POLICY PERSPECTIVES

COMPETING CLAIMS IN PRIVATIZATION OF FANNIE MAE AND FREDDIE MAC

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INTRODUCTION

Nearly 20 years ago, on September 6, 2008, the GSEs Fannie Mae and Freddie Mac entered conservatorship. Since that time there have been many proposals to restructure, eliminate, or release the GSEs. Once again, there is talk about the privatization of Fannie Mae and Freddie Mac.

Privatization faces many hurdles both political and financial. Here we will take a look at some of the financial considerations and show that any solution will require a compromise between competing financial claims.

Privatization, by definition, requires finding investors who are willing to take on the risk/reward profile offered by the GSEs. Several factors weigh into that assessment: chief among them are the regulatory capital requirements, the scope of GSE activities, and the nature of the government guarantee on GSE obligations, as well as the resolution of government claims under the Senior Preferred Stock Purchase Agreements (PSPAs) and its various amendments.

CAPITAL REQUIREMENTS

A threshold question is whether the companies have sufficient earnings relative to their capital requirements to attract private investment.

Tables 1 and 2 summarize the balance sheets and income statements of the GSEs for 2024.

Table 1 – Combined Summarized Balance Sheet

Balance Sheet	**Fannie Mae**	**Freddie Mac**	**Combined**
$ Billions	12/31/2024	12/31/2024	12/31/2024
Assets			
Mortgage Loans	4000	3172	7172
Other	350	215	565
Total Assets	**4350**	**3387**	**7737**
Liabilities			
MBS	4088	3058	7146
Debt	139	247	386
Other	28	22	50
Total Liabilities	**4255**	**3327**	**7582**
Sr. Pref Stock Draw	120	72	192
Pref Stock	19	14	33
Retained Earnings	-39	-23	-62
Other	-5	-3	-8
Total Equity	**95**	**60**	**155**
Eligible for Capital	*-37*	*-18*	*-55*
Liquidation Preference	*212*	*129*	*341*

Table 2 – Combined Summarized Income Statement

Income Statement	**Fannie Mae**	**Freddie Mac**	**Combined**
$ Billions	*12/31/2024*	*12/31/2024*	*12/31/2024*
Income			
Net Interest	28.7	19.7	48.4
Credit Losses	0.2	-0.5	-0.3
Other	2.1	4.2	6.3
Expense			
Operations	-3.6	-2.8	-6.4
Assessments	-3.8	-3.2	-7.0
CRT	-1.6	-2.3	-3.9
Other	-0.7	-0.3	-1.0
Net Income Before Tax	21.3	14.8	36.1
Fed Taxes	-4.3	-2.9	-7.2
Net Income After Tax	**17.0**	**11.9**	**28.9**

Based on these financial results it seems that the GSEs represent an attractive investment, with a return on equity of 18.6% ($28.9B/$155B). However, the equity story of the GSEs is complicated. Table 3 shows a variety of equity measures for the GSEs. Under their current capital requirements, the GSEs would require $336 billion, or 4.3% of the $7.7 trillion assets. The leverage capital requirement is $244 billion, 3.2% of assets. The current $155 billion of equity represents only 2.0% of assets. The senior preferred stock totaling $192 billion does not count toward their capital requirements as it needs to be repaid to the US Treasury. Under current regulations, the GSEs have a nearly $400 billion equity shortfall.

Table 3 – GSE Equity

	$ Billions	**% of Assets**
Risk Based	$336	4.3%
Leverage	$244	3.2%
Equity	$155	2.0%
Eligible Equity	($55)	(0.7%) [1]
Shortfall	$391	5.1%

Even without considering obligations to the US Treasury, the GSEs' return on required equity may not be sufficient to attract private capital. At the risk-based capital requirement of $336 billion, or 4.3% of assets, the GSE return on equity during 2024 would have been 8.6%, less than half of the reported 18.6% return. Given the uncertain prospects of "released" GSEs this may not be sufficient to attract private capital (see Table 4).

Elsewhere, we have written about how the capital requirements may be excessive, and one solution may be to lower them to more economically justified levels. However, such changes are closely related to the government guarantee of GSE liabilities, as discussed below.

Table 4 – Return on Equity

	$ Billions	**Before Tax**	**After Tax**
Net Income		$36.1	$28.9
		Return(%)	**Return (%)**
Assets	$7737	0.47%	0.37%
Equity	$155	23.3%	18.6%
Risk Based Capital	$336	10.7%	8.6%
Leverage Capital	$244	14.8%	11.8%

SCOPE OF GSE ACTIVITES

Another challenge facing any plan to release the GSEs is the scope of their activities. Many of the proponents of release also favor reducing their footprint and limiting their activities. A 2019 study by Michael Stegman and Richard Cooperstein (A Missing Piece of the Administrative Reform Puzzle: How the GSEs Generate Cross-Subsidies | Harvard Joint Center for Housing Studies) demonstrated that investor loans and cash-out refinances provided $11 billion of subsidies to the GSEs' lending for purchase and non-cash-out refinances. Without these programs, the GSEs would need to significantly increase guarantee fees on their remaining businesses to maintain comparable levels of return on equity.

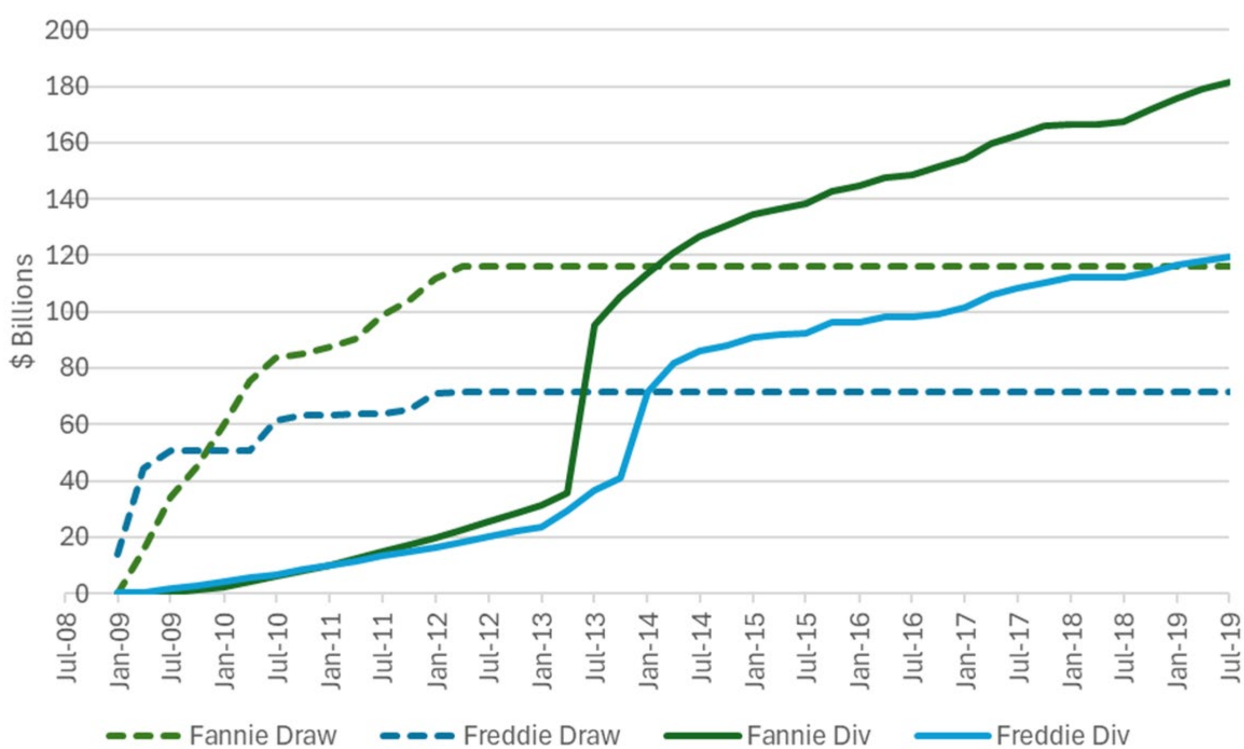
Release of the GSEs would also need to address the income implications of the guarantee provided by the US government (whether implicit or explicit) for the GSE-issued MBS and debt. If the guarantee were made explicit, the GSEs would likely have to pay a guarantee fee ranging from 5 to 10 basis points, representing 10% to 20% of their current income before tax. This might be offset by higher prices for guaranteed MBS, which would allow the GSEs to increase guarantee fees. If, on the other hand, the guarantee was removed or deemed to be less secure, that would decrease the value of MBS in the market and might cause the GSEs to lower guarantee fees to remain competitive with other financing alternatives.

A reasonable approach might be to lower the GSE capital requirements in conjunction with establishing a paid-for guarantee. While many people feel that congressional action might be required to set up such a guarantee, it appears that the government is already providing a paid-for guarantee through the senior preferred stock. A better structure would be a coverage of excess loss by vintage that mirrors the credit risk transfer market. A detailed discussion of that approach is beyond the scope of this report.

It is also worth noting that the GSEs owe the US government a total of $341 billion under the liquidity preference of the Senior Preferred Stock Purchase Agreements, with $155 billion of retained earnings in excess of the $187 billion draw for senior preferred stock. The full $341 billion would need to be addressed in any planned release of the GSEs. Some have argued that the $192 billion draw has already been more than paid back, so the senior preferred stock obligation should be eliminated.

Figure 1 shows the draws and payments on the senior preferred stock. The initial draws in 2009 were largely related to the changing status of deferred tax assets that became worthless as the GSEs forecast losses. However, as the GSEs became profitable the deferred tax assets gained in value and produced excess capital that was used to make payments to the senior preferred stock. As shown in the chart, the $301 billion paid to the government has more than exceeded the draws of $187 billion. Note that after September 30, 2019, the GSEs retained additional earnings totaling $155 billion, as mentioned above.

Figure 1 – PSPA Cashflow



The government received $114 billion more than they advanced for a return on the SPS of 12.5%. Discounted at 10%, the government netted $42 billion. While it would then seem that the government has been more than compensated, it is important to note that the SPS only brought the GSEs to a net equity position of zero. That is, there was no capital provided to bear risk. Thus, there is a strong argument that the government in the first loss position is entitled to all the earnings of the GSEs.

With considerations of capital, earnings, and obligations in mind, we can turn to potential proceeds from a sale of the GSEs. It should be clear already that it will not be possible to satisfy all the constraints of providing a reasonable return to investors, limiting the scope of GSE activities, and repaying the government for its role as equity provider.

A comparison with JP Morgan (JPM), as shown in Table 5, may provide some insight into the value of the combined GSEs as well as how daunting it would be to have an equity raise of this magnitude.

JPM's 2024 income of $57 billion is nearly double that of the combined GSEs on assets that are just over half that of the GSEs. JPM is a diversified financial institution, while the GSEs are primarily in the business of providing credit guarantees on mortgages funded with mortgage-backed securities. If the GSEs could achieve a valuation similar to that of JPM their equity would be worth roughly $375 billion. It probably makes sense to think of this as an upper bound on the valuation of the GSEs. Note that this amount is also close to the risk-based capital requirement of $336 billion and the liquidity preference amount of $340 billion. That would mean a choice between using the proceeds of a sale of equity to paying the liquidity preference amount to the government and leaving the GSEs undercapitalized, or using the proceeds to cover most of the $391 billion of capital shortfall under the current capital rules.

Table 5 – Comparison of JPM and Combined GSEs

$ Billions	JPM	GSEs
Net Income	$57	$29
Assets	$4350	$7737
Equity	$344	$155
Market Cap	$750	--

Ratios	JPM	GSEs
ROA	1.4%	.37%
ROE	16.8%	18.6%
P/E	13x	--
Price to Book	2.2x	--

A pathway to recapitalization and release of the GSEs will require a set of compromises, and perhaps innovations, to succeed. First, it will be necessary to reduce the capital requirement to a more economically justifiable level. Without getting into the dynamics of leverage and risk-based capital, a capital requirement of about 2.5% would probably be sufficient if the GSEs had a government backstop against catastrophic losses for their mortgages and program-related debt and appropriate use of credit risk transfer (CRT). For this analysis we will assume that they pay a guarantee fee of 6 basis points (4 basis points after tax) for a government wrap on their bonds. They could have a modest decrease in their balance sheets to bring them below $7 trillion for now, but would need to be able to grow with the market to achieve the 12x valuation implied here. These changes would produce annual income of approximately $26 billion per year.

Assuming a 12x multiple for the sale of the equity, that would produce $310 billion of proceeds versus a capital requirement of $175 billion, leaving an excess of $135 billion to be paid to the government, versus the $341 billion liquidation preference. Government accountants could decide how to allocate that money given the senior preferred stock draws and dividends and the GSE-retained earnings owed to the government.

Table 6 – MBS Spread to UST

	Ratios	$ Billions
Assets		$7000
Equity	2.5%	$175
Income AT	0.37%	
Wrap Fee (6bps, 4bps AT)	(0.04%)	
Net	0.33%	$26
ROE	15%	
Multiple	12x	$310

Of course, raising $310 billion in a sale of equity in two companies with an uncertain regulatory future would be extremely difficult, if not impossible. A better approach would be to establish a tracking stock that provided a share of the income of the GSEs to investors that could eventually convert to voting stock. The tracking stock could be issued in smaller increments that would increase over time until private capital was sufficient to meet the capital requirements and own the firm outright. During the time that the private investment was increasing, the government would continue to earn a commitment fee on the shortfall in private equity, versus capital requirements.

An important consideration that is not addressed in this numerical analysis is the regulatory structure of the GSEs. Much of the regulation since 2008 has been under the conservator powers of the Federal Housing Finance Agency (FHFA). Released GSEs would only be subject to the regulatory powers of the FHFA, which might not be sufficient to the task. With a gradual release, using tracking stock, the government could refine the regulatory approach to the GSEs and the form of guarantee on the GSE obligations over time, perhaps enacting legislation that would provide greater certainty to investors and better protection to taxpayers from future GSE losses.

With this plan, no one would get what they want now, but perhaps the GSEs could emerge from conservatorship as more stable, more productive, privately owned companies over time.

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