



BUDGET BULLETIN

SENATE COMMITTEE ON THE BUDGET
CHAIRMAN MIKE ENZI | @BUDGETBULLETIN

114th Congress, 2nd Session: No. 16

July 14, 2016

Budget Perspectives for Fannie and Freddie

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Fannie Mae and Freddie Mac, which play a key role in the U.S. housing-finance system, have been in conservatorship since 2008. Calls for reform of these government-sponsored enterprises (GSEs) have followed the conservatorship, and Fannie and Freddie remain in legal and financial limbo.

This issue of *Budget Bulletin* provides background on the two GSEs and explains how Fannie and Freddie fit into the federal budget. Understanding this context is an essential step in evaluating any future reform proposals.

Fannie and Freddie Overview: History and Operations

The Early Days of the Two GSEs

In 1938, Congress created the Federal National Mortgage Association (Fannie Mae) as a government agency to purchase, hold, and sell loans insured by the Federal Housing Administration (FHA). Then, in 1954 and 1968, Congress transformed Fannie into a shareholder-owned for-profit company. The 1968 reorganization changed Fannie's operations to focus on conventional conforming mortgages, rather than FHA loans, and established that Fannie would be funded through the stock and bond markets. As a result, Fannie's operations were no longer reflected in the federal budget.

In 1970, Congress established the Federal Home Loan Mortgage Corporation (Freddie Mac) to help savings-and-loan banks manage interest-rate risk. Initially, the Federal Home Loan Banks owned Freddie, but in 1989, Congress reorganized Freddie as a shareholder-owned for-profit company.

The 1967 Presidential Concepts Commission established criteria for determining whether a GSE should be included in the federal budget, including assessing who owns the entity, supplies its capital, and selects its managers. The commission recommended that entirely privately owned GSEs should be omitted from the budget. Despite their government originations, both Fannie and Freddie had become entirely privately owned. Consequently, the two GSEs met the standard for exclusion from the budget, which remained the case in the budget until the housing-finance crisis of the latter-2000s.

How the Two GSEs Operate

The mission of Fannie and Freddie is to provide liquidity and stability in the secondary mortgage market. In the primary market, mortgage lenders arrange mortgages with home purchasers. Lenders can then sell those mortgages to investors in the secondary mortgage market.

Fannie and Freddie often serve as the middleman between lenders and investors, purchasing mortgages from lenders, repackaging them with other mortgages as mortgage-backed securities (MBS), and then selling them to investors with a guarantee that principal and interest on the underlying mortgages will be paid in full. In theory, the two GSEs assume the risk of unpaid mortgages. To compensate for this risk, Fannie and Freddie charge lenders a fee, which lenders usually pass on to the borrower. This fee is known as the guarantee fee, or g-fee.

As detailed below, under the conservatorship, the government requires the two GSEs to pay all profits into the Treasury, while slowly depleting their capital. Without capital, the two GSEs have no cushion to guarantee MBS. In other words, the two GSEs transfer the risks and compensation for risks of MBS to the U.S. government. Thus, it is the taxpayers – not the two GSEs – who ultimately guarantee principal and interest payments on the mortgages comprising MBS.

The Housing-Finance Crisis and Conservatorship

In the early 2000s, the United States experienced a housing bubble. For reasons beyond the scope of this *Bulletin*, this bubble burst and home prices declined. At the time, many homeowners owed more on their mortgages than their homes were worth and defaulted in droves. As Fannie and Freddie had guaranteed payments to investors on many of these mortgages, the two GSEs were on the hook for an overwhelming amount of money. They could not afford to guarantee the mortgages.

As part of its response to this financial crisis, Congress passed the Housing and Economic Recovery Act of 2008. Under authority provided by this act, on September 6, 2008, the two GSEs agreed to be placed into conservatorship, with the Federal Housing Finance Agency (FHFA) serving as the conservator. An organization placed in conservatorship temporarily relinquishes control of its own affairs to a conservator, which helps the entity achieve sound

financial condition. Through the FHFA, the U.S. government serves as Fannie and Freddie's conservator.

On September 7, 2008, FHFA on behalf of the two GSEs arranged for the Treasury Department to provide financial support to Fannie and Freddie through a senior preferred stock purchase agreement. This agreement allowed the two GSEs to make a quarterly draw from the Treasury to cover their losses. In return, FHFA gave the Treasury \$1 billion in senior preferred stock and a warrant to purchase 79.9 percent of outstanding common stock for a nominal price.

Normally, senior preferred stock has priority over common stock in dividend payments – payments to shareholders of a fraction of profits. In this case, Fannie and Freddie originally agreed to make an annual dividend payment to the Treasury Department equaling 10 percent of the money the two GSEs withdrew from the Treasury. Under the original agreement, each year the two GSEs would pay the U.S. government 10 percent of the amount used to bailout the two GSEs. Since taxpayers spent \$187.5 billion to bailout Fannie and Freddie, this would equal \$18.75 billion per year.

On three separate occasions, the Treasury Department and FHFA agreed to amend the senior preferred stock purchase agreement. The third and most significant amendment occurred on August 17, 2012. Often referred to as the “net worth sweep,” this controversial third amendment changed the agreement in two significant ways.

First, the third amendment set the dividend amount at 100 percent of Fannie and Freddie's net worth – 100 percent of net worth greater than their capital reserves – thus consuming all of the two GSEs' profits. The two GSEs paid \$40.2 billion in dividend payments in 2014 and \$15.8 billion in 2015. Although the two GSEs have repaid more than they received, these dividend payments are not considered repayment on the debt the two GSEs owe to the government for bailout money.

Second, this amendment set the capital reserve of each of the two GSEs to be reduced annually until the capital reserve reaches zero on January 1, 2018.

Thus, rather than a 10 percent annual dividend payment, the two GSEs send 100 percent of net worth greater than their capital reserves directly to the Treasury each quarter. Once the capital reserve reaches zero, rather than rely on their own funds to guarantee mortgages, the two GSEs will rely solely on funds from the Treasury to cover their losses.

Differing Budgetary Treatment

The Office of Management and Budget (OMB) and Congressional Budget Office (CBO) take differing approaches to the costs associated with the two GSEs in the federal budget. OMB focuses on money flowing in and out of the government; CBO, on the risks the government

assumes in backing the two GSEs. This stems from differing views about the relationship of the government to the two GSEs.

The history, operations, and current legal structure of the two GSEs generally lead observers to take one of two views on the relationship of Fannie and Freddie to the government. The first is that the entities are an arm of the government that guarantees mortgages on behalf of the government. Proponents argue that the government owns, controls, and funds the entities. The government uses its control of the two GSEs to fulfill the public policy goal of supporting the housing-finance market. In this view, the two GSEs are de facto government agencies, not private financial institutions.

The second view is that the two GSEs legally remain private entities under a temporary conservatorship. Proponents argue that the entities are statutorily created to be shareholder-owned for-profit companies. Under this view, these private entities have agreed to a temporary conservatorship under the FHFA. This conservator entered into a contract with Treasury on behalf of the two GSEs to exchange funding for ownership interests.

CBO takes the first view that the two GSEs are government agencies, while OMB holds the second view that the two GSEs legally remain private entities. This leads to different methods of accounting for the costs and benefits of the two GSEs.

Since OMB views the two GSEs as private entities, it records transactions with Fannie and Freddie on a cash basis. Any draw that the two GSEs make on the Treasury is considered a cash infusion to them and recorded in the budget as spending. Funds coming into the Treasury from dividend payments of the two GSEs are considered offsetting receipts by OMB, which means that rather than increase revenue, this incoming cash instead reduces overall spending. OMB includes projections of these cash transactions in future years. These projections are limited to capturing expected cash shortfalls or surpluses.

CBO, on the other hand, views the two GSEs as government agencies. As such, CBO focuses on reflecting the risks to the government associated with Fannie and Freddie's mortgage guarantees. CBO records these risks as a subsidy. In their view, the income of Fannie and Freddie cannot cover the cost of the risks to taxpayers. Therefore, the government is subsidizing the secondary mortgage market by taking on the risks. CBO projects the cost of these risks to taxpayers using accrual and fair-value accounting. The accrual approach captures the lifetime cost of the new mortgage guarantees by Fannie and Freddie, while fair-value accounting considers the market risks.

CBO considers any transfer of funds between the Treasury and the two GSEs as an intragovernmental transfer. Per CBO, money in the possession of the two GSEs is government money. Transferring it between the Treasury and the two GSEs does not change the total amount of money possessed by the government.

As such, CBO only records on a cash basis the actual loss or profit of the two GSEs for the previous year and the expected loss or profit for the current year. Similar to OMB's method, CBO records the two GSE draws from the Treasury as spending and records dividend payments as offsetting receipts. Unlike OMB, CBO does not project dividend payments or draws from the Treasury by the two GSEs for years beyond the previous and current fiscal years. In CBO's view, these potential dividends or draws are captured in their subsidy estimates.

The estimates of CBO and OMB cannot accurately reflect the fiscal picture surrounding the two GSEs. While CBO makes an effort to reflect the cost of risk, for example, its estimates do not weigh the economic consequences of the policy decision to involve the government in the housing market. Such involvement is intended to change incentives to encourage certain behaviors by those participating in the market. This change in behavior changes the market.

In addition, OMB's estimates do not accurately reflect the cost of reforming the two GSEs. For example, if Congress were to significantly change their roles, OMB's estimates could reflect a major increase in spending. OMB does not balance this benefit against the cost to taxpayers of guaranteeing the mortgages. If taxpayers were no longer on the hook for mortgage guarantees, the government would be in a better financial position. Still, OMB would consider the government's financial situation worse due to the lost dividend payments, not taking into account the future obligations of mortgage guarantees.

Uncertain Future

As Congress considers various reforms, Fannie and Freddie face an uncertain future. At this time, the two GSEs are able to access several hundred billion dollars before reaching the limits of bailout funds available to cover their losses and meet their obligations to guarantee mortgages.

Neither Fannie nor Freddie has made a draw from the Treasury since 2012. Through dividend payments, each of the two GSEs has paid back more than it has received in bailout money. Yet this money does not pay down the debt to the government owed by Fannie and Freddie. Meanwhile, the money that the two GSEs previously set aside to cover their losses is slowly being depleted, as required by the net-worth-sweep amendment to hit zero on January 1, 2018.