AMERICAN ECONOMIC LIBERTIES PROJECT

Seven Key Questions About the Potential Release of Fannie Mae and Freddie Mac from Government Conservatorship

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Last week, President Trump declared he was giving "serious consideration" to privatizing Fannie Mae and Freddie Mac after 17 years of government conservatorship. Without a thorough legislative process that imposes proper safeguards, the release of Fannie and Freddie from conservatorship could spike mortgage rates, reduce access to credit, drive smaller mortgage lenders out of business, and disrupt the global market for US mortgage-backed securities. This issue brief provides background on how Fannie and Freddie arrived at this point and identifies seven key questions that will determine how a possible release from conservatorship could affect consumers and America's mortgage and financial markets.

Background

Fannie Mae and Freddie Mac are government-sponsored enterprises, or GSEs, and central actors in America's housing market. Congress created Fannie Mae in 1938, during the Great Depression, to make it easier for Americans to obtain mortgages. It created Freddie Mac in 1970 to compete with Fannie Mae. Although Congress established the GSEs, they operated as fully private entities from 1970 onward.

The GSEs do not issue mortgages directly. Instead, they purchase mortgages from banks and other lenders, thereby offering liquidity to those lenders so they can issue more mortgages. The GSEs then package mortgages, guarantee the principal-and-interest payments on those mortgages, and sell them as credit-risk-free mortgage-backed securities. This steady flow of liquidity — from purchasers of mortgage-backed securities to the GSEs to primary mortgage market lenders to home purchasers — has increased access to home ownership in America and sustained uniquely American financial products like the 30-year fixed-rate mortgage.

In the run up to the 2008 financial crisis, the GSEs began taking on more risk. Traditionally, the GSEs had robust underwriting criteria — refusing to purchase and guarantee mortgages with no or minimal down payments, or where the home purchaser had a very low credit score. The refusal of the GSEs to purchase those loans meant that mortgage lenders were hesitant to issue them at all, knowing they would be stuck carrying those riskier loans on their own books. But the 1990s saw efforts from Congress and the executive branch to push the GSEs to expand the pool of loans they would purchase. While that led to some expansion in the "credit box" — the types of loans the GSEs would purchase — it occurred in tandem with a much larger expansion of credit that accompanied the rise of private-label securitization (PLS) in the 2000s. This led to a surge of private entities purchasing loans of all types — no-down-payment loans, subprime loans, loans with severe teaser rates that would spike after a few years — and then selling packages of those loans to investors seeking higher returns. The GSEs reacted by expanding the types of loans they would purchase and by buying those higher-return private-label securities to goose returns for their private shareholders.

When the housing market collapsed in 2008 and millions of homeowners struggled to make their required monthly principal-and-interest payments, the GSEs found themselves in an untenable financial condition. They had far too little capital on hand to absorb the losses they were projected to take from covering both the missed payments on defaulted mortgages they had guaranteed and the private-label securities they had purchased, which were cratering in value. Policymakers feared that if the GSEs collapsed, so would the American housing market.

In response, Congress passed the Housing and Economic Recovery Act (HERA) in July 2008. Among many other provisions, HERA established the Federal Housing Finance Agency (FHFA) and authorized it to put the GSEs into government conservatorship. In September 2008, FHFA invoked that authority, placing the GSEs in conservatorship and working with the Treasury Department to use nearly $200 billion in public money to help stabilize the GSEs' finances. In addition, Treasury and FHFA reached an agreement known as the Senior Preferred Stock Purchase Agreement, or PSPA. Under its terms, Treasury invested $1 billion in senior preferred stock in both Fannie and Freddie, which entitled the Treasury to a 10% annual dividend payment and a liquidation preference, putting Treasury at the front of the line for repayment in the event the GSEs were liquidated. The GSEs' existing private shareholders — who owned junior preferred shares — saw the value of those shares drop precipitously.

Since 2008, FHFA has strictly regulated the operations of the GSEs in conservatorship, and the primary and secondary mortgage markets have functioned smoothly. And per the PSPA, Fannie and Freddie have provided the Treasury with significant dividends — each fully repaying the funds the Treasury provided to stabilize their finances and billions more.

Despite this stable situation — where taxpayers are compensated for the value of the guarantee they are providing the GSEs, mortgage originators are largely happy with the service the GSEs provide, and investors are getting credit-risk-free mortgage-backed securities in a deep and liquid market — there are still those who would like to see the GSEs released from conservatorship. Hedge funds and other investors who own junior preferred shares in the GSEs have a strong financial interest in such a release because the value of those shares would likely increase. There are both policymakers and advocates who would like the GSEs to be released because they believe that conservatorship was supposed to be a short-term solution, not a permanent state of affairs. Some policymakers also believe the release could be part of a grand bargain that would produce a steady stream of funding for affordable housing construction.

The chances of a release appear higher today than at any time in the 17 years since the GSEs entered conservatorship. In addition to President Trump's recent comments, his treasury secretary and FHFA director have expressed a desire to explore such a release. The value of Fannie and Freddie junior preferred shares have risen sharply, as investors raise the odds of a possible release.

Key Questions

The GSEs underpin America's housing market, which is roughly one-sixth of its economy. The potential release of the GSEs from conservatorship and back into private hands is extraordinarily complex and could have significant implications for investors, homeowners, homebuyers and sellers, mortgage lenders, and taxpayers. The public should consider these seven key questions as the debate over release continues.

Question One: If the Trump administration pursues a release from conservatorship, will it do so legislatively or administratively?

While this seems like a technical question, it has significant ramifications. If the administration opts to use its existing legal authorities to release the GSEs from conservatorship, there are serious limitations on the reforms it can pursue. For example, it is unclear whether the administration could unilaterally require the newly private GSEs to pay the government in exchange for an explicit guarantee that the government would step in to support the GSEs financially if they were in distress. Since the GSEs are critical to the function of the mortgage market and it is likely that the government would need to step in if they were at risk of failure, it would be a raw deal for taxpayers if they implicitly guaranteed the viability of the GSEs without receiving compensation for the value of that guarantee. An implicit — rather than explicit — guarantee would also likely drive up costs for the GSEs, filtering down to higher costs for homebuyers.

If the administration pursues a legislative process, it can modify any aspect of the operation of the GSEs and the terms of their release from conservatorship. This could also be an attractive option for policymakers because certain types of GSE reform could bring in revenue to the federal government, making reform a potential budgetary offset for tax cuts or spending increases. But legislative reform is likely to be extraordinarily difficult and time-consuming given the complexity of the issue and the thorny political considerations required to balance the interests of mortgage lenders, taxpayers, potential homeowners, and investors. The Senate put significant effort into legislative reform in 2013 and 2014, building on a bipartisan bill from Senators Mark Warner and Bob Corker, but that process ultimately petered out as political objections from external stakeholders and within the Senate piled up. A similar fate could await another legislative push.

Question Two: What will happen to mortgage rates, especially for borrowers with lower incomes or credit scores who are currently benefiting from the GSEs' cross-subsidization?

Under conservatorship, the GSEs engage in "cross-subsidization" to promote access to affordable mortgages for creditworthy borrowers with lower incomes and credit scores. As of 2023, the GSEs were charging an average of a 66-basis-point fee to provide a guarantee on any loan that met its eligibility criteria, with relatively minimal variation from that average based on individual loan characteristics. In other words, the GSEs are charging low-risk borrowers a slightly higher guarantee fee so that they can charge riskier borrowers a slightly lower guarantee fee and provide an easier pathway to home ownership for borrowers without large incomes and pristine credit scores. And by maintaining the other underwriting guardrails around loan size, down payment amount, and credit score, the GSEs are avoiding subsidizing borrowers who are unlikely to be able to repay their mortgages.

If the GSEs were to eliminate cross-subsidization, the guarantee fee could fall by roughly 20-30 basis points for the least risky borrowers (those with higher incomes and credit scores) and could rise by a similar 20-30 basis points for the most risky borrowers who meet eligibility criteria. That, in turn, could translate into mortgage rates 20-30 basis points higher for these riskier borrowers, resulting in less access to credit and a harder path to home ownership for borrowers whose credit scores are strong but not flawless.

Question Three: Will the GSEs narrow the types of mortgages they are willing to purchase and guarantee, thereby limiting access to credit for borrowers with lower incomes and weaker credit scores?

The GSEs currently purchase a relatively constrained set of mortgages. The weighted average credit score for a mortgage in the GSEs' portfolios is in the mid-750s. That is quite a bit higher than the credit score of the average American, and substantially higher than the average credit score for Black households (677) and Hispanic households (701). The credit box is also limited by rules on minimum down payment size, loan type, and loan size. As explained above, these limitations have a strong influence on the primary mortgage market because lenders are hesitant to issue loans that do not qualify for purchase and guarantee by the GSEs.

The current credit box does reflect government mandates to purchase and guarantee mortgages from certain populations. Under the GSEs' affordable housing goals, mortgages from lower-income homebuyers must make up at least 25% of their loan purchases, and mortgages from minority neighborhoods must make up at least 12% of their purchases. These mortgages must still meet the other credit box requirements on down payment size, credit score, and loan size, but the mandate to purchase a certain number of these loans nudges primary market lenders into communities they might not otherwise serve to provide mortgages to creditworthy borrowers.

If the GSEs exit conservatorship under the Trump administration, these requirements are likely to disappear, and the credit box is likely to shrink. The affordable housing goals have been a long-standing target of conservatives. In addition, if the GSEs are operating as fully private entities without a public mission, they may decide to focus on lower-risk borrowers, pushing up minimum credit score and down payment requirements. The net effect is likely to be significantly less access to credit for young first-time homebuyers and for borrowers in lower-income or minority communities.

***Question Four*: What kind of capital requirements will apply to the GSEs upon release?**

Like other corporate entities, financial firms fund themselves through a mix of equity and debt. Capital requirements describe the minimum percentage of funding a firm derives from equity. As described above, in the lead-up to the financial crisis, the GSEs had a very small amount of capital relative to the level of risk they had taken on, which meant that when they started to take big losses, they did not have enough equity to absorb the losses and required public dollars to stay afloat.

Typically, it is more expensive to fund operations with equity rather than debt. As a result, higher capital requirements can be more expensive for companies. But if capital requirements are too low, companies may not be able to survive a downturn.

After they were placed into conservatorship in 2008, the GSEs essentially operated without capital requirements. Because the GSEs had a direct line of credit with the US Treasury, there was no need for them to rebuild their capital. That started to change in 2020, toward the end of the first Trump administration, when FHFA imposed minimum capital requirements on the GSEs and directed them to start retaining earnings to build capital — a precursor to trying to release them from conservatorship. The GSEs would need roughly $300 billion in capital combined to meet these requirements.

If the GSEs were released from conservatorship and then designated by the federal government's Financial Stability Oversight Council as systemically important financial institutions (SIFIs) — a label that applies to the very largest banks and financial firms in the United States — they would be subject to higher capital requirements than they are currently subject to under FHFA regulations. The more stringent capital requirements for SIFIs reflect that they are so large and interconnected in the financial system that they need to take extra precautions because their failure could precipitate widespread harm to the financial system and the US economy.

Given their size and role in the market, Fannie Mae and Freddie Mac should qualify as SIFIs. If the same rules applied to them as to other SIFIs, they would have to substantially increase their capital, which could result in additional pressure to stop serving riskier borrowers and focus more narrowly on low-risk borrowers who offer larger and more reliable returns. That would further shrink the credit box and reduce mortgage access in the US. Alternatively, if Fannie and Freddie were somehow exempted from SIFI capital standards, they would be more vulnerable to financial downturns and more likely to need hundreds of billions of dollars in taxpayer support, as they did in 2008.

***Question Five*: Will the GSEs continue to offer the same pricing to mortgage lenders regardless of their size, or will they start charging higher rates to small lenders?**

Under current FHFA oversight, the GSEs are required to offer the same pricing to lenders regardless of their size or the number of mortgages they are attempting to sell to the GSEs. In other words, while many purchasers offer volume discounts — where they offer a seller a lower price if they sell them a large quantity at one time — the GSEs do not. That is because FHFA believes it is in the public interest for smaller lenders — who often serve harder-to-reach communities — to be able to offer pricing that is competitive with larger lenders. If larger lenders could consistently get lower guarantee fees from the GSEs for their mortgages, they could offer lower rates in the primary market, scoop up more market share from smaller lenders, and potentially drive them out of business.

If the GSEs exit conservatorship and are no longer subject to the fair pricing requirement, they may seek to increase profits by offering more differentiated pricing based on lender size. It is more time-intensive to purchase a few mortgages at a time from smaller lenders than it is to purchase large blocks of mortgages from a single large lender, and the GSEs could choose to charge the smaller lenders substantially higher guarantee fees to reflect those costs. It is also possible that as Fannie and Freddie compete with each other, one may decide to offer much lower prices to large lenders to attract their business, allowing that lender to offer lower pricing in the primary market compared to smaller lenders in the areas they serve. That could drive smaller lenders out of business, lead to areas where very few — or no — lenders are operating consistently, and concentrate the primary mortgage market in certain communities. Ultimately, without rules to reflect the public interest in ensuring a dynamic, competitive mortgage market and access to credit in harder-to-serve rural areas and minority communities, it is likely that these offerings would dry up.

***Question Six*: What kinds of restrictions on Fannie and Freddie's activities will endure?**

Before the financial crisis, Fannie and Freddie spent hundreds of millions of dollars on lobbying and campaign contributions. In many cases, those lobbying dollars were dedicated either to stopping efforts to regulate the GSEs in ways that would lower their profits, or to supporting efforts to remove restrictions on the GSEs. As noted above, in the lead-up to the financial crisis, the GSEs also operated massive investment portfolios, which produced billions in profits during good times but ended up pushing the GSEs into distress when their risky investments in private-label mortgage-backed securities started to blow up.

Under conservatorship, the GSEs cannot lobby the government and have had to significantly scale back their investment portfolios. The GSEs' investment portfolios have been cut by more than 80% compared to their 2008 peak of $1.5 trillion in investment assets.

These restrictions could evaporate upon a release from conservatorship. It is not clear whether the administration could continue to impose these restrictions without legislation to make sure they apply to the newly private entities. If, in fact, the GSEs are no longer subject to these requirements, there could be a return to the pre-crisis lobbying, campaign contributions, and risky investments that set the stage for the 2008 crisis. As the GSEs lose their public mission and focus on maximizing returns for private shareholders, they could once again expand their investment portfolios with riskier assets. There will be a particularly strong incentive to take these risks because GSE leaders know the federal government would almost certainly step in if they had another period of distress like they did in 2008.

Question Seven: Will release produce a steady stream of funding for affordable housing construction?

One consistent selling point in favor of releasing the GSEs from conservatorship has been that it can be done in a way that generates funding for affordable housing construction. There is a need for new affordable housing supply to put downward pressure on rents and create more options for first-time homebuyers. The prospect of funding for affordable housing construction appeals to policymakers across the political spectrum.

There are two main ways that releasing the GSEs from conservatorship could accomplish this. The GSEs could be required to either contribute a fixed portion of their profits or charge a small fee on the mortgage-backed securities they sell to produce a dedicated stream of funding each year for affordable housing construction funds at the federal level, like the Housing Trust Fund at the Department of Housing and Urban Development. Alternatively, the release from conservatorship could produce a large one-time contribution to affordable housing construction funds if some of the proceeds from selling the government's senior preferred shares in the GSEs were dedicated to such funds.

While more federal funding for affordable housing would be desirable, these approaches would require legislative action to execute and are therefore unlikely to come to fruition in the near term. Under current law, the administration would not have the authority to require the GSEs to charge ongoing fees or to take profits from a sale of government shares and dedicate them to a specific government funding program. And as noted above, there are a number of roadblocks to legislative action to address the GSEs. Even if the administration were to pursue legislative action to accomplish these goals, they would likely face stiff opposition from policymakers who believe they represent heavy-handed government interference in the operation of entities that should be strictly private. They would also face resistance from both policymakers and market participants who would argue that such requirements could distort the market pricing of mortgages and make it harder for the GSEs to raise necessary capital.

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Ultimately, release from conservatorship seems like a solution in search of a problem. While the status quo is not perfect, it generally accomplishes the original goals of the GSEs: delivering relatively low-cost liquidity to the primary mortgage market to help support the fixed-rate, long-term mortgages that set the US mortgage market apart from its global counterparts. Even a gradual and cautious release from conservatorship creates serious risks to the US mortgage market and global financial markets, with relatively little upside for homebuyers, home sellers, mortgage lenders, taxpayers, and investors. Meanwhile, a hasty release of the GSEs from conservatorship via a purely administrative process could throw the housing market into chaos and compound the economic risks that have emerged from the Trump administration's economic agenda. With all the other economic issues facing the administration, they might decide – as other recent administrations have – to let the issue lie.