

The Next Step for the GSEs

The reelection of Donald Trump to the US presidency has ignited a flurry of speculation about whether his second administration will attempt to reprivatize Fannie Mae and Freddie Mac, also known as government-sponsored enterprises "GSEs." President Trump previously sought to end the conservatorship of Fannie and Freddie in his first term, but those endeavors were cut short when his tenure came to an end. The effort is expected to gain momentum under the second Trump administration as his party will also control both branches of Congress. If the Trump administration does pursue privatization, the process is unlikely to move quickly as several significant hurdles remain.

Background

Fannie and Freddie are technically private, shareholder owned corporations but have been under government conservatorship since the Global Financial Crisis "GFC" (September 2008). They were chartered by Congress with a public mission to promote homeownership and provide stability to the mortgage market. Due to their conservatorship arrangement, the US Treasury has the largest financial interest in Fannie and Freddie today, akin to that of a majority shareholder.

As a reminder, the GSEs don't originate or service mortgage loans themselves. They buy and securitize mortgages originated by other lenders and guarantee the principal and interest, which transforms individual mortgage loans into marketable bonds. This enables a competitive takeout for lenders, which means they don't have to hold loans on their books or hold capital against them. It also enables non-depository institutions to compete in the space, all of which helps to bring the cost of mortgages down.

Their Conservatorship Arrangement

Prior to the GFC, the GSEs were funded entirely with private capital but had a \$2.25 billion line of credit with the Treasury, which was interpreted as an implied government backing. As the

housing market deteriorated, the ability of the GSEs to service their \$5+ trillion of outstanding debt became questionable and the government intervened. That intervention came in the form of "conservatorship," which is a legal status that allows their regulator, the Federal Housing Finance Agency "FHFA," to essentially fulfill the role of and replace the rights of the companies' shareholders and board of directors.

The Treasury also stepped in financially through a formal "Preferred Stock Purchase Agreement" (PSPA) that assured the Treasury would support the creditworthiness of both companies. In the first few years of conservatorship, the GSEs drew about \$190 billion in funding from the Treasury in the form preferred stock and warrants. In return, they were required to send most of their profits back to the Treasury for repayment. Consequently, the GSEs were not retaining earnings to rebuild capital until a 2019 amendment under the first Trump administration permitted them to retain some of their earnings.

Even after the Treasury's capital injection was paid back, the Treasury continued to receive the bulk of GSEs' profits. Those payments have gone into general Treasury funds, reducing the amount the government has to borrow each year. Since the 2019 amendment, Fannie and Freddie have been permitted to maintain modest capital reserves.

The Path to Reprivatization

Releasing the GSEs from conservatorship is a complex and multifaceted process. At this point, there is also no agreed upon path for how to do it. FHFA regulations prohibit the GSEs from being released until they are fully recapitalized and various other requirements are met. The most straightforward way to recapitalize the entities would be through accumulating retained earnings. However, because the GSEs have only been permitted to retain some earnings, it would likely still take a number of

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years more for them to retain enough to meet a minimum capital requirement.

Another complicating factor is the nature of their PSPA agreement with the Treasury, which compensated the Treasury for its financial support by awarding it warrants on the GSEs common equity for ~80% of the shares of each GSE. This means that were conservatorship to end, the government would still effectively have 80% voting control of each GSE. Selling those positions to fully unwind government control would not be straightforward either. Given the size of the positions, which is estimated to be more than 8x the largest IPO ever done, selling the shares could take several years to complete.

Additionally, increased capital requirements could lead to higher guarantee fees from the agencies, potentially resulting in an unpopular upward pressure on mortgage rates. According to some estimates, the resultant increase in mortgage rates could be close to 1%. Analysts also believe an explicit government guarantee, akin to what they currently have under conservatorship, would likely still be necessary to ensure mortgage-backed securities remain attractive to investors. The future path of the GSEs is undoubtedly uncertain but this will be an important issue for investors to watch as the new administration takes office, especially given the potential consequences on the mortgage market and the implications on homeowner affordability.

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