# GSE Reform Remains Important

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The novel coronavirus has wreaked havoc with financial markets and forced the Federal Reserve to resort to extraordinary measures to provide liquidity and ensure that markets do not seize up and exacerbate an already-difficult economic situation.

The timing of the Fed's intervention has proven to be somewhat unfortunate, at least from the perspective of housing finance policy, as it occurred shortly before the Federal Housing Finance Agency planned propose a rule that would allow Fannie Mae and Freddie Mac, the government-sponsored entities that help inject liquidity the housing market by purchasing, packaging, and then selling the mortgage-backed securities, to retain capital and begin to take steps towards leaving their government conservatorship.

The crisis has caused some to suggest that the Agency cease its efforts and allow the GSEs to remain in their current status quo indefinitely. While the agency has sensibly delayed issuing any new rule, citing the impracticability for interested parties to provide them feedback on any rule in the current environment, it has indicated that it will go ahead and issue a proposed rule as soon as it is feasible.

As well it should : Recapitalizing Fannie and Freddie is long-overdue, and their current limbo, where they are at once private corporations and wards of the state, has been one reason why the construction of new housing remains far below what it was prior to the Great Recession and that housing shortages exist in many regions of the country.

Here's the issue: the government put Fannie and Freddie into a conservatorship in 2008, in the height of the financial crisis, and injected nearly $200 billion of capital into them. In exchange it took a claim on just less than 80% of the company. Under the dictates of the conservatorship the GSEs were to pay the Treasury dividend equal to ten percent of its investment each year.

The GSEs suffered heavy losses during the financial crisis and its immediate aftermath, largely due to risky portfolios they retained in an effort to goose profits and stock prices. When the economy recovered, housing prices started to rebound and the companies started to make money again—a lot of it: in 2013 alone Fannie Mae and Freddie Mac reported profits of over $130 billion.

In 2011 the Obama Administration Treasury forecast that the GSEs were about to go into the black, and realized that continued increases in housing prices would make the GSEs wildly profitable. It decided to take advantage of that by imposing a new rule that allowed it to sweep the net worth of Fannie Mae and Freddie Mac into its coffers.

Since the implementation of the net sweep, the Treasury has taken in more than $340 billion—well more than the capital it put into the GSEs. The sweep proved to be politically advantageous, as their profits allowed the administration to reduce its reported deficits for the 2012 election year. However, the maneuver left Fannie Mae and Freddie Mac undercapitalized and dependent upon Treasury for funding if they incur any losses in the future.

In 2019 Mark Calabria, a former staffer for the senate banking committee and Cato Institute economist (where we were briefly colleagues) became FHFA Administrator, and he quickly made it clear that his first goal was to recapitalize the GSEs, end the sweep, and sever their dependency on the Treasury. Allowing them to retain more capital would allow them to ultimately make more loans, thereby boosting the construction of new housing. Also, allowing them to retain capital and grow would help stabilize the entities and put the Treasury in a position where it could start to sell some of its 79.9 percent share of each GSE, which would generate another chunk of change for Treasury's coffers—well over $100 billion, based on the cash flow of the last few years.

Recapitalizing the GSEs and then selling them back to the private market would not only be good for home construction but it would also send a signal to the economy that, despite the government's necessary intervention into the markets to staunch a potential financial or economic collapse due to the novel coronavirus, such wholesale government intrusions into the market do not represent a new modus operandi for our government.

Given that the legislation President Trump signed into law last week allows the Administration to demand warrants from businesses who receive government assistance, recapitalizing the GSES would help the Administration argue—truthfully—that the cost of this bailout may end up to be significantly less than $2 trillion allocated via the CARES Act.

Regardless of how long this coronavirus-recession lasts, we will come out of it with the same housing shortage we have today. Further delaying the recap and release of the GSEs will do nothing but exacerbate that problem when economic growth resumes.