March 20, 2018

Housing Finance: Recent Policy Developments

Several recent developments have affected the financial condition of Fannie Mae and Freddie Mac. In February 2018, Fannie Mae announced that one-time tax adjustments due to the 2017 tax revisions (P.L. 115-97) would require it to request $3.7 billion in support from Treasury, and Freddie Mac requested $312 million from Treasury. This followed a December 2017 decision by the Federal Housing Finance Agency (FHFA) and the Treasury to allow Fannie Mae and Freddie Mac each to retain a "capital reserve amount" (or net worth) of $3 billion. Prior to this announcement, the capital reserve amount was scheduled to be zero effective January 1, 2018. The $3 billion net worth will reduce the likelihood that Fannie Mae and Freddie Mac will need additional Treasury support, but it does not eliminate it.

This In Focus analyzes recent developments and several housing finance issues stemming from them.

Context

Fannie Mae and Freddie Mac (known as government-sponsored enterprises or GSEs because of their congressional charters) buy home mortgages and pool them into mortgage-backed securities (MBS), which are sold to investors. One source of profit is the guarantee fee that they charge sellers for guaranteeing investors timely payment of principal and interest. Their other source of profit comes from retaining some MBS as portfolio investments. The GSEs retain the credit risk (i.e., the risk associated with a borrower defaulting) on all of the mortgages they purchase. In addition, the value of the MBS that they retain fluctuates when interest rates change.

In September 2008, Fannie Mae and Freddie Mac were in weak financial condition and they entered conservatorship, which means that FHFA (their regulator) became their conservator and manager. The goal of conservatorship is to keep a financial business operating while restructuring it to improve its financial strength. Part of the initial conservatorship agreement included a contract to sell Treasury enough senior preferred stock as necessary to maintain a positive net worth at Fannie Mae and Freddie Mac, and to pay a 10% dividend on that stock. To date, Treasury has purchased a combined $187 billion of senior preferred stock from Fannie Mae and Freddie Mac. The GSEs have paid dividends of $279 billion to Treasury.

The original contracts have been amended four times. Changes include the following:

- The first amendments (May 6, 2009) double the maximum amount that Treasury would invest in Fannie Mae and in Freddie Mac to $200 billion each.

- The second amendments (December 24, 2009) adjust the maximum that Treasury would invest in Fannie Mae and in Freddie Mac based on previous draws and their financial conditions at the end of 2012.

- The third amendments (August 17, 2012) require Fannie Mae and Freddie Mac to cap their mortgage holdings at $250 billion by the end of 2018. It, also, changed the dividend each pays quarterly to Treasury from 10% annually on Treasury's investment to all of its net worth except for a "capital reserve amount," which was scheduled to become zero at the start of 2018.

  FHFA said,

  > Replacing the current fixed dividend in the agreements with a variable dividend based on net worth helps ensure stability, fully captures financial benefits for taxpayers, and eliminates the need for Fannie Mae and Freddie Mac to borrow from the Treasury Department to pay dividends.

- The fourth amendments (December 21, 2017), officially called letter agreements, allow Fannie Mae and Freddie Mac each to retain a net worth of $3 billion. The $3 billion is much less than either GSE's net worth prior to conservatorship. At the end of 2007, approximately eight months before entering conservatorship, Fannie Mae had a net worth of $44 billion and Freddie Mac had a net worth of $27 billion.

The move to allow the GSEs to retain a net worth of $3 billion has been a source of significant debate. Supporters of the fourth amendments argue that the policy change would avoid minor draws on the lines of support with Treasury that stem from normal market movements and thereby avoid upsetting financial markets. FHFA has stated that it "considers the $3 billion capital reserve sufficient to cover other fluctuations in income in the normal course of each Enterprise's business. We, therefore, contemplate that going forward Enterprise dividends will be declared and paid beyond the $3 billion capital reserve in the absence of exigent circumstances." Opponents of the fourth amendments argue that, because of the significant amount of financial resources available to the GSEs, minor future draws would not upset the markets. Instead, the argument goes, the buildup of capital diverts money to the GSEs that should go to compensate taxpayers and potentially makes it easier for the GSEs to be returned to private shareholders, a move opposed by many reform advocates.

2018 Events

The GSEs and the mortgage market face several changes in 2018.

Reduced Mortgage Portfolio

Historically the GSEs' portfolios have been large and a major source of profits. For example, at the end of 2008, these portfolios were valued at approximately $800 billion each. The initial support agreements required each GSE to cap its portfolio at $850 billion at the end of 2009, and to reduce their portfolios annually until they reached a cap of $250 billion by the end of 2021. The first amendments increased the maximum 2009 retained portfolios to $900 billion and allowed the GSEs until 2022 to reach the $250 billion maximum. The second amendments were designed to clarify some of the language concerning the GSEs' retained portfolios. The third amendments, which were signed in 2012, reduced the 2012 maximum to $650 billion (from $900 billion) and moved the $250 billion maximum to 2018. At the end of 2016, Freddie Mac had a retained investment portfolio of $298 billion, and Fannie Mae had one of $272 billion. In addition, FHFA has told the GSEs to reduce their portfolios to no more than 90% of the contractual amounts.

The GSEs' portfolios have been an important source of profits. Because of their close relationship to the federal government, the GSEs are able to sell bonds at an interest rate slightly more than the Treasury bonds. They have taken advantage of this to sell bonds to finance their portfolios of MBS. With this source of profits reduced in size, future draws on Treasury may be more likely (all else equal).The smaller portfolios, however, reduce the GSEs exposure to adverse interest rate movements.

Accounting for Reduced Corporate Income Tax Rates

The 2017 tax revision (P.L. 115-97) reduces the value of certain deferred tax assets held by the GSEs. Some of their deferred tax assets resulted from losses in previous years. At the end of 2016, Fannie Mae reported that it held $36 billion in deferred tax assets, and Freddie Mac reported that it held $16 billion. For 2017, Fannie Mae wrote down their deferred assets by $9.9 billion, and Freddie Mac wrote down their tax assets by $5.4 billion as a result of the reduced tax rates. The reduced value of the deferred tax assets reduced their net worth which, as mentioned earlier, resulted in the GSEs each having a negative net worth at the end of 2017. Pursuant to their agreements with Treasury to prevent them from having a negative net worth, Fannie requested $3.7 billion in support from Treasury and Freddie Mac requested $312 million from Treasury.

Similar to Fannie Mae and Freddie Mac, many other financial companies are affected by the change in corporate tax rate. The reduction in the corporate tax rate has reduced the value of deferred tax assets. Many financial companies reported large losses during the recession and have reported charges or adjustments to the value of the deferred tax assets. For example, Citigroup reported a $22-billion charge for the fourth quarter because of the reduced value.

Even though the reduced corporate tax rate reduced each of the GSEs' net worth in the short run, other things being equal it will increase net income in the long run, which is after taxes.

Possible Impact on Affordable Housing Funds

By law, the GSEs must support certain aspects of affordable housing. One of the requirements is that the GSEs make annual contributions to the Housing Trust Fund and the Capital Magnet Fund based on the unpaid principal balance of mortgages purchased during a year. (A portion of the contributions are also set aside for the HOPE Reserve Fund to pay for any losses under the Hope for Homeowners program, a foreclosure prevention program that ended several years ago.) When the GSEs entered conservatorship, FHFA suspended their contributions, but in 2015, FHFA cited improved financial health and directed the GSEs to start making the payments. For 2017, Fannie Mae's payments to the two funds are calculated to be $323 million and Freddie Mac's should be $175 million.

When FHFA directed the GSEs to resume making payments to the three affordable housing funds, it announced that in the event of a future draw on Treasury, these payments would be suspended, but reserved the right to modify this directive. On February 7, 2018, Director Watt notified Fannie Mae and Freddie Mac that because their draws on their Treasury support did not "relate to any financial instability on the part of the Enterprise" that they should make their payments to the Housing Trust Fund and the Capital Magnet Fund. While supported by affordable housing advocates, the move has been criticized by those who believe this contradicts Director Watt's earlier statement, and that the money should go to Treasury as part of the GSEs' dividend sweep.

On December 13, 2017, the House Committee on Financial Services ordered reported H.R. 4560, the GSE Jumpstart Reauthorization Act of 2017. If this bill becomes law, the GSEs would be required to suspend payments to the affordable housing funds for any year that the GSEs reduce their dividend sweeps to build net worth, which FHFA has ordered the GSEs not to do.

N. Eric Weiss, Specialist in Financial Economics

IF10851

Disclaimer