

First Steps to GSE Reform

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This month marks the ten year anniversary of the government placing Fannie Mae and Freddie Mae into conservatorship. While the future role and format of these enterprises is still a matter of debate in Washington, it was never Congress's intention for the conservatorships to be permanent. The GSEs remain the only financial institutions that have not been recapitalized following the 2008 financial crisis.

Regardless of the specifics of the ultimate mandate for the GSEs, it is imperative that they start building capital. All of the possible end-states of housing finance reform require substantial private capital to protect taxpayers. To accomplish this there are two important steps that should be taken now.

The first course of action to rebuild private capital would be for the GSEs to suspend payment of dividends to Treasury. Since the conservatorship began, the GSEs have sent the government \$280 billion in dividend payments, nearly \$90 billion more than the \$191.5 billion invested to backstop them after the financial crisis. Fannie and Freddie have now paid back all of the money they received plus a 10% annualized return, fulfilling the original terms of the taxpayers' investment.

The second step would be to declare the government's senior preferred shares fully paid. In 2012, the government changed the dividend terms from the original 10% rate to a complete sweep of all future GSE earnings. By doing so, the government's nearly \$200 billion in senior preferred shares were never amortized, no earnings were retained, and the GSEs remain in a perpetual state of insolvency. By re-characterizing historical dividends in excess of the contractual 10% rate as pay-down, the senior preferred can be fully amortized. This is crucial, because by declaring the senior preferred fully paid, the GSEs can now retain all their earnings and start building common equity capital to protect taxpayers against the risk of future bailouts.

By implementing these two steps, the GSEs can begin to chart the path out of conservatorship. Having a capital buffer will also maximize the government's flexibility when deciding on the specifics of the GSE's future role. In addition to building capital, there is a silver lining in this situation. Frequently forgotten, the other key term of the conservatorship is that Treasury was provided with 79.9% of the common equity in the GSEs. While the senior preferred remains outstanding, it will be impossible to raise any new private capital. However, with the senior preferred stock deemed repaid, the enterprises can raise substantial private capital, and the government can monetize its majority ownership position in Fannie and Freddie – following the successful example of AIG. Financial analysis published by my firm, Moelis & Company has estimated that sale of the government's equity stake could yield \$75-100 billion in incremental profits above and beyond the nearly \$90 billion of taxpayer profits received to date. Together, this would represent by far, the largest gain for the Treasury in U.S. financial history.

The time has come for the Treasury to work with the GSEs' regulator in taking the first steps towards removing the GSEs from conservatorship. By suspending dividends and declaring the senior preferred fully paid, the GSEs can begin to rebuild the capital necessary to exit the conservatorship. Importantly, building capital at the GSEs by no means precludes other options that Congress or the Administration may consider as they continue to deliberate on the future of housing finance. To the contrary, starting the process of building capital maximizes the Treasury's future flexibility. As an added bonus, taking these two steps today will begin to crystalize the value of the government's equity investment, which can produce an additional \$75-100 billion taxpayer profit.

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The views expressed in this article are those of the author and not necessarily the views of his employer. Moelis provides financial advisory services to clients on matters related to the mortgage industry, including advising the non-litigating junior preferred shareholders of both Fannie and Freddie.