dollar as the world's primary reserve currency.

I. Securing the Lifeline⁴

Rescuing Fannie Mae and Freddie Mac was always going to be a delicate operation. The GSEs themselves refused to acknowledge they were in trouble. While Fannie and Freddie had bipartisan support and long-standing ties to many Democrats on Capitol Hill, conservative Republicans were widely opposed to anything that smacked of a bailout. Even as we concluded new powers were needed, we knew there were risks in approaching Congress. Secretary Paulson described the situation as the “catch-22” of crisis policymaking: “There was always the chance by asking for these powers we would confirm just how fragile the GSEs were and spook investors,” he wrote. “Then, if Congress failed to come through, the markets would implode.”⁵

To lessen the risk of a failure, Secretary Paulson consulted with Congressional leaders; the Federal Reserve; the GSE's regulator, the Office of Federal Housing Enterprise Oversight (OFHEO); and the GSEs. With the groundwork laid, Secretary Paulson proposed a plan to Congress on July 13, 2008, that was designed to permit the GSEs to continue operating in support of the housing and mortgage markets, to assure that the GSEs had adequate capital to continue their business and to reduce systemic risk by strengthening regulation of the GSEs.⁶

⁴ This chapter only covers the period up to December 2009, when the GSE policies in response to the financial crisis were largely completed.

⁵ *On the Brink*, p. 148.

⁶ See <https://www.treasury.gov/press-center/press-releases/Pages/hp1079.aspx>.

The proposal had three key elements:

- 1) Providing temporary authority for Treasury to purchase GSE securities, including the ability to inject capital;
- 2) Creating a new regulator for the GSEs, with the powers to place Fannie and Freddie in receivership, and giving the Fed a consultative role in setting new capital requirements and other prudential standards;
- 3) Providing a liquidity backstop for the GSEs by increasing their line of credit with the Treasury.

We knew this was a bold move, limiting the independence of the GSEs and requiring Congress to cede much of its power over Fannie and Freddie. We sought “standby” authority for the Administration to deal with a liquidity problem, such as a failed auction of agency debt, and insisted on the ability to make an equity investment, if necessary to overcome insolvency. We did not propose a specific dollar amount. Instead we characterized the authority as “unspecified,” which would be constrained only by the government’s debt limit. The idea was that an effectively bottomless federal backstop would prevent investors from losing confidence in the GSEs, even if large losses continued.

Complicating matters, OFHEO had recently said that both Fannie and Freddie were adequately capitalized—calling into question whether our request for massive resources was necessary. There was concern at Treasury, however, that the GSEs were in serious jeopardy. Their financial performance was deteriorating, equity investors voted with their feet, the overall housing picture was bleak, and the GSEs’ thin capital layers did not provide an adequate cushion to absorb the losses many were forecasting. Given this backdrop, putting a dollar cap on the request would have been counterproductive, creating its own issues. A specific request, for example, might have implied that we had identified the size of the capital hole, which we had not.

We recognized that it would be politically impossible to ask Congress both for an unlimited sum of money and an unlimited amount of time. So we set an expiration date on the authorities for the end of December 2009—a date chosen to give the next administration some breathing room to assess next steps.

But even asking for those authorities on a temporary basis was a stretch. Many lawmakers didn’t believe that we needed these new powers; others were simply stunned by the sheer magnitude of the request. Even in their current state Fannie and Freddie still held enough sway on Capitol Hill to add language to the bill requiring that the administration obtain the GSE’s prior consent for any government investment. This ultimately would become a serious constraint.

Still, Secretary Paulson insisted that the bigger and broader the government’s firepower, the less likely it was to use it—and the less it would ultimately cost taxpayers. “If you’ve got a squirt gun in your pocket, you may have to take it out,” he famously told the Senate Banking Committee. “If you’ve got a bazooka, and people know you’ve got it, you may not have to take it out. By having something that is unspecified, it will

increase confidence, and by increasing confidence it will greatly reduce the likelihood it will ever be used.”⁷

We also asked Congress to create a new and strengthened regulator to oversee the GSEs. OFHEO had limited authority and a reputation for lax oversight. The newly created Federal Housing Finance Agency (FHFA), while taking on the previous OFHEO staff, would have more flexibility to make judgments about the financial condition of the GSEs, just as prudential bank regulators were able to do. We also asked Congress to provide the FHFA with the ability to place the GSEs in receivership, giving it the power to facilitate the orderly resolution of a failed GSE, similar to how the Federal Deposit Insurance Corp. had long approached failed banks. Further, we believed permitting the Fed to act in a consultative role on capital standards would lead to a better assessment of the current capital position of the GSEs and over time lead to enhanced regulatory oversight with improved capital standards.

Our plan reflected an effort to balance a host of competing interests. We needed to cover the losses, but we sought to do so in a way that made clear to the markets that the government was fully committed to taking responsibility and ownership of the GSE while not shocking the public into fearing that our investment would end up being a total loss to taxpayers.

A little more than two weeks after the proposal, following a series of intense negotiations, Congress approved the Housing and Economic Recovery Act (HERA) on July 30. It was, as Secretary Paulson noted, “the most expansive power to commit funds ever given to a Treasury secretary.”⁸

II. Assessing the Financial Condition of the GSEs

As soon as the legislation passed, we pulled together a “due diligence” team from across the government, led by a handful of banking examiners from the Fed working in close collaboration with colleagues from Office of the Comptroller of the Currency and the FDIC. None of these regulatory agencies had previously been responsible for GSE oversight or had access to their internal records. Having been designated a “consultative” regulator, the Fed for the first time gained the same access to the information that Fannie and Freddie provided its primary supervisor, now the FHFA. We also retained Morgan Stanley to provide an independent review, and together with our outside counsel, Wachtell Lipton, provide advice on capital alternatives. The first task of the team was to estimate the potential losses of the GSEs relative to their capital position.

By law, FHFA was confined to basing its capital adequacy determination on whether the GSEs held the minimum capital required by statute. Congress required that the GSEs hold capital equal to 2.5 percent of their balance sheet assets, and 0.45 percent of off

⁷ Henry Paulson, “Recent Developments in U.S. Financial Markets and Responses to them,” *Senate Committee on Banking, Housing, and Urban Affairs*: July 15, 2008, Transcript, pp 19.

<https://www.govinfo.gov/content/pkg/CHRG-110shrg50410/pdf/CHRG-110shrg50410.pdf>.

⁸ Paulson, *On the Brink*, pp 154.

balance sheet guarantees, much less than the capital that banking regulators required of commercial banks. The Fed examiners were free to assess whether an institution was, or could be, operating in an unsafe or unsound manner. In reaching that determination, the Fed could take into account a GSE's current or likely future financial condition as opposed to analysis based on more dated financial and regulatory reporting.

Throughout August, the banking regulators and their mortgage experts analyzed the GSE mortgage holdings and guarantees to determine estimates of potential future losses. The findings were more than troubling. The Fed found that the GSEs were significantly “under-reserved,” and that the combined losses of Fannie and Freddie could total between \$60 and \$70 billion,⁹ suggesting that both companies were already insolvent. The OCC also found insufficient loss reserves and identified significant problems in credit and risk management. Additionally, a significant portion of their regulatory capital was in the form of deferred tax assets, which traditional banking regulators limit for measuring capital adequacy.¹⁰ The analysis raised significant concerns about the viability of the GSEs as free-standing businesses; we were concerned about risking taxpayer funds in shareholder-owned companies with such dire prospects ahead.

Nonetheless, executives at Fannie and Freddie continued to tell Treasury that they were adequately capitalized and could manage through the housing downturn without breaching their required capital levels. Their loss projections were more favorable than our cross-agency team's findings in part because they had not considered the prospect of a sharp, nationwide decline in housing prices. Tellingly, each time the GSE's executives came in for a meeting, their prior worst-case loss projections turned into the next presentation's best-case scenario. Right up to the moment they were placed into conservatorship, both GSEs maintained that they were adequately capitalized.¹¹

While maintaining that their finances were still sound, Fannie's management asked for a significant government investment to boost confidence and encourage investors to come off the sidelines with fresh capital. Given our assessment of their capital position, we viewed their idea as unworkable.

Given the magnitude of the GSEs expected losses relative to their capital resources, we concluded we could not invest in Fannie and Freddie in their current form while providing adequate protection for taxpayers. Indeed, given that the boards of the GSEs had a fiduciary duty to protect their shareholders, we doubted they would accept any serious deal. And we worried that protracted negotiations, which almost certainly would leak, would only cause further market distress. Accordingly, Secretary Paulson decided the only investment he could endorse would be to stabilize the GSEs following their entry into either receivership or conservatorship.

⁹ Tim Clark Interview.

¹⁰ Frame, W. Scott, Andreas Fuster, Joseph Tracy and James Vickery. *The Rescue of Fannie Mae and Freddie Mac*. Federal Reserve Bank of New York Staff Reports, March, 2015. Pp 34. http://som.yale.edu/sites/default/files/Frame_W_Scott_et_al_The_Rescue_of_Fannie_Mae_and_Freddie_Mac.pdf.

¹¹ In the end, the GSEs required a government investment totaling \$191 billion.

III. Conservatorship or Receivership?

HERA left the decision on how to handle an insolvent GSE to the Director of FHFA, not the Treasury Secretary. And FHFA could not place Fannie or Freddie into receivership or conservatorship unless it concluded that the GSEs were severely undercapitalized or operating in an unsafe and unsound manner. As part of HERA, Congress incorporated our request to grant FHFA a new set of legal tools that empowered it to resolve the GSEs. This process, known as receivership, effectively called for FHFA to take over the administration of the GSEs and liquidate their assets.

Receivership, however, was fraught with peril. Resolving a financial institution through receivership requires the government to affirm or reject various contracts—everything from the leases for office space to complex financial derivatives—in a couple of days. Not only would that be extremely disruptive to Fannie and Freddie’s businesses, but we also doubted we could execute such a plan in the time required without the full cooperation of the GSEs. Based on management’s assertion that the GSEs had adequate capital, and their significant support on Capitol Hill, we had no expectation that they would voluntarily and confidentially work to develop a credible plan for receivership prior to a public announcement. We were also worried that receivership could leave us tied up in a morass of litigation. Our goal was to stabilize markets and build confidence and we feared the uncertainty of receivership would have the opposite effect.

Moreover, FHFA had a modest staff and no institutional experience managing a receivership. Fannie and Freddie would be two of the biggest receiverships of all-time. Could they really do the job?

By contrast, conservatorship—effectively a government takeover—would provide a “time out” and permit a more managed process. The GSEs would avoid a devastating default. Treasury’s commitment of capital would stabilize the GSEs and permit them to keep operating, supporting the mortgage market.

Given the potential for chaos, our team moved swiftly to reach a resolution with the GSEs. We knew that markets were fragile and suspected more bad news was on the way from Lehman, Washington Mutual and Wachovia. We feared that continued uncertainty over the status of the GSEs would lead to further difficulties for other financial institutions. We hoped announcing a solution for the GSEs would put us in the strongest possible position to deal with what lay ahead.

The GSEs could enter conservatorship either voluntarily or involuntarily by order of the FHFA. Our preference was to have the GSEs recognize the reality and volunteer. But we knew we had to build an airtight case for involuntary conservatorship so the GSEs would have no choice but to acquiesce.

As we were making our plans, we discovered a problem. On August 25, we learned that FHFA’s examiners had recently drafted and sent letters to Fannie and Freddie reviewing their second quarter financial statements. They had concluded that both companies were at least adequately capitalized and, in fact, exceeded their regulatory

capital. Still, FHFA had an out: the agency had discretionary authority to downgrade that assessment.

If we were to carry through with the conservatorship process, we would have to help FHFA build a much stronger case. The FHFA examiners suggested arguing that the GSEs had employed unsafe and unsound practices. But we knew, and the Fed and OCC agreed, that we couldn't impose capital punishment for what was essentially a bunch of speeding fines.

We could, however, return to the data. Using more sophisticated models than the ones FHFA employed, both our cross-agency team and Morgan Stanley identified significant weaknesses in the GSEs' capital positions. And unlike FHFA's point-in-time analysis, our team relied on a "stress test"-like approach, which identified a range of potential losses that, once exposed, could contribute to further deterioration.¹² The findings were clear and the Fed and OCC examiners who led the effort were persuasive. As a result of their analysis, the FHFA staff changed its assessment and concluded the GSEs were indeed significantly undercapitalized.

IV. Structuring the Investment

Heavily discounting managements' optimistic outlook, our team had already begun considering different ways to inject capital into the GSEs, even before receiving the estimated losses from the regulators.

Once we decided that we would invest only after Fannie and Freddie entered conservatorship, we then had to decide the form of investment. Even though the United States government had never explicitly guaranteed GSE debt, investors—including a significant number of foreign governments—purchased the securities with an expectation that the US would stand behind the debt. So, we knew that we would have to protect the senior debt holders to reduce systemic risk.

The next question was the treatment of subordinated debt. The subordinated debt had been introduced with the idea of increasing market discipline at the GSEs. If possible, we would have placed the government investment senior to the subordinated debt. Doing so, however, would have triggered a default on the senior debt. Committed to avoiding default on the senior debt, we had no choice but to protect the subordinated debt as well.

That meant that the government's investment would be junior to the debt but senior to the existing preferred and common stock. Concerned about any potential systemic risk, we asked the banking agencies to assess the potential exposures of banks to the GSE

¹² Our approach essentially marked the first time that macro-based stress tests had been applied as a significant supervisory tool. Six months later, stress tests became a critical component of the Geithner Treasury's crisis response plan, when the Fed a comprehensive assessment of the financial health of the nation's largest banking institutions.

preferred and they concluded that only a limited number of small institutions had holdings that were significant relative to their capital. Placing the Treasury investment senior to the existing preferred and common was highly unpopular with investors but we thought it was essential to protecting taxpayers.

V. Creating the Preferred Stock Purchase Agreement

The next question we faced was even thornier: Just how much money would we need to stabilize the GSEs? The ultimate losses were unknown, so we sought the flexibility to increase the size of the investment as needed. But we were constrained by the HERA legislation, which only permitted us to invest up to December 31, 2009.

We found the germ of a solution in the use of a “keepwell” agreement. In traditional corporate finance, a keepwell is an agreement between a parent company and a subsidiary in which the parent guarantees it will provide the required capital for the subsidiary.

We applied similar logic to the GSEs.

The keepwell, which became known as the preferred stock purchase agreement (PSPA), allowed us to maintain a positive net worth at the GSEs regardless of the future losses. In exchange for an initial payment from each GSE of \$1 billion (in the form of preferred stock), the Treasury committed to maintain the GSEs’ positive net worth. As losses mounted, the GSEs could ask for more capital from the government and Treasury’s preferred stock claim would increase accordingly. The benefit of this structure was that it met the requirements of HERA legislation to make the investment before our authority expired at the end of 2009, while providing the flexibility to increase future funding.

We also designed the preferred stock to be perpetual, meaning it did not have a stated maturity date. This provided further assurance that the GSEs would be able to continue their business without worrying about a looming maturity date for the preferred.

No one would care about the level of GSE capital if they were backed by a government promise to keep them solvent. The PSPAs effectively made explicit the previously implicit government guarantee of the GSEs and provided the reassurance long-term investors needed.

While the PSPAs were an elegant solution, we were concerned that some in Congress might complain about the appearance of circumventing lawmakers’ intent. As it turned out, there was little criticism.

In selecting the size limit of the PSPA commitment, we wanted a big number to eliminate any reasonable concern. The ultimate constraint was the debt ceiling, which had been increased by \$800 billion. Initially we wanted to continue with the concept of the “unspecified” authority by not selecting a specific number. The Justice Department’s

Office of Legal Counsel, however, suggested that we would be on firmer ground if we set a cap. We settled on \$100 billion per GSE, or \$200 billion in total—a figure that was much larger than the estimated losses at the time. Importantly, we knew we were leaving the next administration with the flexibility to add to the investment if our estimates of losses and capital requirements were too low. The Obama administration later took advantage of this to double the size of the commitment.

We should also make some reference to our desire to not only cover losses but the 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 taxpayers. Fortunately, the PSPAs permitted an amendment to increase the limit, as was later undertaken by the Obama administration.

VII. Obtaining Ownership in the GSEs

We set the dividend rate on the preferred based on a review of the market for similar securities. The preferred would pay a 10 percent cash dividend, except if a GSE failed to pay the required dividend in cash. In that case dividends would accrue at 12 percent.

We were determined that Treasury receive warrants to acquire common shares so that it would share in the upside if the GSEs returned to profitability. If we could have made the taxpayer stake equivalent to 100 percent of the common shares, we would have. But that would have created an accounting issue. If the government had obtained an 80 percent or larger stake in the GSEs, it would be required to consolidate the GSE's financial results onto its own balance sheet. By acquiring warrants for 79.9 percent of total shares, just under that threshold, we avoided adding trillions of GSE debt and guarantees to the federal balance sheet. At the same time, Treasury worked with the IRS to obtain regulations that helped preserve tens of billions of dollars of future tax benefits for the GSEs.

VIII. Reforming the GSEs

Beyond the financial terms of our investment, we took a number of steps to begin reshaping the GSEs. Secretary Paulson had been adamant that if large sums of taxpayer money were to be spent, we would need to send a strong message of a fresh start by replacing the chief executives of these institutions. We were fortunate to find two excellent and well qualified people to become new CEOs immediately.

To reduce the systemic risk, we limited the ability of the GSEs to increase their debt by more than 10 percent from their June 30, 2008, balances. Large debt balances had been used to finance the growth of their investment portfolios.

To maintain stability in the current mortgage market, we permitted the GSEs to increase their portfolios modestly until the end of 2009, up to \$850 billion each. But to reduce systemic risk from that point on, we required the portfolios to be gradually reduced by 10 percent per year, largely through natural run off, until they reached \$250 billion.

Another important action was curbing GSE lobbying. From the 1990s on, Fannie and Freddie relied on an aggressive lobbying strategy to advance their corporate interests. They would regularly host events in the districts of influential lawmakers, court the affordable housing partners, and built up a significant PAC to contribute to campaigns. Now, with the companies in conservatorship and the government as the controlling investor, it was both unnecessary and inappropriate for the GSEs to lobby. Eliminating lobbying also had the effect of appeasing some of the critics of the deal.

There were other steps with less immediate financial impact but with significant policy implications. One was putting compensation restrictions on members of the senior management team, including limits on potential golden parachute payments. We also set up a separate program to help troubled homeowners, known as HOPE NOW. Given the government intervention, we believed that Fannie and Freddie needed to focus on their basic business first.

IX. Stabilizing the Mortgage Markets

To further support the availability of mortgage financing, we created a program for Treasury to purchase newly issued mortgage-backed securities guaranteed by the GSEs. The Treasury MBS purchase program launched in early September and almost immediately had a positive effect, helping send mortgage rates lower. Treasury purchases over time totaled approximately \$225 billion. The Fed's quantitative easing program, initiated later, included the purchase of more than \$1 trillion of GSE MBS, providing additional support for the housing market.

On September 7, 2008, the FHFA placed the GSEs in conservatorship and Treasury announced its commitment to purchase preferred stock.

X. GSEs and the Next Phase of Financial Crisis Response

From the perspective of those of us joining the Obama Administration, the Paulson Treasury's conservatorship plan gave us breathing room to focus attention on the issues in the rest of financial system. The preferred stock purchase agreements helped reassure investors, at least temporarily, that Fannie and Freddie would continue to have the capital they needed to safely operate more safely. The debt purchases showed that the U.S. government believed in the GSE guarantee. And the credit facility provided additional reassurance that Fannie and Freddie would have access to the funds they needed.

We also quickly came to the same conclusion as our predecessors. As much as we found the government takeover distasteful and the GSEs in desperate need of reform, it would be premature to start making sweeping changes. For one thing, GSE securities were embedded throughout the global financial system. At the same time, keeping the mortgage finance market functioning as smoothly as possible was a necessary element of our larger effort to revive the damaged economy.

The importance of the GSEs was only reinforced by the lack of alternative channels of mortgage finance. When President Obama entered office, the private mortgage securitization market was effectively closed. And with investors concerned by a morass of litigation swirling around troubled mortgage bonds, there was little hope at the time for reviving it quickly. Nor could we expect the Federal Housing Administration to take on any more of the load it was already bearing. Fannie and Freddie, as a result of their government support, were essentially the only game in town. If we did anything to undermine their stability, we would risk a further collapse in housing prices, which would drag the economy further into a downward spiral.

XI. Raising the PSPA Commitments

For these reasons and more, we concluded that it would be unwise to start backing away from the GSEs, even as critics called for winding them down. Indeed, we would ultimately have to increase our support of the GSEs.

By the end of the year, many Wall Street analysts were conducting their own “stress tests” on the potential losses at the major banks. Those of us on the Obama Administration transition team were concerned Fannie and Freddie might capture their attention next. By our own projections, the results would be alarming. We feared the GSEs might easily require more than the previous Administration had committed. Just how much more, we asked ourselves, would be needed to maintain a well-functioning mortgage credit market?

Even though the Paulson Treasury had come up with an innovative way of supporting the GSEs, they capped that support at \$100 billion for each GSE, suggesting that amount would be more than sufficient to cover losses. However, as the housing market continued to decline, it became clear that more support would be necessary.

We faced the same dilemma as our predecessors. How much capital should we commit? It had to be enough so that the GSEs would be stable and we wouldn’t have to face the same question again and again. But if the number were too large, it might spook the markets into thinking that Fannie and Freddie were in even more dire shape than previously believed.

The result? In May 2009, we doubled the size of the PSPA commitment to \$200 billion per GSE.

XII. Raising the Portfolio Limits

The other issue we had to address was what to do about the enormous mortgage bond investment portfolios that Fannie and Freddie had accumulated. Because of their implicit government guarantee, over time the GSEs had abused their quasi-government status and taken advantage of ultra-low borrowing costs to purchase mortgage-backed securities—and then capture the spread income for their private shareholders. To its critics, this was a far cry from supporting the American dream of homeownership; it was operating an investment fund funded by the full faith and credit of the taxpayer. If the Geithner Treasury was serious about reforming the GSEs, the argument went, it would need to force them to shrink these portfolios.

The trouble was that we once again faced Augustine’s dilemma—the right answer for the future was the wrong answer for here and now. The portfolios needed to shrink, but not yet. Forcing Fannie and Freddie to reduce the size of their portfolios would have established two negative dynamics.

First, it would encourage a massive fire sale of mortgage assets at the precise time that we were rolling out program after program to avoid the type of downward pricing spiral it would have fueled. (That’s why the Paulson Treasury calibrated its GSE mortgage portfolio reduction policy to the natural run-off schedule of the investments.)

Second, it might exacerbate the artificially forced selling that was already going on as a result of the GSEs management of non-performing loans. In the ordinary course of making good on their guarantees of pools of mortgages, Fannie and Freddie would buy back the individual non-performing loans from pools that they guaranteed and hold them in their mortgage investment portfolio. So as the losses in their guarantee book increased, Fannie and Freddie were forced to buy hundreds of billions of dollars of loans that became delinquent in the fall of 2008. Their portfolios—which were supposed to be shrinking—started to sharply increase. If they were then forced to limit their holdings to stay under a set ceiling, it could put upward pressure on mortgage rates. Moreover, the increase was part of fulfilling their core mission as opposed to making investments in other securities for profit.

For these reasons, even though we agreed that the GSEs needed to reduce their investment portfolios over the medium-term, we didn’t think it was prudent to begin that process in the middle of a crisis. So, in May 2009, we lifted the cap on the portfolios by \$100 billion each—a move that not only avoided a fire sale but gave Fannie and Freddie some additional headroom to continue buying more of the distressed mortgages from their own mortgage security trusts.

XIII. Raising the PSPA Commitments—Again

In the spring and summer of 2009, we began to see small signs of stabilization in the housing market and what some were calling “green shoots” of an economic recovery. The stress tests for the banks, along with other actions we had taken, had injected some

much-needed confidence into the financial system. With interest rates low and the expansion of programs to encourage mortgage modifications, creditworthy borrowers were refinancing their home loans in droves.

With all of the focus on stress tests for the banks, it was only a matter of time before market participants and others began calling for similarly rigorous analysis of the GSEs. We wanted to get ahead of that, so we asked our colleagues at both FHFA and the Fed to each conduct stress tests to evaluate the depth of the losses on Fannie's and Freddie's books. Just as we had for the banks a few months earlier, we wanted to get a better handle on the GSEs' ability to withstand a severe recession. Neither GSE fared well.

Wall Street, meanwhile, was offering up its own projections. One Barclays Capital research analyst put out a note predicting that Treasury might need more than the \$200 billion that we had committed to each GSE.

With hundreds of thousands of foreclosures still in the pipeline and home prices still falling (although at a less severe clip), our outlook on the housing market remained negative. And we were very concerned about what might happen to Fannie and Freddie's finances if the economy failed to recover in 2010, leading to still more losses.

Confronted with the very real possibility that the GSEs might need even more capital, we were faced with a difficult if now somewhat familiar choice. We could seek to provide unlimited capital, authority, but the politics of this choice were as bad as they were when we considered and dismissed it in May 2009 and our predecessors had considered and dismissed it in 2008. We could try to increase the limits just before our authority ran out, but would run the risk of choosing a number that ultimately proved inadequate to cover the ultimate losses. So we settled on what we referred to as “doing unlimited without doing unlimited.”

The concept was to increase the PSPA cap by the amount of any losses the GSEs incurred. That way, definitionally, the cushion inside the cap would be a permanently fixed number and the cap could essentially increase automatically as needed. Since there was no hard-set limit, it also avoided the risk of a front-page headline: “Obama Administration Increases Cap to \$400 billion.” Instead, “Obama Administration Changes Formula,” was a less newsworthy event.

The formula we envisioned was straightforward. Our \$200 billion would increase by the amount of the net loss going forward. For example, if the GSEs lost another \$10 billion on top of the \$200 billion of capital we had already committed, the limit would increase to \$210 billion and the draw would go up by \$10 billion. There would always be enough money.

Secretary Geithner was reluctant to go that far and concerned that it would not pass muster with Congress. So, he advised us to put a stop date after which the mechanism would terminate and whatever cap was in place at that date would be the permanent cap.

This seemed a sensible approach. What's more, if Fannie and Freddie were going to suffer additional losses, they would probably be front-loaded because they are forced to set aside additional money in reserve if they believe they face a credible pattern of losses.

As a result, any capital needs were most likely going to come earlier rather than later, giving us confidence that we could give our "formulaic increase" device an end date of December 31, 2012. After that, the PSPAs would no longer be allowed to grow.

We announced the amendment on Christmas Eve of 2009, drawing little public attention. It was the one action most incongruous with all the steps we had taken to wind down the government's direct involvement in the financial sector that year. We had allowed healthier banks to start repaying their TARP funds. We were withdrawing our federal support from the liquidity that helped resuscitate important markets. Yet we were ratcheting up our involvement with the GSEs even as we vowed to wind them down.

We were convinced that it was critical that we provide Fannie and Freddie with a taxpayer lifeline during the crisis. And ultimately, we thought, Congress would figure out a way to do comprehensive housing finance reform within the next three years. (In 2011, in fact, we put out a white paper outlining several options.)

XIV. Lessons and Assessment

LESSON 1: THE GSE STRUCTURE WAS HIGHLY FLAWED

The combination of a public mission with private ownership and implied government support proved a toxic combination. The GSE guarantee was not explicit, priced, regulated or structured in any meaningful way. Compare the original GSE implicit guarantee with a similar liability guarantee for the banking system: deposit insurance. In that case, the guarantee is well-structured, explicit, priced, and regulated by an independent body. As a result of the poor design of the GSE guarantee, it became necessary at an early stage of the crisis to make the implicit guarantee explicit.

The regulatory supervision and capital standards for the GSEs were also wholly inadequate. Capital rules for financial intermediaries should be divorced from political economy and enforced by strong, independent regulatory agencies.

LESSON 2: MAINTAINING THE GSEs WAS A CRITICAL ELEMENT OF THE CRISIS RESPONSE

Treasury's investment in, and commitment to, the GSEs following their conservatorship played a vital role in addressing and reducing the potential impact of the crisis. The series of actions by both administrations fulfilled their primary mission: avoiding a destabilizing failure of the GSEs and supporting the shaky housing finance market.

But they accomplished even more. Unheralded by comparison to so many other crisis-era moves, these actions also eased the path to recovery. Most homeowners never realized it, but preserving Fannie and Freddie’s operational capabilities permitted credit to continue flowing into the mortgage market, helping to stop the downward cycle in home prices and contributing to the slow but steady economic recovery.

While profit was not the motive for the investment, and should not be the sole or primary basis for evaluating the actions, the government has received dividends in excess of the funds it invested. Over the last decade, Fannie and Freddie have paid total cumulative dividends of more than \$285 billion compared to an aggregate investment of \$191 billion under the PSPAs.¹³ The positive budget impact may be a significant reason that Congress has allowed them to survive in their current form.

LESSON 3: CONSERVATORSHIP CAN BE AN EFFECTIVE TOOL

While conservatorship is not the best choice in all situations, it was the most effective tool here. Under the circumstance in September 2008, pursuing a receivership would not have met the policy goals of reducing systemic risk, maintaining mortgage availability and protecting the taxpayer.

Conservatorship, on the other hand, permitted a “time out” to allow the GSEs to continue guaranteeing mortgages and supporting housing finance while providing clarity of governance and duties for the board of directors and the management team. The conservatorship itself was not a permanent solution, but it eliminated the immediate systemic threat posed by the potential failures of the GSEs. The ability to execute the conservatorship depended upon the substantial funding authorization obtained from Congress.

Institutionally, compared to bank holding companies as they existed prior to the crisis, the GSEs were also better candidates for conservatorship. They had a relatively simple operational model and a less complicated liability structure that was unlikely to deteriorate substantially under a prolonged period of government control.

LESSON 4: CONSERVATORSHIP WAS NOT DESIGNED AS A GSE REFORM PLAN

Our primary goal was to avoid a failure of the GSEs and thus a further collapse in the housing market and the financial system. We were trying to prevent a disaster—not

¹³ Tabulated using the standard calculation dividends from PSPAs less draws under the PSPAs. See: FHFA, “Dividends on Enterprise Draws from Treasury,” https://www.fhfa.gov/DataTools/Downloads/Documents/Market-Data/Table_2.pdf. FHFA, “Quarterly Draws on Treasury Commitments to Fannie Mae and Freddie Mac per the Senior Preferred Stock Purchase Agreements,” https://www.fhfa.gov/DataTools/Downloads/Documents/Market-Data/Table_1.pdf. Note: This number doesn’t include the profit from selling the GSE MBS portfolio (\$25 billion). See: <https://www.treasury.gov/press-center/press-releases/Pages/tg1453.aspx>.

design a reform package. Indeed, our plans intentionally allowed the GSEs to continue to function while Congress settled on a long-term plan.

Given that the GSEs remain under what was supposed to be a temporary conservatorship a decade later, it is tempting to ask whether we should have designed a mechanism to force an ultimate resolution of their status. We believed then, and continue to believe today, that this could well have destabilized markets by creating ongoing doubt over how the situation would be resolved against a looming deadline. So while we view the overhaul of the GSEs as important to the health of the housing market and the economy, we remain convinced that the steps we took were the right ones under the circumstances.