Reprivatizing Fannie and Freddie: Getting a fair deal for taxpayers

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Prepared for Shadow Open Market Committee meeting, November 7, 2025, NYC

Background

- Fannie and Freddie (the GSEs) have been in federal conservatorship since 2008
  - Bailed out at fair value cost of $291 billion (CBO)
  - Currently $6.6 trillion of mortgages guaranteed, about half of US mortgage market
- The Trump administration has stated its intention to reprivatize them
- If re-privatized, government backing is expected to continue because of their importance to the mortgage market, the financial system and the economy
  - Government backing creates a large contingent liability for taxpayers
  - Continued backing may be explicit, implicit, or some combination
  - Subsidized guarantees lower GSE borrowing costs and increase prices of GSE-backed MBSs
  - Subsidies accrue to GSE shareholders, mortgage borrowers, and other stakeholders
- Fannie and Freddie are gov't assets because the Treasury owns equity claims to cash flows
  - Gov't holds senior preferred stock and warrants, plus liquidation preference
  - Value in guarantee fee revenues net of defaults, and in the NPV of future activities

Is reprivatization a good idea?

Pros

- Shifts risk/return/pricing to private sector
  - More efficient allocation of capital to housing market
  - Generates mkt information about risk build-ups
- Removes GSEs from direct federal control
  - Reduces hidden and off-budget subsidies
- Incentives for greater product innovation

Cons

- May reinstate monopoly or duopoly status
  - Causing mtg rates to exceed competitive levels
- Likelihood of underpriced gov't guarantee
- Risks transferring wealth from gov't/taxpayers to investors with poorly designed IPO

Why worry about wealth transfer from gov’t/taxpayers to investors?

- The government’s legal claim is complex
  - Dividend policy has been changed by regulatory fiat several times in the past
- Government is likely to show a profit from IPO even if there is a large economic loss
  - Government accounting does not reflect true economic consequences of asset sales
  - Cash received in sale counts as gov’t revenue
    - With some possible offsets from projected loss of receipts over the budget window
  - Opportunity cost of surrendering current ownership stake at below its market value is not booked as a loss
- Powerful vested interests
  - Deal intermediaries
  - Existing common stock holders
  - Existing preferred stock holders

Fannie and Freddie's stock prices climb on announcement of possible IPO

THE WALL STREET JOURNAL

Trump Preparing IPO for Fannie Mae and Freddie Mac Later This Year

Some officials believe offering could raise around $30 billion and value firms at roughly $500 billion or more combined

Federal National Mortgage Association

OTCMKTS: FNMA

Market Summary > Federal National Mortgage Association

10.76 USD

+ Follow

+8.76 (438.00%) ↑ all time

Closed: Nov 4, 4:01 PM EST • Disclaimer

After hours 10.76 0.00 (0.00%)

1D | 5D | 1M | 6M | YTD | 1Y | 5Y | Max

Federal Home Loan Mortgage Corp

OTCMKTS: FMCC

Market Summary > Federal Home Loan Mortgage Corp

10.14 USD

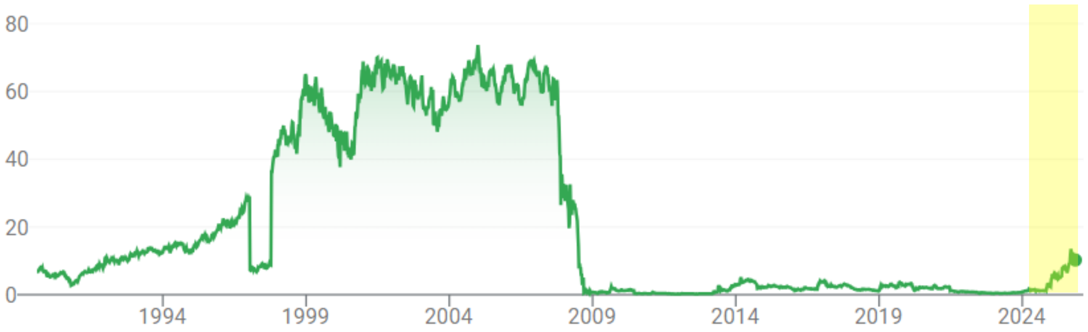
+ Follow

+3.51 (52.94%) ↑ all time

Closed: Nov 5, 4:01 PM EST • Disclaimer

After hours 10.17 +0.030 (0.30%)

1D | 5D | 1M | 6M | YTD | 1Y | 5Y | Max



Balance sheet and hierarchy of equity claims (Fannie Mae)

Fannie Mae's equity claims (Q2 2025, $ billions)

- Total book equity $101.6

- Gov't senior preferred $120.8
- Gov't senior preferred with liquidation preference $219.8

- Investor-held preferred stock $ 19.1

- Common stock 1,158,087,567 shares outstanding $ 0.7
- Gov't has warrants to purchase 79.9% of common stock on a fully diluted basis for a nominal price of $0.00001.

KEY TAKEAWAY: On a book value basis, gov't owns 100% of equity.

Condensed Consolidated Balance Sheets — (Unaudited)

(Dollars in millions)

	As of	
	June 30, 2025	December 31, 2024
ASSETS		
Cash and cash equivalents	$ 38,229	$ 38,853
Restricted cash and cash equivalents (includes $33,264 and $31,893, respectively, related to consolidated trusts)	40,323	39,958
Securities purchased under agreements to resell (includes $1,553 and $0, respectively, related to consolidated trusts)	23,753	15,975
Investments in securities, at fair value	77,430	79,197
Mortgage loans:		
Loans held for sale, at lower of cost or fair value	393	373
Loans held for investment, at amortized cost:		
Of Fannie Mae	51,905	50,053
Of consolidated trusts	4,076,080	4,095,287
Total loans held for investment (includes $4,892 and $3,744, respectively, at fair value)	4,127,985	4,145,340
Allowance for loan losses	(8,247)	(7,707)
Total loans held for investment, net of allowance	4,119,738	4,137,633
Total mortgage loans	4,120,131	4,138,006
Advances to lenders	2,211	1,825
Deferred tax assets, net	10,127	10,545
Accrued interest receivable (includes $11,031 and $10,666, respectively, related to consolidated trusts)	11,678	11,364
Other assets	14,345	14,008
Total assets	$ 4,338,227	$ 4,349,731
LIABILITIES AND EQUITY		
Liabilities:		
Accrued interest payable (includes $11,116 and $10,858, respectively, related to consolidated trusts)	$ 11,841	$ 11,585
Debt:		
Of Fannie Mae (includes $327 and $385, respectively, at fair value)	128,316	139,422
Of consolidated trusts (includes $15,305 and $13,292, respectively, at fair value)	4,082,196	4,088,675
Other liabilities (includes $1,663 and $1,699, respectively, related to consolidated trusts)	14,238	15,392
Total liabilities	4,236,591	4,255,074
Commitments and contingencies (Note 14)	—	—
Fannie Mae stockholders' equity:		
Senior preferred stock (liquidation preference of $219,811 and $212,029, respectively)	120,836	120,836
Preferred stock, 700,000,000 shares are authorized—555,374,922 shares issued and outstanding	19,130	19,130
Common stock, no par value, no maximum authorization—1,308,762,703 shares issued and 1,158,087,567 shares outstanding	687	687
Accumulated deficit	(31,647)	(38,625)
Accumulated other comprehensive income	30	29
Treasury stock, at cost, 150,675,136 shares	(7,400)	(7,400)
Total stockholders' equity	101,636	94,657
Total liabilities and equity	$ 4,338,227	$ 4,349,731

Estimates of market value of total equity claims

- My simple estimates based on net income valued as a growing perpetuity
  - E.g., discount rate of 10%, growth rate of 2.5%
  - => **Fannie Mae $227 billion**
  - => **Freddie Mac $158 billion**

$385 billion combined value

- Other's estimates
  - Financial statements of U.S. Government reports $300 billion combined value
  - CBO shows scenarios with value ranging from $247 billion to $521 billion

- Realized value will depend on expectations about future regulatory policies
  - Capital requirements; Restrictions on investment risk (e.g., only conforming mortgages vs. some subprime); Restrictions on growth of book of business and of balance sheet; Restrictions on pricing; Insurance premiums charged to GSEs (fair value estimated at 5 to 8 bps on assets annually)

Goals and challenges for IPO

- Raise enough equity to meet regulatory capital requirement
  - Equity of about 4% of book assets is required under current regulatory (FHFA) rules
  - Currently negative regulatory capital
- Attract new equity investors without diluting value of government claim
  - Government's senior preferred stock agreements (PSPAs) would dilute new common stock holders
  - A simple write-down of the PSPAs to gov't-owned common stock would surrender value to investors
- The need for price discovery
  - Currently no reliable market price signals about entity valuations
  - To preserve value of government claims, IPO needs to be structured so that price discovered affects the post-IPO ownership stakes of gov't and private sector claimants

Illustrative outcomes for Fannie if enterprise value were known

- **Say market equity is $227 billion** (vs. $106 billion book)
  - Note that this covers capital requirement of $185 billion
- **Case 1: Without liquidation preference**
  - Senior preferred gov't claim paid in full $120.8
  - Investor preferred stock paid in full $19.1
  - Remaining common is 227 – 120.8 – 19.1 = $87.1 billion
    - 80% government share because of warrants = $69.7 billion
    - 20% share to existing common shareholders = $17.42 billion
  - **Total government claim = $120.8 + 69.7 = $190.5 billion**
- **Case 2: With liquidation preference**
  - **Total government claim = liquidation preference = $219.8 billion**
  - Investors in preferred stock gets $227 – 219.8 = $7.2 billion
  - Investors in common stock get nothing.
- **Case 3: Uncompensated conversion of preferred stock to common**
  - Investor preferred stock paid $19.1
  - Total government claim = .8(227 – 19.1) = $166 billion
  - Existing common shareholders get (227 – 19.1 – 166) = $41.9 billion

TAKEAWAYS:

1. The best case for gov't is liquidation. The worst case is a voluntary give-up of senior preferred status.
2. Cases 1 and 2, each investor group receives common shares (or payouts) that achieve target value allocation. The gov't trades senior preferred for common shares, but it preserves the value of its claim.
3. The capital requirement would be satisfied without additional equity issuance.
4. Rather than a giant IPO, government could liquidate its common stock position over time.

Achieving best outcomes for taxpayers when enterprise value is not known

- The need for price discovery adds an additional wrinkle, but it can be achieved through a well-structured IPO and contractual structure that preserve the value of the government's senior claim

- The plan:
  - Step 1: All senior preferred shares are converted to a very large number of common shares at the start of the IPO that belong to the government.
  - Step 2: A stated number of additional shares are sold in a modestly sized IPO.
  - Step 3: Immediately post IPO, the government transfers some of its shares to old preferred and common investors according to a formula that takes into account the IPO price, and that preserves the value of the government's senior claim.
    - The formula is announced prior to the IPO and will affect the IPO prices
    - The formula for achieving this outcome is on the next slide…

- Conclusion:
  - There is a strong case for reprivatizing the GSEs. It could be accomplished without financial concessions from the government if there is the political will to make that happen.

A plan for price discovery & share issuance to preserve value of seniority

- The legal claims of existing preferred and common stock holders would be satisfied by granting them a payout that is conditional on the share price determined in the IPO, P_{IPO}.
  - The formulas determining the distribution of shares or payouts would be publicly disclosed prior to the IPO, and hence, the IPO price would reflect the effect of those commitments on the value of the common stock.
  - Post-IPO, the value of the government's shares is $N_G \times P_{IPO}$. The value of investors' shares is $N_I \times P_{IPO}$. The value of the investors shares is equal to what they paid for them. The entire equity claim is the sum of the two.
  - The size of any payment to preferred stock holders and former common stockholders will depend on the market price of the common shares and whether the government's claim includes all or part of the liquidation preference.
  - The government's legal claim arising from their senior preferred stock or liquidation preference is denoted "V_G."
  - If $V_G \geq N_G \times P_{IPO}$ then the market value of the GSE is too low for the preferred shareholders or old common shareholders to receive any compensation and their claims are extinguished.
  - If $V_G < N_G \times P_{IPO}$ then $N_G \times P_{IPO} - V_G$ will be transferred from the government to those other claimants via a transfer of shares of common stock
    - The payout to preferred shareholders is max(min(\$19.1 billion, $V_G - N_G \times P_{IPO}$), 0).
    - i.e., preferred shareholders receive any excess value up to their maximum legal claim, taken here to be \$19.1 billion
  - The payout to previous common stock holders will be zero unless surplus $S = N_G \times P_{IPO} - V_G - \$19.1$ billion > 0.
  - If S > 0, then the government's warrants give them claim to 79.9% of S. The other 20.1% of S would be paid out from the governments shares to previous common shareholders, and their old shares would be extinguished.

EXTRA SLIDES

Capital requirements for Fannie Mae

- Set by FHFA, last modified in 2021. FHFA has the authority to change them.
- They are suspended as long as GSEs are under conservatorship
- Multiple components: risk-based + leverage + buffer
- In 2025 Q2, total capital requirement if in effect would be $185 billion
  - This amounts to 4.16% of book assets
- In 2025 Q2, the capital requirement shortfall was $214 billion
  - The shortfall is larger than the computed capital requirement because the relevant capital calculation implies a capital deficit of $29 billion.
  - The $29 billion deficit is largely explained by the senior preferred stock not counting as capital

More about the plan for price discovery & share issuance to preserve value of seniority

- Consider a process where the first step, as in the above analysis with a known equity value, is that all gov't claims are converted into (a very large number of) common shares, N_G.
- Then N_I additional common shares are issued in an IPO.
  - New investors in the IPO do not need to worry about being diluted by the government.
  - Investors may still be concerned about continuing government control because of its majority ownership stake
  - To allay such concerns, the government contractually commits to a schedule of dates by which at minimum some number of its shares are sold.
  - It could also commit to other mechanisms to reduce control prior to reducing shares to < 50% or fully divesting.
- The size of the IPO would be determined by consultation with the i-bank(s) handling the IPO. The size should be large enough to determine a credible market price for Fannie's stock, but not so large that the difficulty of finding sufficient participants depresses the clearing price.
  - The primary purpose is to uncover the market value of Fannie's equity; raising money to satisfy regulatory capital requirements should initially be a secondary concern.
  - The IPO plus the government's share may or may not be big enough to fully satisfy the regulatory capital requirement. However, most estimates suggest it should come close to meeting or exceed them.
  - Additional capital could be raised over time with a combination of retained earnings and subsequent equity issues.