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Will Fannie and Freddie Need Another Bailout?

Low reserves, volatile earnings raise chances taxpayers may need to rescue mortgage giants again

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Eight years after the financial crisis, the core businesses of mortgage giants Fannie Mae and Freddie Mac are remarkably healthy.

But an unusual confluence of factors all but guarantees that one or both of them will need another taxpayer bailout in the future.

The problem is twofold. First, the government allows the companies to carry only a tiny capital buffer, meaning even a small loss can result in the need for more taxpayer funds.

Second, the companies' use of derivatives to hedge risks in their mortgage portfolios exposes them to accounting quirks that can cause large—but illusory—losses to appear from quarter to quarter. For the first quarter, for example, Freddie Mac posted a loss of $354 million due to derivatives accounting, despite an otherwise healthy mortgage market.

The combination of low reserves and volatile earnings boosts the chances that taxpayers come to the mortgage giants' rescue again. The issue has been noted by the chief executives of Fannie and Freddie as well as the companies' regulator. In the meantime lawmakers, who were expected to have addressed Fannie's and Freddie's futures years ago, haven't yet decided what a future housing-finance system should look like.

While the potential scope of the next bailout isn't clear, some worry that a large one could set off a knee-jerk political reaction with uncertain consequences.

If there is a large bailout, "You're going to see some pressure to do something about it," saidMark Calabria, director of financial-regulation studies for the libertarian Cato Institute.

Fannie and Freddie don't make loans. Rather, they buy loans from lenders, wrap them into securities and provide guarantees to make investors whole in case of default.

In 2008, the U.S. government took over the companies, putting them under the control of the Federal Housing Finance Agency. Taxpayers eventually sent the companies $187.5 billion.

Under the current terms of the bailout, Fannie and Freddie send nearly all profits to the U.S. Treasury. The companies have paid taxpayers $245.8 billion in dividends.

The terms allow the companies in 2016 to keep a capital buffer of $1.2 billion each but the buffer falls to zero by 2018. The buffer can absorb losses if either company posts one, but any losses greater than the remaining buffer would cause Fannie or Freddie to need a new taxpayer infusion.

When the terms went into effect in 2012, government officials thought legislators by now would have passed legislation replacing Fannie and Freddie with a new system. But Congress remains divided on how large the government's role in the mortgage market should be.

A problem could arise because of how the companies account for derivatives they use to hedge the risk of losses when interest rates rise.

The companies seek not to lose or make money when rates rise or fall, and their hedging strategies eliminate that risk, said Jim Vogel, a strategist at FTN Financial.

Despite that, the accounting method that the companies use causes large, but illusory, losses or gains over short periods of time.

That's because the rules require the companies to value the derivatives at the market price every quarter, while the value of the hedged assets doesn't change.

If the volatility swings in the wrong direction when the companies have little capital, the resulting loss can trigger a bailout.

The accounting mismatch could eventually have a real-world impact. The companies have about $258 billion in remaining bailout money to draw on—a credit line that calms mortgage-backed securities investors.

But the credit line can't be replenished, meaning that as the line is chipped away over time, investors could start to doubt the guarantee of their investments and drive mortgage rates up.

FHFA Director Melvin Watt in a February speech highlighted that concern. "It's unclear where investors would draw that line, but certainly before these funds were drawn down in full," he said.

The remaining funds available through the credit line are so large that many involved in efforts to overhaul the housing-finance system say the risk to the economy is far in the future.

They argue that requiring Fannie and Freddie to retain more capital to prevent a bailout is less beneficial to taxpayers than bailing out the companies when and if it is needed, since all profits go to the U.S. Treasury.

Some liberal advocacy groups and trade groups have called for Fannie and Freddie to keep capital to avoid the political risk. The fear is that if taxpayers sent another bailout to Fannie and Freddie, however small, lawmakers could pass a bill in haste that damages mortgage availability.

A couple of congressmen have also introduced bills that would retain capital, though political analysts say they have little chance of progressing soon.

But some housing watchers worry that building capital, without other changes, could set the stage for a return to a housing-finance system they say held too little capital and created too much incentive for risk taking.

“If you just let them earn money and retain capital without these other reforms, you’re taking a step toward going back to the old, evil Fannie and Freddie,” said Alex Pollock, a fellow with the R Street Institute, a conservative think tank.