Markets

Trump Clears Fannie-Freddie Capital Boost, Leaves Fates to Biden

By Joe Light
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- Treasury announces last-minute changes to bailout agreements
- Revisions mean U.S.'s stake in companies to keep growing

The Trump administration has set a path for releasing Fannie Mae and Freddie Mac from government control, but President-elect Joe Biden gets to decide whether to take it.

In one of its last acts, President Donald Trump's Treasury Department announced changes Thursday that allow Fannie and Freddie to retain their profits to build up hundreds of billions of dollars in capital, in effect indefinitely suspending dividend payments they make to the U.S. government. However, taxpayers' ownership interest in the mortgage giants will continue to increase as they add to their capital buffers, and Treasury didn't address how that issue would be resolved.

The net effect of the announcement will be that Fannie and Freddie will slowly keep accumulating the funds they need to protect against another housing downturn, and the Biden administration will determine the companies' fates. That likely means that Fannie and Freddie --

firms crucial to the housing market because they backstop roughly $5 trillion of mortgages -- will remain in federal conservatorship for the foreseeable future, which has been their status since the 2008 financial crisis.

In a statement, Treasury Secretary Steven Mnuchin said the revisions mark “an important step for housing finance reform and leaves behind a blueprint that we hope will help guide additional reforms.” The administration “would have preferred to have been able to achieve further reforms,” he added.

Fannie and Freddie don’t make mortgages themselves. They buy them from lenders, put them into mortgage bonds and guarantee to investors the payment of principal and interest. The government took over the companies as the housing market cratered more than a decade ago and eventually injected them with $187.5 billion in bailout money.

In return for the funds, the U.S. Treasury received a new class of senior preferred stock that originally paid a 10% dividend, along with warrants to acquire nearly 80% of the companies’ common stock. The accords outlining the arrangement, known as the preferred stock purchase agreements, or PSPAs, govern Treasury’s compensation for providing an ongoing U.S. government backstop of Fannie and Freddie, as well as other requirements the companies must meet.

Multiple Amendments

The government has amended the PSPAs several times, most significantly in 2012, when the original 10% dividend on the senior preferred stock was replaced with a sweep of nearly all of the companies’ profits to the Treasury. Owners of the companies’ legacy shares have said that change was illegal and sued.

More recently, Fannie and Freddie’s regulator, the Federal Housing Finance Agency, and the Treasury Department have raised the amount of capital the companies can hold, a limit which had been capped at a combined $45 billion. The changes announced Thursday in effect remove those capital limits and eliminate the profit sweep. In return, taxpayers’ ownership interest in Fannie and Freddie will also keep rising.

The Treasury Department’s latest modifications to the bailout contracts, an agreement between it and the FHFA, stipulate that Fannie and Freddie can build capital until they reach their regulatory minimums.

At that time, the dividend will revert to 10% or to the increase of the companies' net worth in the prior quarter, whichever is smaller. Treasury said that it and the FHFA will also determine what fee the companies should pay for the ongoing backstop before the regulatory minimum capital is reached.

Treasury said that the contract changes will also make it so that Fannie and Freddie can't exit government control until litigation related to the conservatorship is resolved, and they build common equity capital tier 1 capital of at least 3% of their assets -- a target they are years away from.

A senior FHFA official estimated that it could take decades for the companies to meet their capital requirements through retained earnings alone.

The companies will be allowed to issue new common stock -- a step that is all but essential to meeting their capital demands -- only after Treasury exercises its warrants to acquire nearly 80% of the companies and the litigation is dealt with.

Biden's Move

The upshot of all the changes is that they leave it to the Biden administration to implement a more sweeping overhaul that moves the companies toward an off ramp -- something officials at the FHFA and Trump's Treasury Department acknowledge. To that end, the new agreement calls on Biden's Treasury Department to write a report, due later this year, to address the unresolved issues.

Thursday's agreement also locked in several policy changes that Fannie and Freddie have already been meeting under the guidance of FHFA Director Mark Calabria. The amount of mortgages they can hold in their investment portfolios was reduced. The accord also sets caps on how much multifamily business the companies can engage in and limits their business in higher-risk loans, such as in mortgages for investor properties.

The agreements also seek to require Fannie and Freddie to treat small and large lenders equally, likely permanently ending a pre-crisis practice where the companies would cut deals with giant mortgage lenders in exchange for more business.

"Today's agreement that allows Fannie Mae and Freddie Mac to continue retaining earnings is a step in the right direction, but more hard work remains," Calabria said in a statement, adding that the companies will be at risk of failing in a fresh crisis until they can raise private capital. A senior FHFA official said that Calabria pushed for the Treasury Department to address the senior preferred shares but was unable to convince Mnuchin to modify it.

Now, focus will turn to the Biden administration's goals for Fannie and Freddie and the future of Calabria, a Trump appointee whose term doesn't expire until 2024. People familiar with the matter say Biden is unlikely to prioritize Fannie-Freddie reform, instead keeping them in government control for some time.

Calabria can keep making changes that prepare the companies for a government release as they build capital, but how much time he'll have left is in question. The Supreme Court in December heard arguments that Biden should be allowed to fire the FHFA director at any time, and it's expected to make its decision by the midyear.

The same case, which was brought by legacy shareholders in Fannie and Freddie, could provide clarity on whether the 2012 profit sweep was illegal, potentially providing an impetus for the government to modify its ownership stake.