

## **The continuing saga of Fannie Mae and Freddie Mac**

# **10 YEARS AFTER HENRY PAULSON'S COLOSSAL BLUNDER**

**Take the money and run.**

**Trump can claim credit for making the best deal since the Louisiana Purchase . . .**

**. . . unless he lets the opportunity slip away.**

**They may have been able to fool most of the judges most of the time,  
but the government hasn't been able to fool Judge Margaret Sweeney.**

The Treasury Department's public affairs office reached **Cam Fine** at home early on Sunday morning, September 7, 2008. The caller wanted to know if the then-head of the **Independent Community Bankers Association** could be available for an important conference call at 2 p.m. Secretary of the Treasury **Henry Paulson** and **James B. Lockhart III**, head of the **Federal Housing Finance Agency** ("FHFA"), would be hosting the call. The invitation was also being extended to the heads of other major financial industry trade groups. Mr. Fine dutifully took down the dial-in number and passcode.

Shortly after the appointed hour, Paulson came on the line. He announced to the assembled participants that **Fannie Mae** and **Freddie Mac**, two of the largest publicly-traded, and, until only recently, most profitable companies in the world, had been placed into conservatorship. Government agents had occupied their offices the previous evening, securing their premises and taking possession of their property.<sup>1</sup>

"A stunned silence followed," Mr. Fine would write in the **American Banker** a decade later, "a

silence so deep that it was deafening." After all, less than two months earlier, on July 8, 2008, Lockhart had assured the markets that the two mortgage insurance behemoths were holding capital "well in excess" of what FHFA, their regulator, required. "They have large liquidity portfolios, access to the debt markets and over \$1.5 trillion in unpledged assets." Paulson confirmed the same thing when appearing that day before the **House Financial Services Committee**. (His testimony would be echoed a week later by **Ben Bernanke**, chairman of the Federal Reserve.)

Mr. Fine continued:

"As if sensing the shock of the participants, Paulson hastened to say that [the] move was necessary, but that it was only a 'time-out' and he expected the conservatorships to last only a couple of years at most." It was, Mr. Fine wrote, an "egregious" mistake. "It marked the triumph of **FM Watch** — the coalition of Wall Street megabanks that had been working to bring down Fannie and Freddie for more than a decade."

<sup>1</sup> In his memoirs, Paulson would refer to it as an "ambush". "Do they know it's coming, Hank?" President Bush asked me. "Mr. President," I said,

"we're going to move quickly and take them by surprise. The first sound they'll hear is their heads hitting the floor."

The financial markets had been skittish since early March, when Paulson and his team at Treasury had engineered a bailout of storied Wall Street investment bank **Bear Stearns**. Later that month, on March 19<sup>th</sup>, Lockhart called the notion that Fannie and/or Freddie might need bailouts “nonsense”, adding that they were “safe and sound and they will continue to be safe and sound.” So, coming when it did, Paulson’s announcement was like pouring gasoline on a smoldering fire. Especially since just two weeks earlier, on August 22<sup>nd</sup>, Lockhart’s agency had again confirmed that Fannie and Freddie were fully capitalized. Indeed, although having recorded losses due to the then-raging housing crisis, they had recently reported their highest levels of capital ever. And just *three days* before the seizure, the two companies had been able to raise \$6 billion of *unsecured* debt in an *oversubscribed* offering underwritten by a ‘who’s who’ of Wall Street firms. Hardly the stuff of companies in desperate need of a government bailout.

### The s—t hits the fan.

Mr. Fine and his fellow participants on the conference call were not the only ones taken aback by the draconian move. As Paulson later explained in his memoirs:

*“ . . . that Sunday afternoon in my office, placing calls all around the world, I couldn't help but feel a bit relieved . . . we had, I thought, just saved the country, and the world, from financial catastrophe . . . (instead), the next day, Lehman Brothers began to collapse.”* (Emphasis added.)

In retrospect, it should have come as no surprise. That Paulson expected the markets to not react after he’d just incinerated over \$80 billion of shareholder equity revealed an astonishing level of naivete. (This from a former head of **Goldman Sachs**, no less.) When markets in Asia opened a few hours later, investors were facing the reality that if the government could seize Fannie and Freddie, no one was safe. (Rumors immediately began circulating that **Citibank** would be next.) As the expression goes, the s—t had hit the fan. By the time U.S. markets reopened on Monday, many commercial and investment banks, fearful of “counterparty risk”, stopped lending and trading altogether. The contagion spread quickly: the credit markets froze and stock markets plunged.

<sup>2</sup> *Capitalism 4.0: The Birth of a New Economy in the Aftermath of Crisis*, PublicAffairs/Perseus Books Group (2010); Ch. 10 – “The Economic Consequences of Mr. Paulson”.

Plans in the works to throw a lifeline to **Lehman**, then flirting with bankruptcy, were doomed. (It would fail a week later). Worldwide, investors were running for the exits. As well-intentioned as he no doubt was, Paulson had inadvertently set loose what the distinguished British economist **Anatole Kaletsky** would later describe as a “financial doomsday machine . . .

*“ . . . whose mechanism began its inexorable grind within 24 hours . . . (raising) a Sword of Damocles over every U.S. financial institution that might conceivably need to raise any new capital in the foreseeable future . . . the almost inevitable result was a run on every major bank and financial institution, first in America and then around the world.”* (Emphasis added.)<sup>2</sup>

In his memoirs, former FDIC Chairman **William Isaac** would call Paulson’s decision a “boneheaded” move. Indeed, before the carnage ended, 15 banks which held Fannie and Freddie securities were seized by the FDIC (their shareholders were wiped out), while dozens more took major hits to their capital accounts, severely crimping their ability to provide loans to their communities (just when they were most needed). Thousands of Fannie and Freddie employees saw their 401k plans eviscerated. Nationally, unemployment topped 10 percent, millions of Americans lost their jobs, homes and businesses, and the stock market dropped by a whopping 43 percent (the Dow Jones Industrial Average would bottom at 6,443).

There had been nothing like it since the Great Depression.

### Hank, “you got some ‘splainin’ to do . . .”

*“Paulson’s decision seemed to have been a philosophical one, rather than one forced by imminent crisis. Of course, for stagecraft purposes, it was played as an impending disaster,”* wrote **Andrew Ross Sorkin** in the *New York Times* three days after the seizure.<sup>3</sup> Sure enough, the storyline put out by Paulson, Lockhart and other Administration officials was that Fannie and Freddie’s financial statements – even though they had been repeatedly certified by their independent auditors and had carried the stamp of approval of Lockhart’s own agency – were, in reality, inaccurate. Relying on a seriously flawed internal study which a White House official had earlier leaked

<sup>3</sup> *Paulson’s Itchy Finger, on the Trigger of a Bazooka*, NYTimes, Sept. 9, 2008, at C1.

[to the media](#), they claimed that assets were overstated and liabilities understated. Hence, according to the ‘analysis’, the two companies were actually undercapitalized – and only a government bailout could save them.<sup>4</sup> For the next several years, this false narrative (the expression “fake news” had not yet entered the lexicon) would be promoted by Treasury officials, along with FM Watch’s ‘amen chorus’ of Fannie/Freddie congressional opponents, big-bank lobbyists, and conservative op-ed writers. (Ironically, by then many of the megabanks which had sponsored FM Watch were themselves lining up for government assistance.) But it turns out Fannie and Freddie were never undercapitalized; that is, *not until the government got its hands on them*. It was only after Treasury seized control and gained the power to fire management that it ordered their accounting staffs to start booking massive non-cash paper losses which made the companies appear to be undercapitalized. Because of the ‘paper’ holes in their stockholder equity accounts which the ‘paper’ accounting entries had created, the companies were forced to sell Treasury a matching amount of preferred stock to bring their net worths back into positive territory. Even though both already had ample cash reserves, they were forced to accept an additional \$189.5 billion in exchange for preferred shares bearing a 10 percent annual dividend.<sup>5</sup> As additional “upside”, Treasury demanded warrants to purchase 79.9 percent of both companies’ common shares for \$0.00001 per share. Lockhart, now serving not only as Fannie and Freddie’s regulator, but also as their purported ‘conservator’, readily consented.

### **Surprise: the housing market recovers.**

During the next four years, Fannie and Freddie dutifully paid Treasury its dividend each quarter. But by summer, 2012, the national housing market had dramatically improved. Under applicable accounting rules, the previous non-cash write-downs had to be reversed. No longer burdened by what had been, effectively, ‘cookie jar’ accounting entries, Fannie and Freddie became massively profitable, so much so that they were in position to begin repaying the government and rebuilding their balance sheets.

<sup>4</sup> In various court filings, DOJ continues to advance the shopworn argument that the government had no choice but to take over Fannie and Freddie in order to avert a major financial crisis. But the facts do not support that argument. To the contrary, Dr. Kaletsky argues convincingly that it was Paulson’s ham-handed action which triggered the crisis which immediately ensued.

That, in turn, was supposed to result in their release from the conservatorships into which they had been forced (with the 20.1 percent of their shares not owned by the government being returned to their public shareholders). Apparently, however, Treasury and its pals at FM Watch hadn’t thought that far ahead. They assumed that before that happened, Congress would pass legislation to “reform” Fannie and Freddie (i.e., put them out of business). But it hadn’t. So . . . what to do?

### **Change the rules.**

*“They (aren’t going to be allowed to) repay their debt and escape”,* a top **Obama Administration** official confided in an [August 18, 2012 email](#) (which would not surface until four years later – see below). A day earlier – Fannie and Freddie having just reported the largest profits in their histories – the 10 percent dividend on Treasury’s preferred stock was changed to a ‘net worth sweep’ equal to *100 percent* of their net worths. It requires the companies to fork over, on a quarterly basis, ALL of their shareholder equity – *whatever the amount* – and to do so *in perpetuity*.<sup>6</sup> Nonetheless, no matter how much Fannie and Freddie pay (at this writing, it’s already *\$124 billion* more than the 10 percent dividend would have required), *not a penny counts towards principal reduction*. As things stand, Fannie and Freddie will continue to owe Uncle Sam \$189.5 billion *for the rest of time*. Like the restaurant owner who borrowed from the Mob, they have found themselves in an unseverable relationship.

### **The shareholders fight back.**

Beginning in 2013, angry shareholders started filing lawsuits. In the earliest stages of the litigation, the Justice Department (“DOJ”) was able to convince Judge **Margaret Sweeney** of the **U.S. Court of Federal Claims** to sign a gag order putting over 11,000 relevant documents under seal. DOJ argued that allowing their disclosure might set off another financial crisis and affect “national security”. In 2016, however, a by-then-clearly-skeptical Judge Sweeney released a batch. Their contents were shocking. As

<sup>5</sup> Banks which subsequently received government support via the TARP program would be charged half that.

<sup>6</sup> Minus a small reserve that was set to shrink to zero by 2018.

**Richard Bove**, the dean of Wall Street banking analysts, asserts in this 5-minute [CNBC interview](#), they proved the government had been lying all along. With each turn of the evidentiary page, it is clear the seizure of Fannie and Freddie 10 years ago this weekend wasn't the 'bailout' sold to the American public at the time; *it was a 'stick-up'*. A heist.

So far, most of the shareholder lawsuits have been dismissed on procedural grounds (several are still on appeal). As such, the judges hearing those cases have been able to side-step the merits of the shareholders' arguments. Significantly, no court has yet addressed the fundamental issue of the confiscation of private property, which, if proved, would be a violation of the stockholders' rights under the fifth amendment to the U.S. Constitution. The cases that directly take aim at that issue are the ones pending before Judge Sweeney. They argue that by 'sweeping' 100 percent of the GSEs' earnings and net worths to Treasury – leaving nothing for anyone else – the government has 'taken' the shareholders' property. Given what the many incriminating documents which the government unsuccessfully tried to keep secret clearly show, I believe it is an argument which will be very difficult for DOJ's spinmeisters to contest. Based on her previous rulings (as well as comments from the bench at various hearings), I would be very surprised were Judge Sweeney to block access to the courthouse. To the contrary, I believe that much as did her predecessor in the **Meritor** and other 'supervisory goodwill' lawsuits of the 1990s (Senior Judge **Loren A. Smith**), this judge 'gets it'. No matter what arguments the government might advance – and there are many – ([you can read their brief here](#)), the reality is that a dismissal in the Court of Claims would leave the shareholders without a remedy. That cannot be and is not the law. While it is premature to make predictions, I believe Judge Sweeney has little choice but to find a clear violation of the constitution's proscription:

*“. . . nor shall private property be taken for public use, without just compensation”.*

By late January, the case will be fully briefed. I expect Her Honor to rule by late spring.

### **Trump's opportunity.**

See also:

HINDESight™ Sept. 6, 2017: [“The Case of the Concrete Life Preserver”](#)

HINDESight™ Aug. 25, 2017: [Fanniegate: The Cover-up Unravels](#)

Fannie and Freddie remain two of the largest and most profitable companies on the planet. Between them they have over \$6 trillion in assets and earn about \$30 billion per year. And by the end of this year, Uncle Sam will have collected over \$100 *billion* more than he advanced. Yet 10 years after Mr. Paulson showed up with his “bazooka”, they remain wards of the state. Despite their having been continuously looted by Treasury, a group of Fannie and Freddie preferred shareholders recently put forth a [plan](#) to recapitalize the companies under which the government would keep its \$100 billion profit and the lawsuits would be withdrawn. Further, **Bill Ackman**, whose **Pershing Square Capital** is one of the largest holders of common shares, estimates that were it to monetize its 79.9 percent equity stake (as it successfully did with **AIG**), the government could pocket another \$150 billion. Were the preferred holders' plan – or something like it – to be adopted, the government stands to walk away with \$250 billion – a *quarter trillion* profit. If, as Treasury Secretary **Steven Mnuchin** has said repeatedly, the administration really is committed to getting Fannie and Freddie out of conservatorship, Trump & Co. could end up taking credit for making the best deal for America since the **Louisiana Purchase**. On the other hand, the opportunity is significantly diminished if Judge Sweeney allows the shareholders their day in court. That's because while the other lawsuits challenge only the net worth sweep (and seek only a return to the original 10 percent dividend), one of the cases before her challenges the legality of the 2008 takeover itself. A court ruling invalidating Paulson's seizure would not only negate the aforesaid \$250 billion profit, the equation would then reverse, as it opens a Pandora's Box which could end up exposing the taxpayer to the possibility of hundreds of billions in damages instead.

The clock is ticking. Spring is not that far away. As the author of *The Art of the Deal* likes to say, “we'll see what happens”.

**Gary E. Hinds**  
**September 4, 2018**  
**646-467-5242**

[gary.hinds@delawarebayllc.com](mailto:gary.hinds@delawarebayllc.com)

HINDESight™ Sept. 6, 2016: [The Myth of Private Gains and Public Losses](#)

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