

DEPARTMENT OF THE TREASURY WASHINGTON, D.C. 20220

April 21, 2015

The Honorable Charles E. Grassley Chairman Committee on the Judiciary United States Senate Washington, DC 20510

Dear Chairman Grassley:

Thank you for your recent letter regarding the senior preferred stock purchase agreements between the Department of the Treasury and the government-sponsored enterprises that purchase and securitize home loans (Fannie Mae and Freddie Mac). I appreciate the opportunity to clarify some misunderstandings reflected in recent press reports.

Most important, I wish to clear up the misconception that Treasury and the taxpayers have been "repaid" for the extraordinary commitment of public funds to Fannie and Freddie. Treasury did not make an ordinary loan to the enterprises; instead, it committed (and continues to make available) hundreds of billions of dollars of capital, an amount that far exceeds the \$187.5 billion in funding drawn by the enterprises to date. Treasury also took on an enormous risk when rescuing the enterprises in the middle of a financial crisis – a risk for which any private investor would have demanded substantial compensation. The dividends paid by Fannie and Freddie under the preferred stock agreements compensate Treasury and the taxpayers for that risk and for continuing to make available hundreds of billions of dollars of funding capacity to maintain market confidence in the enterprises.

In 2008, Treasury and the Taxpayers Rescued Fannie and Freddie

As the financial crisis worsened in the summer of 2008, Congress passed the Housing and Economic Recovery Act of 2008 (HERA). HERA authorized Treasury to infuse taxpayer funds into Fannie and Freddie by purchasing securities from them; the Act also created the Federal Housing Finance Agency (FHFA) to oversee the enterprises. By September 2008, Fannie and Freddie were at the brink of insolvency. FHFA exercised its authority under HERA to place Fannie and Freddie into conservatorship, thus preventing the two enterprises from inflicting even greater harm on the economy.

¹ See Federal Housing Finance Agency, Statement of FHFA Director James B. Lockhart at News Conference Announcing Conservatorship of Fannie Mae and Freddie Mac (Sep. 7, 2008), http://www.fhfa.gov/Media/Public Affairs/Pages/Statement-of-FHFA-Director-James-B--Lockhart-at-News-Conference-Annnouncing-Conservatorship-of-Fannie-Mae-and-Freddie-Mac.aspx.

On September 7, 2008, FHFA, as conservator of the enterprises, entered into agreements with Treasury under which Treasury ultimately committed hundreds of billions of dollars of public funds to Fannie and Freddie to maintain the solvency of those enterprises. In exchange, Treasury received senior preferred stock in Fannie and Freddie, along with additional economic rights designed to compensate Treasury for the value of its commitment to the enterprises. Under the preferred stock agreements executed in 2008, Fannie and Freddie agreed to pay quarterly fixed dividends to Treasury equal to 10 percent of the total amount of outstanding funding Treasury had provided. All dividend payments are required to be deposited into the general fund of the Treasury.²

In 2012, the Third Amendment Addressed a New Threat to the Stability of Fannie and Freddie

In 2012, Treasury and FHFA, as conservator, entered into the Third Amendment to the preferred stock agreements to address a new threat to the stability of the enterprises. For several quarters leading up to the Third Amendment, Fannie and Freddie were not earning sufficient profits to pay the 10-percent dividends owed to Treasury under the original preferred stock agreements. In quarters in which Fannie and Freddie experienced net losses, the enterprises had to draw down additional funds under the commitments from Treasury and return those funds to Treasury as dividend payments. The enterprises projected that, for the foreseeable future, they would be unable to pay the 10-percent dividends without taking additional draws.³ To make matters worse, each draw to pay a dividend decreased the amount of available funding capacity under Treasury's commitments, raising the prospect that the enterprises would exhaust those commitments and again face imminent insolvency.

The Third Amendment ended the vicious circle of taking funds from Treasury – meaning the taxpayers – to pay Treasury the fixed dividends. It changed the structure of the dividend payments to ensure that Fannie and Freddie would no longer have to take a draw from Treasury in order to pay a dividend. The Third Amendment replaced the 10-percent fixed dividends with a formula under which each enterprise pays Treasury, as a dividend, the amount by which its net worth for the quarter exceeds a set capital reserve. If the enterprise's net worth for a given quarter is lower than the specified reserve, that enterprise would not owe a dividend to Treasury. The Third Amendment thus removed the threat to Fannie's and Freddie's solvency posed by exhausting the funding capacity under the agreements to pay the fixed 10-percent dividends, and it maintained market confidence at a critical time for the housing market and the economy.

The fact that Fannie and Freddie subsequently enjoyed greater earnings than expected when the Third Amendment was executed does not negate the reasonableness of the agreement Treasury and FHFA made in 2012. As FHFA's Office of the Inspector General recently found, the earnings the enterprises experienced in 2013 and 2014 were attributable in significant part to

² See 31 U.S.C. § 3302(b); see also 5 Comp. Gen. 289 (1925).

³ See Fannie Mae 2011 Form 10K at 21 ("We do not expect to earn profits in excess of our annual dividend obligation to Treasury for the indefinite future."), http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2011/10k_2011.pdf; Freddie Mac 2011 Form 10K at 2 ("it is unlikely that we will regularly generate net income or comprehensive income in excess of our annual dividends payable to Treasury"), http://www.freddiemac.com/investors/er/pdf/10k_030912.pdf.

one-time tax benefits and litigation recoveries, and the enterprises' future profitability is far from assured.⁴ In addition, in April 2014, FHFA released projections of the enterprises' financial performance, which predicted future draws from Treasury under specific economic scenarios and demonstrated the possibility of continued taxpayer support in spite of the earnings recorded that year.⁵

Courts Have Dismissed Lawsuits Challenging the Third Amendment

As your letter notes, several hedge funds and other investors in Fannie and Freddie have sued Treasury and FHFA, complaining about the terms under which Treasury makes available hundreds of billions of dollars of taxpayer funds to maintain market confidence in Fannie and Freddie. Treasury and FHFA have prevailed in the two cases resolved to date. In September 2014, a D.C. federal court concluded that Treasury and FHFA acted within their congressionally granted authority under HERA in entering into the Third Amendment, and it dismissed all of the plaintiffs' claims. A federal court in Iowa subsequently dismissed the case before it and expressed agreement with the D.C. federal court's reasoning. The Department of Justice is defending the remaining lawsuits.

The Extraordinary Financial Commitment Made by Treasury and the Taxpayers to Fannie and Freddie Has Not Been "Paid Off"

It is not accurate to say, as some news reports have done, that Treasury and the taxpayers have been "paid off" for their extraordinary financial commitments to Fannie and Freddie. As an initial matter, Treasury did not make a simple "loan" to Fannie and Freddie. It made available hundreds of billions of dollars of funding capacity to ensure market confidence in the continued stability of the enterprises at a time when that stability was very much in doubt. The terms of the preferred stock agreements are intended to compensate Treasury and the taxpayers for that ongoing financial commitment, not to pay back a one-time loan.

In addition, the amount of taxpayer support provided by the preferred stock agreements far exceeds the \$187.5 billion in funding capacity drawn by the enterprises to date.

First, today, Treasury continues to make available to Fannie and Freddie more than \$258 billion in undrawn funding capacity, meaning Treasury and the taxpayers continue to be on the hook for future losses those enterprises may incur. Any private lender would demand substantial compensation for providing that kind of ongoing funding commitment. Treasury was entitled under the original preferred stock agreements to periodic commitment fees to compensate for that available but undrawn funding capacity, but the Third Amendment suspended those fees while the net-worth-sweep dividend structure is in place.

⁴ See Federal Housing Finance Agency Office of Inspector General, *The Continued Profitability of Fannie Mae and Freddie Mac is Not Assured* (Mar. 18, 2015), http://fhfaoig.gov/Content/Files/WPR-2015-001.pdf.

⁵ See Federal Housing Finance Agency, *Projections of the Enterprises' Financial Performance (Stress Tests)* (Apr. 30, 2014), http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/GSEFinProj2014FINAL.pdf.

⁶ See Perry Capital LLC v. Lew, No. CV 13-1025 (RCL), 2014 WL 4829559 (D.D.C. Sept. 30, 2014).

⁷ See Continental W. Ins. Co. v. Fed. Hous. Fin. Agency, No. 4:14-CV-00042, 2015 WL 428342 (S.D. Iowa Feb. 3, 2015).

Second, in 2008, Treasury and the taxpayers took on enormous financial risk when rescuing the two firms. Fannie and Freddie exist today only because Treasury provided them with billions of dollars of public funds to cover their massive investment losses during the financial crisis. Again, any private lender would have demanded a substantial risk premium for that assistance in 2008.

Finally, Treasury's funding commitment has lowered borrowing costs for Fannie and Freddie and directly contributed to their earnings in recent years.

Thus, as recognized in a recent Federal Reserve Bank of New York staff report, "[t]he answer is no" to the question whether "the Treasury, and therefore taxpayers, have been 'repaid' by Fannie Mae and Freddie Mac."

We believe that this explanation addresses the questions in your letter insofar as they pertain to Treasury's actions. Some of your questions concern FHFA's roles as regulator and conservator of Fannie and Freddie, and FHFA is best positioned to address those questions. In addition, I enclose for your convenience copies of the preferred stock agreements and all amendments to those agreements, all of which are publicly available.

Should you have any additional questions, please contact me or have your staff contact Drew Colbert, Office of Legislative Affairs, at (202) 622-1900.

Sincerely,

Randall DeValk

Randall De Valle

Acting Assistant Secretary for Legislative Affairs

Enclosure

cc:

The Honorable Patrick J. Leahy

Ranking Member

⁸ Federal Reserve Bank of New York, Staff Report, *The Rescue of Fannie Mae and Freddie Mac* 26 (Mar. 2015), http://www.newyorkfed.org/research/staff_reports/sr719.html.