What to Make of the Dramatic Fall in GSE Profits

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The government-sponsored enterprises, or GSEs, had a remarkable 2013: Fannie Mae reported profits of $84 billion and Freddie Mac profits of $49 billion. For perspective, Apple reported profits in the same year of $37 billion, just shy of its most lucrative year on record. These numbers gave many such a sense of confidence in Fannie and Freddie that talk began to shift from winding them down to releasing them from conservatorship, taking much of the wind out of the sails of the already flagging push for overhauling the housing finance system. All reform involves risk, after all, and these numbers suggested that we were risking an increasingly healthy system.

In 2014, however, the profit pendulum swung back again. The net earnings of both institutions fell by over 80 percent, Fannie's to $14 billion and Freddie's to $8 billion. Most alarmingly, Freddie's fourth-quarter profits were down 90 percent from the prior quarter. So conversation shifted yet again, from comparisons to Apple to whether Freddie might soon require another draw on the Treasury.

What a difference a year makes.

To understand this dramatic swing, we need first to parse the 2013 figures. About half the profits of each institution came from reclaiming tax assets that were written down during the crisis: Fannie reclaimed $45 billion and Freddie $23 billion. Between a quarter and a third of the profits came from earnings from their portfolios: Fannie earned $19 billion and Freddie earned $16 billion. And a significant sum came from legal settlements, though precisely how much is difficult to decipher, as the settlements are dispersed among several larger revenue streams.

These sources of revenue have one thing in common: they are largely disappearing. The tax reversals were a one-time event for both institutions. Fannie and Freddie's portfolios are being reduced to a fraction of their historical levels under the terms of their Senior Preferred Stock Purchase Agreements (PSPAs) with the US Treasury. And each institution is reaching the end of its major legal actions arising from the crisis.

The only major revenue source not being wound down is what the GSEs generate from their core guarantee business, in which they collect a fee in exchange for guaranteeing the default risk of loans for investors.

In essence, what we're seeing—and will continue to see—is a steady decline of several large but ephemeral sources of revenue, forcing the GSEs to rely increasingly on their guarantee business for their profits.

While Fannie and Freddie's guarantee-fee revenue stream is strong by historic standards, driven by the pristine quality of their books and their dominant market shares, it represents a completely different level of profitability than we saw back in 2013. If we were to strip away all non–guarantee fee earnings from the 2013 numbers, for instance, Fannie would have made about $8 billion in profits ($12 billion taxed at 33.8 percent) and Freddie $3 billion ($5 billion taxed at 32.6 percent). Not bad, but a far cry from $84 billion and $49 billion.

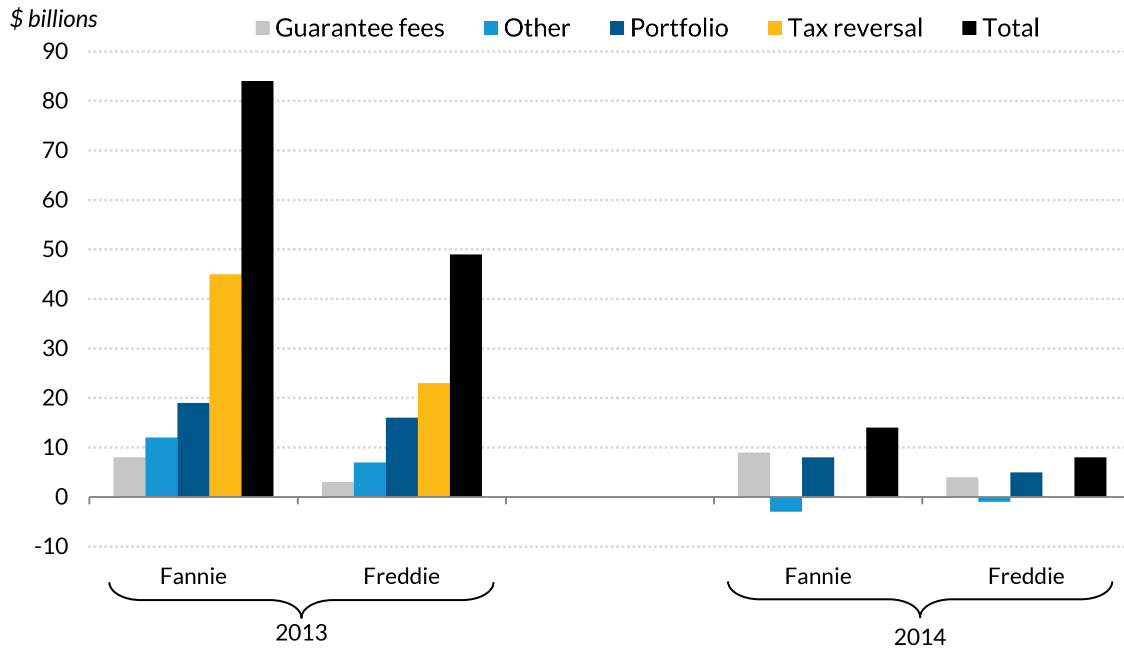
This brings us back to 2014, in which Fannie made $14 billion in profits and Freddie $8 billion. Of this profit, Fannie made about $9 billion from guarantee fees ($14 billion taxed at 32.8 percent) and Freddie made $4 billion ($5 billion taxed at 30.1 percent); the rest came from investments on their portfolio and other net income. Freddie's investment profits were notably down over prior years, in part because its portfolio is being wound down, but also because Freddie took a large loss on a derivative position used to hedge some of its portfolio risk.

It is worth noting that this loss on Freddie's derivative position is an accounting loss, not an economic one. Under the relevant accounting rules, Freddie was required to mark-to-market its derivative position, but not the portfolio position that the derivative position was intended to hedge. So Freddie had to account for a loss in value of one position, but not the gain in another that it offset, presenting a somewhat misleading picture of the institution's economic health.

This accounting loss will likely reverse in the coming quarters, as interest rates rise and the derivative position improves, cushioning Freddie's reported profits over the near term and forestalling the eventual economic reality of much more modest earnings as they are forced to rely almost entirely on revenues from their guarantee business.

FIGURE 1

GSE Profits



Sources and methodology

Fannie's 2013 and 2014 guarantee-fee revenues are from the press release for its 2014 10K, page 5; its effective tax rate is from its 2014 10K, page F44. Freddie's 2013 and 2014 guarantee-fee revenues are from its 10k, pages 69 and 75; its effective tax rate is from page 197 of the same. Technically, I am estimating tax-adjusted guarantee-fee revenues here, not profits. By omitting administrative costs and other expenses, which are a challenge to determine from their financials given the complexities of generally accepted accounting principles, I am actually overstating their guarantee-fee profits.

The Question of a Draw

Freddie's dramatic drop in profits in the fourth quarter has raised some concern that it may be headed for another draw on the Treasury, something both enterprises have avoided since 2012.

The GSEs require a draw when their losses exceed their capital buffer. Each enterprise has a buffer of $1.8 billion in 2015, declining by $600 million each year until it is extinguished altogether in 2018. Under the terms of the PSPAs, the decline in the GSEs' buffers tracks the decline in the GSEs' portfolios, because the dramatic volatility in quarterly earnings that the buffers are intended to guard against will diminish along with Fannie's and Freddie's portfolio investments.

How Likely Is a Freddie Draw?

Several things should shore up Freddie's revenue over the near term, decreasing the likelihood of a draw in the coming quarters:

- Freddie will likely see a reversal of the accounting losses on its derivative position as interest rates rise;
- Freddie will have a still-significant portfolio for next couple of years; and
- Freddie's older loans, which have lower guarantee fees, will gradually be replaced by newer ones with higher fees. As long as Freddie retains a dominant market share, this shift toward more high-fee loans will mean an increase in revenues.

Things may well get trickier in the out years, however. When the private-label securities market finally comes back and Freddie's market share decreases, so will the revenue from its guarantee business. And if Freddie finally opens up its credit box, Freddie will expose itself to more risk and, depending on how well it prices that risk, more volatility in its earnings. No longer able to counter losses in this business with gains on its portfolio investments, Freddie becomes increasingly exposed to changes in the economic environment. In short, Freddie's risk of a draw goes up.

What Happens if Freddie Needs a Draw?

Substantively, not much—for a while anyway. Freddie has a $140 billion line of credit with the Treasury. If and when it draws enough to give investors a sense that Freddie might reach that limit during the lifetime of their investment, investors will begin to demand a discount to cover that risk. If that happens, then Freddie's already precarious financial situation is likely to get a lot worse, and quickly.

But given the size of the line of credit with the Treasury, it will take some *very* big draws to get investors to that point, likely either a dramatic draw or two that suggests more to come, or years of more moderate ones. Either way, we are a long way off from that kind of environment.

The more likely impact of a draw over the near term is political. If Freddie requires a draw, then Congress may finally wake up (once again) to the unsustainablity of the current system, and begin negotiating steps to overhaul it, perhaps with enough external pressure this time to see it through.

Conclusion

Fannie and Freddie's 2013 financials generated a great deal of misplaced confidence in their financial health, which in turn distracted many from the need to reform the housing finance system. Their 2014 financials remind us that the picture of their economic health is more complicated and that we would be well served to turn our attention back to their reform, before we find ourselves forced back by a perceived crisis.

To some, the only problem to be addressed is the risk of a draw, and the logical response is to allow the GSEs to rebuild a capital buffer to protect against that risk. This position faces two challenges, however. First, the shift toward more modest returns shows that any effort to build a buffer will be gradual at best. Second, the Obama administration has made clear that any move to recapitalize the institutions absent reform is off the table. I will discuss that position and its implications in a future brief.

About the Author

Jim Parrott is a senior fellow at the Urban Institute and owner of Falling Creek Advisors, which provides financial institutions with strategic advice on housing finance issues. He spent several years in the White House as a senior advisor at the National Economic Council, where he led the team of advisors charged with counseling President Obama and the cabinet on housing issues. He was on point for developing the Obama administration's major housing policy positions; articulating and defending those positions with Congress, the press, and the public; and counseling White House leadership on related communications and legislative strategy. Parrott was previously a senior advisor to Secretary Shaun Donovan at the Department of Housing and Urban Development. He has a BA from the University of North Carolina, an MA from the University of Washington, and a JD from Columbia University School of Law.

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