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The FHFA and Treasury Should Not Allow Fannie and Freddie to Recapitalize

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Almost a decade into the federal conservatorship of Fannie Mae and Freddie Mac, Congress continues to delay passing legislation that would resolve their fates. Starting in 2018, after several years of scheduled reductions, both Fannie and Freddie will have depleted their capital reserve accounts, leaving them to cover any future and financial losses with further draws from the U.S. Treasury.

This situation has led to efforts, including those by the Director of the Federal Housing Finance Agency (FHFA), to allow both Fannie and Freddie to recapitalize by holding their own explicit capital buffer accounts. However, this is unnecessary given that both government-sponsored enterprises (GSEs) already have sufficient funding commitment under the terms of the Senior Preferred Stock Purchase Agreements (SPSPAs). Indeed, under the existing agreement with the Treasury, both Fannie and Freddie retain a funding commitment with the Treasury totaling $258.1 billion—an amount that significantly exceeds the level likely needed to cover any losses, even under a severe adverse economic scenario.

The FHFA and Treasury should avoid any misguided policy change—including allowing Fannie and Freddie to recapitalize—that would only provide taxpayers a superficial and short-term sense of "protection" without fundamentally addressing the inherent dangers these public–private partnerships truly represent. To protect the long-term interests of taxpayers, Congress should adopt meaningful free-market housing finance reforms—including shutting down Fannie Mae and Freddie Mac and never again creating such public–private partnerships.

The Federal Government's Bailout Terms for Fannie and Freddie

Fannie Mae and Freddie Mac have remained under the federal conservatorship and regulatory authority of the FHFA since 2008. Acting in its conservatorship authority, the FHFA entered into an agreement with the Treasury Department for both Fannie and Freddie to receive a commitment to cover any financial losses. Between 2008 and 2011, Fannie and Freddie combined received $187.5 billion in total capital draws from the U.S. Treasury to cover financial losses,[1] which, under the terms of their SPSPAs, represent commitments by the Treasury that neither Fannie nor Freddie must repay as debt.[2]

Instead, in return for the capital draws, the Treasury retains ownership shares totaling the value of funds transferred to both GSEs. Put differently, in the event that these GSEs are shut down, the Treasury retains a preferred-payout position based on the value of the shares it holds at the time of liquidation—currently $117.1 billion in Fannie Mae and $72.3 billion in Freddie Mac. Moreover, the SPSPAs have generally obligated Fannie and Freddie to pay capital distributions (dividends) to the Treasury based on a share of quarterly positive net worth, which through the third quarter of 2017 has exceeded $275 billion.[3]

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Following amended terms to the SPSPAs in 2012, both GSEs are required to distribute *any* quarterly positive net worth to the Treasury in excess of the amount in their respective capital reserve accounts. Additionally, for several years and in compliance with the 2012 SPSPA amendments, both Fannie and Freddie have reduced the amount held in these capital reserve accounts, and these funds will be depleted by the beginning of 2018. The 2012 amendments to the SPSPAs are not without controversy, because they have resulted in various shareholders of both GSEs challenging the Treasury's net worth (earnings) sweep in federal courts.[4] There have been efforts, including from the FHFA Director,[5] to allow Fannie and Freddie to rebuild capital reserve accounts to cover any future financial deficits.

It must be stressed, however, that Fannie and Freddie do not need to hold their own explicit capital reserve accounts to cover such prospective financial losses. Even with the initial draws of $187.5 billion, these GSEs have a total remaining commitment of $258.1 billion (under the terms of the SPSPA with the Treasury) to cover any such deficits in net worth while they remain under FHFA conservatorship.[6] This commitment amount is sufficient to cover projected losses for these GSEs—even under a severe adverse economic scenario. In fact, the FHFA reports that Fannie and Freddie combined would have almost $160 billion remaining in Treasury commitments even after incurring losses projected under a severe stress test.[7] Furthermore, limiting their availability to cover losses to the funding commitments specified in the SPSPAs enhances transparency, since both Fannie and Freddie remain wards of the federal government while they are under FHFA conservatorship.

GSEs Represent a Fundamentally Flawed Institutional Model

As GSEs, Fannie Mae and Freddie Mac do not operate like other private financial institutions that must compete without the special privileges conferred by the federal government. Throughout their respective histories, both Fannie and Freddie have, at minimum: (1) retained lines of credit with the federal government; (2) held a specified number of board of director seats for politically appointed positions; and (3) since the early 1990s, had to meet federal mandates for affordable housing and various homeownership goals.[8] Indeed, from the beginning of their respective federal charters—1938 for Fannie Mae and 1970 for Freddie Mac—these institutions have functioned as quasi-public enterprises, with mandates to fulfill nebulous federal housing objectives, as well as those of private shareholders seeking to maximize profits.

In effect, this institutional model has made both Fannie Mae and Freddie Mac servants of two separate masters, resulting in immense political corrup-

1. Fannie Mae, "Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934: For the Fiscal Year Ended December 31, 2016," February 17, 2017, pp. 7–9, http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2016/10k_2016.pdf (accessed October 3, 2017), and Freddie Mac, "Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities and Exchange Act of 1934: For the Fiscal Year Ended December 31, 2016," pp. 1–2, http://www.freddiemac.com/investors/financials/pdf/10k_021617.pdf (accessed October 3, 2017).
2. Federal Housing Finance Agency, "Senior Preferred Stock Purchase Agreements," https://www.fhfa.gov/Conservatorship/Pages/Senior-Preferred-Stock-Purchase-Agreements.aspx (accessed October 3, 2017).
3. Joe Light, "Fannie–Freddie Keep Giving Profits to U.S. Amid Talks on Changes," Bloomberg, September 29, 2017, https://www.bloomberg.com/news/articles/2017-09-29/fannie-freddie-keep-giving-profits-to-u-s-amid-talks-on-changes (accessed October 3, 2017).
4. Richard A. Epstein, "Grand Theft Treasury," The Hoover Institution, July 16, 2013, https://www.hoover.org/research/grand-theft-treasury (accessed October 4, 2017).
5. Scott Olson, "A GSE Risk We Can No Longer Ignore: Doing Nothing," The American Banker, April 26, 2017, https://www.americanbanker.com/opinion/a-gse-risk-we-can-no-longer-ignore-doing-nothing (accessed October 3, 2017), and Melvin L. Watt, "Sustainable Housing Finance: An Update from the Director of the Federal Housing Finance Agency," testimony before the Committee on Financial Services, U.S. House of Representatives, October 3, 2017, pp. 6–7, https://financialservices.house.gov/uploadedfiles/hhrg-115-ba00-wstate-mwatt-20171003.pdf (accessed October 3, 2017).
6. Federal Housing Finance Agency, "Dodd–Frank Act Stress Tests Results: Severely Adverse Scenario," August 7, 2017, pp. 2–3, https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2017_DFAST_Severely-Adverse-Scenario872017.pdf (accessed October 3, 2017).
7. Ibid., pp. 2–7.
8. John L. Ligon, "A Pathway to Shutting Down the Federal Housing Finance Enterprises," Heritage Foundation *Backgrounder* No. 3171, December 21, 2016, pp. 2–10, http://www.heritage.org/housing/report/pathway-shutting-down-the-federal-housing-finance-enterprises.

tion, and has confused any notion of private shareholder and property rights[9]—especially since 2008, when the federal government took extraordinary steps to bailout and nationalize both GSEs.

Over the long term, the intertwining of public and private interests behind Fannie Mae and Freddie Mac has led to moral hazard in the mortgage market and an enormous increase in the concentration of debt and risk in the housing finance system.[10] The GSEs have been central to the systematic degradation of credit underwriting standards in the housing finance system over the past several decades, which in particular resulted in their broad-exposure subprime mortgages and financial insolvency as the housing market collapsed between 2007 and 2009.[11] Overall, the increase in moral hazard, concentration of risk, and explosion of mortgage debt have ultimately extracted an enormous cost from American households, especially those that have either lost their homes or those that remain underwater on their mortgages[12]—not to mention federal taxpayers who have covered the bailout costs of financially insolvent institutions.[13]

Congress Must Accomplish Meaningful Free-Market Housing Finance Reforms

The status quo in the housing finance system in unacceptable: The U.S. deserves a housing finance system with robust private-sector competition that encourages innovation and opportunities for truly sustainable and durable housing. Such an alternate housing finance system cannot exist when secondary mortgage market competition is severely restricted to a few government-backed guarantor institutions, and when both borrowers and financial institutions involved in mortgage finance operate at the whims of all-powerful federal regulators such as the Federal Housing Finance Agency.

Allowing Fannie Mae and Freddie Mac to rebuild explicit capital reserve accounts would further distract from the actual circumstances of their financial support by the federal government, as well as detract from congressional efforts to accomplish meaningful conservative free-market reforms in housing finance. The FHFA and Treasury should not allow Fannie Mae and Freddie Mac to recapitalize. Such an action would create unnecessary distractions for Congress, which should pass housing finance reforms that would shut down Fannie and Freddie and protect taxpayers from such dangerous public–private partnerships in housing finance.

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9. James L. Gattuso, "Taking Stock: Shareholder Lawsuits No Barrier to GSE Dissolution," Heritage Foundation *Issue Brief* No. 4225, May 1, 2014, http://www.heritage.org/housing/report/taking-stock-shareholder-lawsuits-no-barrier-gse-dissolution.
10. The GSEs have a long history of high risk and low accountability. In the late 1960s, after an initial attempt by Congress to rein in Fannie's debt to 15 times its capital, the Secretary of Housing and Urban Development consistently approved a higher leverage ratio for Fannie—eventually reaching a level in the 1980s at which its debt was around 50 times its capital. See Norbert J. Michel and John L. Ligon, "Fannie and Freddie: What Record of Success?" Heritage Foundation *Backgrounder* No. 2854, November 7, 2013, pp. 4–5, http://www.heritage.org/housing/report/fannie-and-freddie-what-record-success.
11. Ligon, "A Pathway to Shutting Down the Federal Housing Finance Enterprises," pp. 2–12.
12. From the height of the mortgage credit bubble (2005–2015), an estimated 4.8 million to 5.8 million households lost their homes due to foreclosures. In addition, through the first quarter of 2017, more than five million homeowners remain underwater on their homes. See Jonathan Spader, "How Much of the Homeownership Rate Decline from 2005–2015 Is Due to Foreclosures?" The Harvard Joint Center for Housing Studies, May 26, 2016, http://housingperspectives.blogspot.com/2016/05/how-much-of-homeownership-rate-decline.html (accessed May 18, 2017), and Zillow Research, "Q1 2017 Negative Equity: Slow Progress Beats No Progress," Zillow, July 18, 2017, https://www.zillow.com/research/q1-2017-negative-equity-15888/ (accessed October 3, 2017).
13. Ligon, "A Pathway to Shutting Down the Federal Housing Finance Enterprises," pp. 2–12.