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Fannie Mae Liquidation Seen Sparing Preferred Holders: Mortgages

By Jody Shenn
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Winding down Fannie Mae and Freddie Mac (FMCC) wouldn't necessarily wipe out all of their shares.

Senate banking committee leaders announced this week they plan to introduce a bill to dismantle the two mortgage companies. The government seized them in 2008 after they helped fuel the worst financial crisis since the Great Depression. Common shares of the two companies plunged 34 percent this week on news of the proposal. Preferreds fell 11 percent.

Preferred stock in the companies, which rose fivefold over the past year, could recoup its full value even in a liquidation if the government or the courts reverse a measure that mandates all of their profits go to taxpayers, said Jeffrey Lewis at TIG Advisors LLC. Investors in common shares are betting that Fannie Mae (FNMA) and Freddie Mac would also be allowed to become private companies again and continue to dominate the market, he said.

"It's hard to find any reasonable outcome that's really terrible for the preferreds, given what I perceive to be the value of the business that's already there," said Lewis, a senior portfolio manager at TIG, who helps manage about $400 million, and began buying the preferred shares last year.

The planned legislation, drafted with input from President Barack Obama's administration, would replace Fannie Mae and Freddie Mac with a U.S.-backed mortgage-bond insurer that would cover losses only after private capital bears the first 10 percent, Senate Banking Committee Chairman Tim Johnson and Senator Mike Crapo said in a March 12 statement.

Corker-Warner Bill

Johnson, a Democrat, and Crapo, a Republican, didn't address how investors in the companies, including hedge funds Pershing Square Capital Management LP and Perry Capital LLC and mutual-fund manager Fairholme Capital Management LLC, would be treated. They said their

legislation would be based on a Senate bill introduced last year by Republican Bob Corker and Democrat Mark Warner.

Any wind down of Fannie Mae and Freddie Mac would have to address whether the companies' values -- from the loans and bonds on their balance sheets to income from their existing guarantees on about $4 trillion of securities -- is split up among several stakeholders or left for taxpayers.

The companies have sent the Treasury Department $203 billion since turning profitable in 2012. The government is still owed about $188 billion for its bailout funding, because federal regulators adopted a policy that payments to the government would not be counted as repaying the aid.

Courts Decide

Corker, among the staunchest Congressional opponents to rewarding shareholders, has said that the courts should decide whether that rule should be overturned.

"I have always believed that reform needs to ensure that all assets are disposed of in a legally sound manner, but my view that these shareholders likely won't get a dime has not changed -- except possibly for small remnants, if there are any left, once reform is finished," he said in a January e-mail.

Warner, a former venture capitalist, said in January that taxpayers should earn a return that reflects the size of the risk the government took by stepping in during a crisis.

Preferred shareholders hold notes with a face value of more than $33 billion. Common shareholders, including the government, through its option to take an 80 percent stake, are holding paper that traded at prices this week that pushed the companies' combined market value to more than $55 billion, before crashing.

Ackman's Gains

The slump reduced gains byBill Ackman's Pershing Square on the stock from more than $700 million at the peak on March 11 to about $220 million, according to disclosures about the 10 percent of the outstanding shares he bought starting in October and data compiled by Bloomberg.

Fannie Mae's common shares closed yesterday at $3.54, down from $5.82 on March 10, and up from 29 cents a year ago. One of its preferred issues of $25 fell to $10.85 from $12.70 on March 6 and $2.05 a year earlier.

The companies last year reported $132.5 billion in profits, saying the figures were inflated by reversals of tax-credit writedowns and settlements with lenders over bad loans. They could send $179.2 billion to taxpayers over the next 10 years without changes to how they operate, according to an annual forecast this week from the Office of Management and Budget.

The Corker-Warner bill called for the proceeds from unwinding of the companies' estates once their replacement was established to be first used to pay down the government's investment and then their preferred shares. Anything left would go to holders of their common stock.

Denying Income

The catch is that the legislation would continue sweeping all of their profits to the government until that time, without the payments reducing what they owe, according to Ed Mills, an analyst at FBR Capital Markets & Co.

"To me that was written in a way that was about 'How could we contemplate giving them funds and at the same time, deny them any income?'" Mills said. He added that "there continues to be a general position in Congress that they don't want the preferreds or commons to receive any value."

Fairholme and Perry last year sued to reverse the money sweep, which replaced 10 percent dividends in 2012. The firms, which have concentrated their investments in the preferred shares while owning some common stock, have also been among those lobbying policy makers to allow the companies to live.

Mark Calabria, the director of financial regulation studies at the Cato Institute, worked for the Senate banking panel as it crafted the 2008 bill under which Fannie Mae and Freddie Mac were seized. He said that the legal arguments behind the cases may have merit because the firms were placed into conservatorships and kept alive rather than receiverships meant to wind them down.

AIG Example

He still disagrees with those arguing that, like bailed out insurer American International Group Inc. (AIG), they should ultimately survive and shareholders benefit. "My response is I wanted to let AIG fail," he said in a January interview. "Two wrongs don't make a right."

Michael Cudzil, an executive vice president who specializes in mortgages at Pacific Investment Management Co., also said that he doesn't believe that shareholders should get anything after the companies were kept afloat by the government.

"The shareholders are trying to focus on loopholes and minutiae," said Cudzil, who said his Newport Beach, California-based firm has essentially no investments in the companies' equity.

The main obstacle that preferred shareholders face will be in the courts, said TIG's Lewis. For the common shares to be worth as much as the values reached this month, the companies would need to continue guaranteeing about 60 percent of U.S. mortgages, an outcome opposed by lawmakers, he said.

Liquidating the companies and creating a new housing finance system doesn't mean shareholders can't be paid, said Michael Kao, founder of Los Angeles-based Akanthos Capital Management

LLC, which oversees $120 million and bought the preferred shares in late 2008. One big obstacle may be ill will in Congress toward investment firms that have profited from trading the shares since the bailout.

"I don't understand the Congressional animosity," said Kao. "There's this Don Quixote-like crusade to screw over hedge funds and other investors."