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Fannie, Freddie Weak Earnings Raise Possibility of Future Bailouts

Dwindling profits do not reflect trouble in the companies' mortgage business

By Joe Light

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The delay in reforming the nation's housing-finance system, including Fannie Mae and Freddie Mac, is presenting policy makers with an uncomfortable reality: The terms of the bailout out of the mortgage-finance companies could eventually lead to the need for a new bailout.

The concerns took on increased urgency late this week, as Fannie and Freddie reported sharply lower fourth-quarter earnings. On Friday, Fannie Mae said that it earned $1.3 billion in the last three months of 2014, down from $6.5 billion a year ago, and would send $1.9 billion in dividends to the U.S. Treasury in March. Freddie on Thursday reported earnings of $227 million in the fourth quarter, down from $8.6 billion a year ago, and said it would send the government $900 million.

The dwindling profits don't reflect trouble in the companies' mortgage business, which continues to generate consistent earnings. For example, Fannie's net interest income, which includes fees from backing mortgages, was $5.1 billion in the fourth quarter, compared with $4.9 billion in the same period of 2013.

The swing is partly attributable to rising home prices and settlements, which both bolstered profits in the past but whose effects are fading. The companies are also subject to accounting quirks that can make earnings volatile, though they expect to be profitable on an annual basis. In addition, under a government bailout agreement, the companies can't build their capital buffer, instead sending their profits to the government.

Policy makers put the current bailout structure in place with the idea that by now, Congress would have approved or would be moving toward a broad overhaul of the housing-finance system, replacing Fannie and Freddie. However, about six-and-a-half years since the beginning of the financial crisis, reforming Fannie and Freddie remains the biggest piece of unfinished business facing the government.

As the potential for Fannie or Freddie taking a loss rises, legislators could come under increasing pressure to move forward with reform. In the absence of it, some groups could increase pressure on the Obama administration and Fannie and Freddie's regulator to allow the companies to retain some buffer.

In the latest quarter, both companies lost money on derivatives that they use to hedge their portfolios' exposure to interest rates. Because of a mismatch between how the portfolios are valued and how the derivatives are valued, a decline in rates can lead to losses for accounting purposes.

Freddie in particular came uncomfortably close to reporting a net loss, as the interest-rate drop last quarter erased $3.4 billion in earnings. Company officials said the effect of the derivatives position can be volatile from quarter to quarter, but should be relatively flat over time.

In addition, the companies must reduce their capital reserves by $600 million a year, eventually reaching zero in 2018. In 2015, each company has a reserve of $1.8 billion. The companies have also reduced their mortgage investment portfolios, which had been another source of earnings.

Because of the decreasing capital cushion, "the possibility of our needing to take a draw from Treasury increases over time," said Fannie Mae CEO Timothy J. Mayopoulos on a call with reporters on Friday, saying that any potential change in the terms of the agreement would be up to policy makers.

Both Fannie and Freddie over the course of the past year have become more reliant on their ordinary businesses of collecting fees to guarantee mortgages, rather than one-time events.

"The current system is increasingly without these extra streams of revenue that were keeping us in the black," said Jim Parrott, a senior fellow at the Urban Institute who used to work in the Obama administration. "We're one hiccup in the market away from further draws."

Fannie and Freddie don't make loans. They buy them from lenders, wrap them into securities and provide guarantees to make investors whole if the loans default.

After severe post-housing-book losses, the companies were taken over by the government in 2008, eventually receiving nearly $188 billion from the U.S. Treasury. By March, the companies will have paid the Treasury more than $228 billion.

A Senate-led effort to replace the companies fell through last year, and for now, few analysts expect Congress to seriously consider the issue again before 2016.

The concerns could feed into a growing network of investors and affordable-housing advocates who want the U.S. Treasury Department and the Federal Housing Finance Agency, which regulates Fannie and Freddie, to allow the companies to rebuild capital.

“People say in a self-righteous way, ‘Oh, Congress must act. Congress must come together and determine whether Fannie and Freddie should survive.’ The truth is, that will never happen,” said Wade Henderson, president of the Leadership Conference on Civil and Human Rights, a coalition of groups that over the past few months has sent the FHFA letters calling for the recapitalization of the companies.

Mark Calabria, director of financial-regulation studies for the Cato Institute, said that the companies’ falling earnings could increase pressure on some in Congress to attempt legislation again.

“Despite all that Congress does, most members want to avoid anything that looks like a tough vote. The fact is that if they’re making money and it looks like they’ll continue to make money, it allows a lot of members to say ‘Why do we have to vote on this?’ ” he said. “The argument becomes harder to sustain if there’s a chance that they might actually lose money.”

A spokeswoman for FHFA declined to comment.

In a statement, a Treasury spokesman said, “Treasury maintains that comprehensive housing finance reform legislation is the only way to end the conservatorship responsibly and transition to a new system that brings stability back to the housing market while protecting taxpayers.”