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Fannie-Freddie Watchdog Stokes Quiet Fight With White House

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While the Consumer Financial Protection Bureau grabs headlines, another independent U.S. regulator is quietly locked in its own showdown with the Trump administration.

The Federal Housing Finance Agency is in deep discussions with the White House over what to do with more than $7 billion owed to the government at year-end by Fannie Mae and Freddie Mac.

FHFA officials in negotiations have said they want Fannie and Freddie to keep $2 billion to $3 billion each as a buffer against losses, according to people familiar with the matter. Administration officials in exchange want to limit the mortgage giants' market footprint by steps such as tightening restrictions on the size of loans they back, according to the people, who requested anonymity because the talks are private.

The ongoing negotiations could face a de-facto deadline at the end of December, when Fannie and Freddie are scheduled to pay $7.7 billion to the U.S. Treasury. If FHFA Director Mel Watt chooses to withhold some of that money without the administration's sign-off, it could set off another firestorm between President Donald Trump and an independent agency led by an appointee of his predecessor Barack Obama.

Spokeswomen for the FHFA and the Treasury Department declined to comment.

Shares Jump

Some classes of Fannie and Freddie preferred shares jumped more than 10 percent after Bloomberg reported on the discussions between FHFA and the administration. Shareholders, who include prominent hedge funds, believe that allowing the companies to retain capital is a necessary step to releasing the firms from government control.

"Chatter regarding capital retention at Fannie Mae and Freddie Mac has bolstered shareholders hopes of eventual returns," Isaac Boltansky, an analyst at Compass Point Research & Trading in Washington, said in an email.

Fannie and Freddie don't make mortgages. They buy them from lenders, wrap them into securities and give guarantees to make mortgage-bond investors whole if borrowers default.

The FHFA negotiations stem from the bailout agreements struck when the government took control of the companies in 2008. Fannie and Freddie eventually received $187.5 billion to weather the financial crisis, and in exchange taxpayers received a new class of senior preferred stock that paid a 10 percent dividend, along with warrants to acquire nearly 80 percent of their common stock.

In 2012, the Treasury and FHFA, which controls Fannie and Freddie, amended the agreements. Instead of a 10 percent dividend, taxpayers each quarter receive a dividend equal to all of the companies' net worth above a specified capital buffer.

Zero Buffer

That buffer is $600 million each this year, but drops to zero in 2018. At that point, Fannie and Freddie would need another bailout from Treasury to cover even small quarterly losses. The companies have $258 billion to draw on from the U.S. Treasury if needed, but that amount can't be replenished with future profits. If the companies make their fourth-quarter payment as scheduled, they will have paid taxpayers a combined $283.6 billion.

At the center of the conflict is Watt, a former Democratic congressman picked by Obama to lead the agency in 2013. After fierce opposition from Senate Republicans who tried to block his confirmation, Democrats changed the rules to eliminate the use of the filibuster for some presidential nominees, enabling Watt to get through.

After becoming director, Watt exhibited an independent streak, making moves that irked Democrats and Republicans alike. The behavior won him the respect of many Republican lawmakers. They've limited their criticism of Watt even as they lambasted former CFPB Director Richard Cordray, who set off a public battle over the agency's leadership last week by trying to put his chief of staff in charge as he walked out the door.

Investor Confidence

Watt has said that his concern is with how mortgage-bond investors might react if Fannie and Freddie begin to draw funds from the remaining Treasury commitment. For now, many investors treat the companies' mortgage-backed securities as if they have no risk of losses from borrower defaults. Watt has said that perception could change if the $258 billion line of credit is being tapped to cover losses.

"We reasonably foresee that this could erode investor confidence," Watt said at a House Financial Services Committee hearing in October. "This could stifle liquidity in the mortgage-backed securities market and could increase the cost of mortgage credit."

Some private shareholders of Fannie and Freddie, as well as some housing-industry trade groups, have argued that the lack of a buffer doesn't comport with U.S. regulators' push to increase capital at other financial institutions.

"The U.S. taxpayer is not capital. The U.S. taxpayer needs to be protected by capital. And so running these entities with zero capital just makes no sense to me at all," said Landon Parsons, a senior adviser with Moelis & Co. at a forum at the Cato Institute in June.

Parsons helped author a proposal on behalf of shareholders including Paulson & Co. and Blackstone Group LP to recapitalize Fannie and Freddie and return them to private control.

The possibility of losses is more than theoretical. Freddie Mac in 2015 and 2016 posted small quarterly losses as a result of a quirk in how the company accounted for interest-rate hedges. The capital buffer kept the company from needing bailout money.

One-Time Loss

Fannie and Freddie could also face one-time losses if Congress passes a bill that reduces the corporate tax rate. That's because the change would reduce the value of Fannie and Freddie assets that can offset taxes.

The $2 billion to $3 billion requested by FHFA officials could withstand a small loss but likely wouldn't be enough to protect against a cut in the corporate tax rate.

Treasury Secretary Steven Mnuchin has publicly said he expects the companies to pay their dividends as scheduled.

In the private talks, administration officials have suggested that FHFA agree not to raise the size of a mortgage that Fannie and Freddie can buy. That so-called conforming loan limit currently stands at $424,100 for most of the U.S. and at $636,150 for areas with the priciest homes.

On Tuesday, FHFA raised the limit for most areas of the U.S. to $453,100 for 2018. The agency raises the limit based on changes to its own home-price index, pursuant to the law governing the agency. It's unclear what discretion the FHFA would have in taking steps to limit the increase.

Private Capital

Trump administration officials have said they want to increase private capital's role in the mortgage market, a goal that could be furthered by freezing the loan limit.

FHFA officials have resisted the administration's request to stop a loan-limit increase, the people said. Complicating matters, Watt has publicly said that he believes the companies' bailout agreements allow him to withhold some or all of the dividend without White House approval.

Some lawmakers have urged Watt to let the companies keep capital, while others have said the move could be interpreted as an early step toward fully recapitalizing the companies and releasing them from government control. Watt has been adamant that he won't recapitalize and release the companies without congressional approval.

Retaining a combined $4 billion to $6 billion from a quarter where the companies owe $7.7 billion would allow the companies to make partial payments rather than stopping the dividends completely.