

Fannie Mae and Freddie Mac

WHAT HAPPENED, WHY IT HAPPENED, AND HOW TO FIX IT.

A simple solution: the truth.

Declare victory.

Bush's final words were *"we have to make clear that (conservatorship) is transitory, because otherwise it looks like nationalization."*

-- President Bush to Treasury Secretary Paulson, Thursday, September 4, 2008, in the Oval Office.

Three weeks and two days ago, the conservatorships of **Fannie Mae** and **Freddie Mac** entered their 14th year. The two government-sponsored entities ("GSEs") are currently tied with **Britney Spears** for the title of being among the longest known conservatorships in history. But even though they have been, for the past decade, two of the most profitable companies in the world – and even though the government has been repaid over \$100 billion more than it advanced during the 2008 financial crisis – it appears Ms. Spears might soon be released from her conservatorship, ceding the dubious title to the GSEs. At this point, her plaintive query to the judge overseeing her case is especially relevant: *"I mean, Your Honor, how much longer is this supposed to go on?"*

The **Trump Administration** having dropped the ball on the one-yard line, the **Biden Administration** now must decide what to do about Fannie and Freddie. Should it continue down the recap-and-release path promoted by former FHFA director **Mark Calabria**? Can it/should it use the two companies to promote its affordable housing goals? Should it do nothing and leave the never-ending conservatorships for a fourth Administration to deal with?

Tim Howard, Fannie Mae's former vice-chairman and chief financial officer, has a rather bold yet simple solution: *"Admit that the de-facto nationalization of Fannie and Freddie in 2008 was unjustified and a mistake, then undo it".*

A bit of history.

During the final months of the **Bush Administration**, Treasury Secretary **Henry Paulson** forced Fannie and Freddie into conservatorship. With the private-label mortgage securities market having collapsed, and banks cutting back drastically on lending because of soaring mortgage delinquency rates, the housing market froze up and then saw the worst decline in home values since the **Great Depression**. The Too-Big-To-Fail banks having basically gone AWOL from the home mortgage market, Paulson was unwilling to leave Fannie and Freddie as *"the only game in town"* as the financial crisis was unfolding. He also saw in the crisis an opportunity to get control of two companies Treasury had historically opposed and replace them with a "free market" alternative. Perhaps most important, if the government could obtain control, it could use Fannie and Freddie to douse the conflagration then

raging in the mortgage markets.¹ So after seizing the companies and firing their directors and management, FHFA ordered them to book over \$320 billion in temporary or estimated non-cash expenses. These dubious accounting entries were intended to make the companies *appear* to be insolvent and forced them to draw \$187 billion in non-repayable senior preferred stock from Treasury (which carried a 10 percent after-tax annual dividend, thus creating a crushing payment burden of \$18.7 billion per year – more than the companies’ combined profits in any year in their histories). It was, indeed, the classic “concrete life preserver”, intended to keep them in conservatorship until Congress could pass legislation replacing them. (Only that never happened.)²

After convincing a judge to put 11,000 documents connected with the takeovers under seal (allowing anyone to read them, it argues to this day, would threaten ‘national security’), Treasury and its allies rewrote history to falsely blame Fannie and Freddie for the financial crisis, labeling the \$187 billion (\$151 billion in book losses plus \$36 billion in accumulated dividends paid on the draws from those losses) as a real cost of their “rescue”. In fact, the ‘paper’ losses that Paulson imposed upon the companies fully reversed themselves in just 18 months.³ Yet in the summer of 2012 – just after they returned to profitability – Treasury and FHFA changed the dividend on Treasury’s senior preferred stock from 10 percent per year to a “net worth sweep” of *100 percent* of the companies’ net income *in perpetuity*. There was never a housing-related business reason for this action. To the contrary, the new-and-improved concrete life preserver prevented Fannie and Freddie from recapitalizing and allowed

Treasury to collect \$124 billion more than it would have been owed under the original 10 percent dividend obligation. A top White House official admitted contemporaneously that the real purpose of the net worth sweep was to keep the companies from “*escaping*” conservatorship and to ensure that shareholders would never see a dime of their companies’ profits^{4, 5}.

The Howard solution: the truth.

As Mr. Howard puts it, “*the Biden administration can fix the widespread misconception that Fannie and Freddie caused the financial crisis and are terribly risky . . . by publicly reversing the misguided and ideologically motivated takeovers of Fannie and Freddie by the Bush administration. It has the facts to back this up. Fannie and Freddie were not the worst sources of mortgage finance going into the crisis; they were by far the best. Readily available data show that going into, during and after the crisis their delinquency and default rates were one-third those of banks, and one-tenth those of subprime lenders and the loans in private-label securities. Nor do the companies need reform; they have been reformed. Compared with before the crisis, they no longer are in the portfolio investment business, and no longer give price discounts to larger lenders (both long-time complaints of their critics). Moreover, because of **Dodd-Frank** and other reforms, Fannie and Freddie no longer finance the “toxic” products and risk combinations that resulted in half their credit losses during and after the crisis, and today their average charged guaranty fee is more than double what it was in 2007. With half the riskiness and double the guaranty fees, Fannie and Freddie are far more*

¹ [“They, more than anyone, were the engine we needed to get through the problem.”](#) (FCIC testimony).

² In March of 2016, a group of angry shareholders sued Fannie and Freddie’s outside auditors for having gone along with these ‘cookie jar’ accounting entries. The two firms promptly settled. See [U.S. Angered as Freddie Mac Auditor Settles Investor Suit](#) – *Fortune* October 26, 2016.

³ Reality check: Who borrows \$151 billion and is able to pay it off in 18 months? Answer: *someone who never needed it in the first place*.

⁴ <https://www.nytimes.com/2016/05/22/business/how-freddie-and-fannie-are-held-captive.html>

⁵ In a breathtaking exercise of ‘willful blindness’, Justice **Samuel Alito** and his **Supreme Court** colleagues upheld the NWS in June, ruling that for the first time in history, a ‘conservator’ need not conserve and, at least insofar as the GSEs are concerned, FHFA is allowed to engage in self-dealing and may put its own interest ahead of that of its ward. Never in the history of conservatorships has this been allowed, but thanks to SCOTUS, that is now the law of the land. This astonishing and totally unexpected decision overturned a 9-vote majority *en banc* ruling of the 5th Circuit Court of Appeals and bodes ill for future private capital investments in troubled financial institutions.

resistant to a stress environment than they were pre-crisis.”⁶

Another falsehood put out by the anti-Fannie-and-Freddie crowd (and which the government’s attorneys continue to repeat in court) is that the companies were frozen out of the capital markets and on the verge of collapse during the financial crisis; hence, there was no choice but to step in and save them. Really? How to explain that just three days prior to their seizure, they had managed to sell \$5 billion of unsecured debt (rated AA+/AAA-) through an underwriting group led by Wall Street’s top investment banks.⁷ (Actually, the deal was oversubscribed so it was increased at the last minute to \$6 billion.) Were the underwriters, rating services, and buyers all fools? Did none of these people ‘get the memo’?⁸ And what about the fact that just two weeks earlier, FHFA issued a letter confirming that both companies were in full compliance with their capital requirements? How did that happen? (Actually, there’s a story behind it – which I will leave for another day.)⁹

TINA

There is a reason Congress has not been able to replace Fannie and Freddie for going on 14 years: There Is No Alternative. The Biden administration needs to embrace this reality. It would start by admitting what everyone else knows: Fannie and Freddie have paid back the \$187 billion they were forced to draw during the crisis, with 10 percent

⁶ “Fixing Fannie Mae and Freddie Mac”, Aug. 5, 2021, circulated privately by the author.

⁷ <https://www.reuters.com/article/fanniemaebills/update-1-fannie-mae-freddie-mac-debt-funding-smooth-idUSN0351134120080903>

⁸ There can be little doubt that such a memo exists among the 11,000 documents the government is hiding. Obviously, the takeover of two of the largest publicly traded companies in the world is not done without significant advance planning. Indeed, documents have surfaced indicating the government was considering “nationalization” as early as the **Bear Stearns** crisis in March; it was hardly a ‘fog-of-war’ decision. When it took place in September, it was clear there had been a ‘plan’ which was executed with military precision. So much so that when **President Bush** asked Paulson “do they know it’s coming, Hank?”, his response

interest (double what the banks which accepted TARP money were charged).¹⁰ The administration should deem Treasury’s senior preferred stock to have been repaid in full and should cancel Treasury’s liquidation preference. That the government continues to argue that not only has it not been repaid, but that the GSEs still owe \$187 billion is utterly immoral.¹¹

Quoting Mr. Howard: “Once Treasury’s senior preferred has been deemed repaid and its liquidation preference cancelled, settling the remaining lawsuits should not be difficult. Then, a true risk-based capital standard should enable Fannie and Freddie to raise the capital necessary for their release from conservatorship fairly quickly, since the amount of new equity issued under this standard will be more reasonable, and investors will be more eager to buy it if they believe that as a matter of public policy the Biden administration (actually) wants the companies to succeed.”

Déjà vu.

During the savings-and-loan crisis of the 1990s, the government faced dozens of lawsuits for illegally seizing various banks and S&Ls. Known as the **Winstar** cases, they were presided over by **Loren Smith**, chief judge of the **U. S. Court of Federal Claims**. At one point, Judge Smith called all the parties into his courtroom and told them:

“It is the obligation of the United States to do right. Every free government can be judged by the degree to which it respects the life, liberty, and

was “Mr. President . . . the first thing they’ll hear is the sound of their heads hitting the floor”.

⁹ Someone else who apparently “didn’t get the memo” was Federal Reserve Chairman **Ben Bernanke**, for on July 16, 2008, he told Congress the GSEs were fully capitalized “they are in no danger of failing.”

¹⁰ [August 2020 CBO report](https://www.youtube.com/watch?v=ZJUB5-pBV08); see also Craig Phillips interview at <https://www.youtube.com/watch?v=ZJUB5-pBV08>.

¹¹ Since when does the government make loans which the borrower is never allowed to repay? Did they do that with **Citibank**? **Goldman Sachs**? **AIG**? Or with any of the hundreds of banks to which it gave out TARP money? **Uncle Sam** is now a Mob banker?

property of its citizens. The United States stands tall among the nations because it is a just nation. In the instant cases (however), the United States has not acted in a manner worthy of the great (and) just nation (that) it is. Because the dollars at stake appear to be so large, the government has raised legal and factual arguments that have little or no basis in law, fact or logic.

"While the court can appreciate the concerns of the government's attorneys to protect the public treasury, and they are honorable people, it must severely criticize the tactics and approach of the government . . . if the arguments put forth here are the strongest the United States can muster against liability, then the government has a moral obligation to seek a fair and equitable settlement from the parties whose contracts were breached. If this cannot be achieved, then the court is here to resolve these cases. However, the court is a tool of last resort. Where the government has violated rights, it should first attempt to do justice without judicial prompting."

The rating services.

In the meantime, where are **Fitch, Moody's** and **Standard and Poor's**? For going on 14 years, they have gone along with the charade that the GSEs haven't been nationalized, thus allowing Uncle Sam to keep their \$6-trillion-plus of debt off the government's books. But at some point, they will have to face the reality that we are in what appears to be a never-ending conservatorship. In addition to risking a credit downgrade, adding \$6-plus trillion to our national debt will, at the very least, make Congressional negotiations over extending the debt ceiling limit quite interesting.

An appeal to reason.

Our government was never intended to own private, profit-making, companies, nor should it be allowed to do so under the guise of a never-ending

conservatorship. If it can step in and take all the equity and profits of a company without any compensation to its shareholders – here, essentially, the two largest expropriations of private property in history – then, as one observer put it a few years ago, we are living “in a Stalinist state”. I do not believe that it can – nor that we are.

The total amount of publicly owned preferred stock in Fannie and Freddie is \$33 billion. The combined companies earn that much in a little over a year. The companies have been highly profitable for the past decade and the future looks quite favorable. Yet for the past 13 years, shareholders haven't seen a penny in dividends, while the value of their shares has been decimated. Meanwhile, having already booked over \$115 billion in profit (with another \$100+ billion possible from monetizing the government's warrants to buy 79.9 percent of their common equity for just under \$73,000), Fannie and Freddie have turned out to be the best deal for the taxpayer since the **Louisiana Purchase**.¹² Admitting the government has been fully repaid would immediately open the door for capital infusions from the private sector which would allow Fannie and Freddie to operate at little, if any, risk to the taxpayer.¹³

President Biden has pledged to get us out of what he (and many others) call America's “*never-ending wars*”. What about “*never-ending conservatorships*”? Isn't over \$100 billion of profit, 14 years, and three administrations enough?

It's time for the President to declare victory and finally put an end to this last bit of unfinished business from the 2008 financial crisis.

Gary E. Hindes

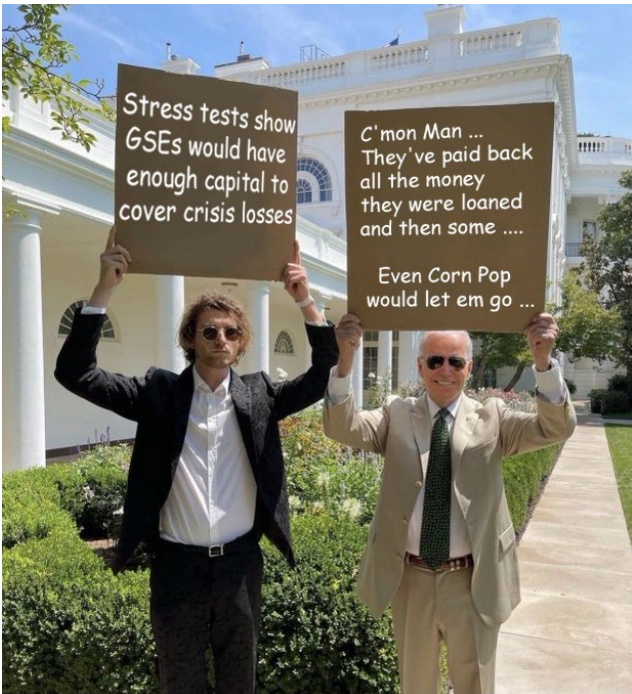
October 1, 2021

646-467-5242

gary.hindes@delawarebayllc.com

¹² It's actually been better. In the case of the Louisiana Purchase, the U.S. had to put up its gold reserves. In the case of the GSEs, we did what we now routinely do with our chronic deficit spending: we *borrowed* the money in the bond market (primarily from our Chinese and Japanese creditors). We paid them roughly three percent, then turned around and loaned it to Fannie and Freddie at 10 percent. Brilliant!

¹³ According to [stress tests](#) released by FHFA in August, even under its “*Severely Adverse*” economic scenario (i.e., a four percent drop in GDP; 24 percent drop in home prices; 35 percent drop in commercial real estate prices, and an unemployment rate approaching seven percent), both Fannie and Freddie would remain profitable throughout and would not require any government assistance whatsoever. Which begs the question: *why are they still in conservatorship?*



Photographer/photoshopper unknown.

Please note that this report was originally prepared and issued by The Delaware Bay Company, LLC for distribution to its limited partners. Other recipients should seek the advice of their independent financial advisors prior to making any investment decision based upon this report or for any necessary explanation of its contents. The information contained herein is based on sources which we believe to be reliable, but is not necessarily complete and its accuracy cannot be guaranteed. Because the objectives of investors may vary, this report is not to be construed as an offer or the solicitation of an offer to sell or buy the securities herein mentioned. This report is the independent work of The Delaware Bay Company, LLC and is not to be construed as having been issued by, or in any way endorsed or guaranteed by, any other parties, including the issuing companies of the securities mentioned herein. The firm and/or its employees and/or its individual shareholders and/or members of their families and/or its managed funds may have positions in the securities mentioned and, before or after your receipt of this report, may make or recommend purchases and/or sales for their own accounts or for the accounts of other persons from time to time in the open market or otherwise. While we endeavor to update the information contained herein on a reasonable basis, there may be regulatory, compliance or other reasons that prevent us from doing so. The opinions or information expressed herein are believed to be accurate as of the date of this report; no subsequent publication or distribution of this report shall mean or imply that any such opinions or information remains current at any time after the date of this report. All opinions are subject to change without notice and we do not undertake to advise you of such changes. Reproduction or redistribution of this report without the expressed written consent of The Delaware Bay Company, LLC is prohibited.