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Fannie Mae and Freddie Mac Face New Problem: Profitability

By: Clea Benson - Apr 1, 2013

Fannie Mae (FNMA) executives are due this week to release the company's earnings report for the last quarter of 2012, a filing delayed by an unanticipated problem: The Washington-based mortgage financier is making money and expects to remain steadily profitable.

Fannie Mae and McLean, Virginia-based Freddie Mac (FMCC), once thought to be the only financial-crisis bailout recipients that would generate a net loss for taxpayers, are poised to begin funneling healthy quarterly revenues back to the U.S Treasury as the housing market rebounds. The reversal of fortune is creating political and administrative headaches in Washington, where few expected the turnaround and the future of mortgage financing remains undecided.

"The good news is they're actually starting to make money again," Senator Mark Warner, a Virginia Democrat, said in an interview on "Capitol Gains" with Bloomberg Television's Peter Cook that aired March 24. "Bad news is if they make too much money, there may be a sense of, 'Well, let's not mess with them anymore.' We need housing finance reform."

Regulators who took the nearly bankrupt enterprises into conservatorship in 2008 didn't create an avenue for the companies to regain independence because lawmakers were expected to wind them down and replace them before they became profitable. That didn't happen.

Congress and the White House have taken only baby steps toward an overhaul of housing finance, which remains heavily dependent on federal support. Fannie Mae and Freddie Mac buy mortgages from lenders and package them into securities on which they guarantee payments of principal and interest. They've drawn $187.5 billion from Treasury and have sent back more than $50 billion in the form of dividends, which count as a return on the government's investment and not as a repayment.

Footprint Shrinking

While proposals for overhauling mortgage finance have ranged from abolishing Fannie Mae and Freddie Mac to keeping them intact, most of the blueprints under discussion would replace the two companies with some form of government backing for home loans that would only kick in after significant losses to private capital. In the absence of a plan from lawmakers, the companies' overseer, the FHFA, has been requiring them to shrink their footprint and explore some merged operations.

If the Obama administration and lawmakers continue to delay action on an overhaul, the two government-owned companies may find themselves in a long-term limbo in which they remain under U.S. control even if they eventually pay more to Treasury than they ever received in aid.

Under the terms of a new agreement with Treasury that went into effect this year, the enterprises will be allowed to retain only $3 billion in net worth. Any profits beyond that amount will go to taxpayers.

No Recapitalization

"They have no ability to recapitalize their business," Tim Rood, a managing director at Washington-based Collingwood Group LLC, a financial services consulting firm. "They could spin off $100 billion next year and it wouldn't make a stitch of difference."

Numbers on that scale aren't out of the question. Fannie Mae in a March 14 regulatory filing said it could soon be required to send as much as $62 billion to the U.S. Treasury because once it is turning a profit, it may have to start counting potential tax credits as part of its net worth. The so- called deferred tax assets weren't reported as assets when Fannie Mae didn't expect it would ever earn taxable income again.
To address the tax credit issue, the company requested extra time to file its quarterly and annual earnings with the Securities and Exchange Commission, and the extension expires this week. Executives are expected to present a solution to the tax-credit issue in the report.

'Significant' Income

Regardless of whether the tax assets are counted, Fannie Mae said it expects to report "significant net income" for the quarter that ended Dec. 31. Freddie Mac reported in February that it earned $11 billion in all of 2012, compared with a loss of $5.3 billion in 2011. Fannie reported profits of $9.6 billion for the first three quarters of last year.
Whether the companies' gains will induce lawmakers to move forward with a plan for winding them down remains to be seen. Members of theHouse of Representatives and the Senate, who have been holding hearings on the issue, have yet to introduce a comprehensive bill this year.

The White House also doesn't appear to be moving quickly. Treasury is continuing to work on a blueprint for housing finance reform, Michael Stegman, counselor to Treasury Secretary Jacob Lew on housing issues, said in an interview last week. Still, Lew has said in recent interviews that a plan isn't imminent.
"I can't sit here today and tell you exactly what the next step is, but we're very much focused on it," Lew told Bloomberg Television on March 14.

'A Beginning'

Meanwhile, Warner and Massachusetts Democrat Elizabeth Warren are working with Senate Republicans including Bob Corker of Tennesseeto craft bipartisan legislation for a housing- finance overhaul. A bill could be introduced by late summer, Warner said.
"The fact that a bipartisan group of people is sitting down and asking, 'What can we all live with?' is a beginning," Mark Calabria, director of financial regulation studies at the Cato Institute, which favors free markets, said in an interview.

There already has been some action to prevent Fannie Mae and Freddie Mac from becoming a permanent arm of government: A largely symbolic budget vote in the Senate last week included a provision banning lawmakers from raising the fees Fannie Mae and Freddie Mac charge to guarantee mortgages and using the proceeds to pay for general government expenses.

Senior Shares

A group of lawmakers including Warren, Warner, and Senator David Vitter, a Louisiana Republican, on March 14 introduced a bill that would ensure Fannie Mae and Freddie Mac couldn't emerge from government control even if they end up paying more to the Treasury than they took in aid. The measure would ban sales of senior-ranking U.S. Treasury-owned preferred shares without congressional approval. It also includes a provision banning the use of fee increases at the enterprises to fund the government.
"I think this is an important development," Julia Gordon, director of housing finance and policy at the Center for American Progress, a group aligned with Democrats. "If the guarantee fee can't be used as a pay-for, that removes the incentive for keeping the status quo."