

PHYSICIAN, HEAL THYSELF

There he goes again.

It seems that hardly a week goes by without our President admonishing someone about the need to abide by the "rule of law".¹ Yesterday it was Mr. Trump . . . (let's not go there). Last week it was President Erdogan of Turkey; the latter's purge of those who might have been involved in the recent unsuccessful coup attempt there must be "consistent with the rule of law", the President lectured. As a simple Google search will confirm, he frequently hectors people on the subject and there is no doubt that he and his speechwriters have long been enamored with the phrase; indeed, as this excerpt from remarks made by President Obama on June 4, 2009 illustrates, *adherence to the rule of law* has been a consistent theme throughout his Presidency (the highlights are mine):

“. . . but I do have an unyielding belief that all people yearn for certain things: the ability to speak your mind and have a say in how you are governed, confidence in the rule of law and the equal administration of justice, government that is transparent and doesn't steal from the people, the freedom to live as you choose. These are not just

American ideas. They are human rights. And that is why we will support them everywhere."

How to square those high-minded ideals with what the President and his colleagues have been doing with Fannie Mae and Freddie Mac?

The back story:

The 2008 'bailout' of **Fannie Mae** and **Freddie Mac** (hereinafter the "twins" or "GSEs") was the most profitable deal for the American taxpayer since the Louisiana Purchase. No kidding.

Claiming they were on the verge of failure, the GSEs were forced into conservatorship by the Bush Administration on September 8, 2008.² Although the two had combined equity capital at the time of \$84 billion (\$23 billion above their required minimums)³, the first thing the **Bush Treasury Department** did, once it had control of the companies, was force them to book a number of non-cash charges, using smoke-and-mirrors accounting to render them book insolvent; i.e., on paper, their liabilities

¹ From Wikipedia: "The *rule of law* is the legal principle that law should govern a nation, as opposed to being governed by arbitrary decisions of individual government officials. It primarily refers to the influence and authority of law within society, particularly as a constraint upon behavior, including behavior of government officials. The phrase can be traced back to 16th century Britain, and in the following century the Scottish theologian Samuel Rutherford used the phrase in his argument against the divine right of kings. The concept, if not the phrase, was familiar to ancient philosophers such as Aristotle, who wrote "*Law should govern*.""

² There are serious questions as to whether or not a bailout of either Fannie or Freddie was ever even necessary. Formerly secret government documents – held under seal since 2008 at the insistence of the Bush and Obama administrations (and only recently released under court order) – cast serious doubts on the government's assertion that a 'rescue' was required. http://gselinks.com/Court_Filings/Jacobs_Hindes/15-00708-0026.pdf.

³ See, http://www.gselinks.com/Court_Filings/Washington_Federal/13-385-0001.pdf at paragraph 62.

exceeded their assets.⁴ As a result, they were forced to accept \$187 billion from Treasury to make up the ‘paper’ shortfall – even though, as later forensic accounting studies would confirm, they had plenty of cash and highly liquid assets on hand with which to pay their bills on time for many years to come and didn’t need a dime.⁵ The terms, dictated by Treasury, were that the government would be issued \$187 billion of preferred stock carrying a ten percent dividend.⁶ In addition, Treasury was to receive what is called in the trade a “sweetener”; i.e., warrants to purchase 79.9 percent of the GSEs’ common stocks for the nominal price of about \$10,000 (yes, the number of zeroes is correct), the thought being that if the world didn’t come to an end and Fannie and Freddie survived the crisis, the taxpayer should be able to participate in the upside over and above its ten percent dividend.⁷

Treasury loots the GSEs.

While that may have sounded fair enough to most (reasonable) people, it apparently wasn’t as far as the by-now **Obama Treasury** was concerned. For in the summer of 2012, four years after the crisis had ended and the housing market had recovered, the twins began making money again. Lots of it. And those paper assets which the **Bush Treasury** had ordered them to write off

four years earlier? Well, they now had value again and under the accounting rules, those values had to be put back on the books. That posed both a problem – and an opportunity – for the administration. It was a problem because once those paper assets were written back up, the GSEs’ net worths would skyrocket and they would be able to – as an alarmed White House official bluntly conceded in an email which was never supposed to see the light of day – “*repay their debt and escape . . .*”,⁸ (meaning that, as one Fannie Mae shareholder wryly put it later, “*the concrete life preserver*” hadn’t worked).

As for the opportunity, it was a ‘two-fer’. First, recall that during the summer of 2012, there was a huge fight going on in Congress about extending the debt ceiling limit, with the Republicans threatening an imminent government shutdown. A ‘windfall’ dividend to the Treasury from the GSEs was just what was needed to extend the debt-ceiling runway and put off the day of reckoning. Second, if the terms of the original bailout were changed via a new-and-improved ‘concrete life preserver’, Treasury and the Big Banks would be able to accomplish their long-held and mutual goal of eliminating Fannie and Freddie and carving up their \$5 trillion dollar businesses.⁹ In a series of contemporaneous emails that the Obama administration refused to

⁴ Former FDIC chairman L. William Seidman described a similar situation which his agency faced during the savings-and-loan crisis of the 1980s; the General Accounting Office (“GAO”) demanded that the FDIC take a large charge for estimated *future* bank failures which would have rendered the agency insolvent (on paper). “*The GAO’s ‘magic accounting’ was merely playing with the numbers. Any accountant can break any company with paper entries merely by debiting net worth and crediting a loss for a future disaster . . . (but) when the money is on hand, one need not borrow, no matter what the accountants may predict*” (emphasis added). Full Faith and Credit, L. William Seidman © 1993 Random House (at page 140).

⁵ See <http://www.housingwire.com/ext/resources/images/A-Forensic-Look-at-the-Fannie-Mae-Bailout-Parts-I-II-III-FINAL-20150616.pdf> and <http://www.housingwire.com/ext/resources/files/Editorial/Trey-Files/Special-Report-8515.pdf>.

⁶ Twice what the government was at the same time charging **AIG** and the various banks bailed out via the **Troubled Asset Relief Program** (“TARP”).

⁷ There is a reason the government did not want to own more than 79.9 percent of the GSEs’ common stock. At 80 percent, accounting rules mandated that it consolidate the trillions of debt owed by Fannie and Freddie onto the U.S. government’s own balance sheet, thus vastly exceeding the national debt ceiling limit and threatening the nation’s AAA bond rating.

⁸ *Fannie, Freddie and the Secrets of a Bailout with No Exit*, New York Times May 22, 2016 <http://www.nytimes.com/2016/05/22/business/how-freddie-and-fannie-are-held-captive.html>.

⁹ *A Revolving Door Helps Big Banks’ Quiet Campaign to Muscle Out Fannie and Freddie*, New York Times December 7, 2015 <http://www.nytimes.com/2015/12/07/business/a-revolving-door-helps-big-banks-quiet-campaign-to-muscle-out-fannie-and-freddie.html?action=click&contentCollection=Business%20Day&module=RelatedCoverage®ion=EndOfArticle&pgtype=article>.

produce until recently ordered to by a federal judge, White House and Treasury officials made no secret of what was to happen next:¹⁰

“ . . . we’re not reducing their dividend, but including in it every dime these guys make going forward and ensuring that they can’t recapitalize . . .

“ . . . we’ve closed off the possibility (that Fannie and Freddie will ever be returned to their shareholders) and sped up the clock on the wind-down of their portfolios . . .

“ . . . so no chance that GSEs recap themselves through higher earnings . . .

“ . . . should lay to rest permanently the idea that the outstanding privately-owned (preferred stock) will ever (have its dividend) turned back on.”

And so late on an August afternoon four years after the financial crisis had ended (and just after the GSEs started to show black ink again), President Obama’s Treasury Department – without any advance notice or opportunity for public comment – retroactively changed the terms of the original ‘bailout’ deal. The old 10 percent dividend was eliminated. Instead, each company was now required to pay *100 percent of its net worth* to Treasury, quarterly, *for the rest of time*. Worse, no matter how much money the government ends up collecting under this new arrangement, not a penny will ever reduce the debt which was forced upon them. To the contrary, Fannie and Freddie will permanently be in hock to the tune of \$187 billion (hence the term ‘concrete life preserver’). “Like a restaurant owner who borrows money from a mobster, Fannie Mae and Freddie Mac have found

themselves in an un-severable relationship.”¹¹ Or as another analyst put it:

“ . . . the entire Net Worth Sweep was an elaborate device to strip the private shareholders of all their wealth in Fannie and Freddie by devices so crude that if (they had been adopted) by private parties, all of them would have gone to jail.”¹²

The ATM.

And what a cash cow the GSEs have turned into! Already they have paid over \$130 billion more than they would have had to pay had Treasury not changed the terms of the original ‘bailout’ (actually, ‘stick-up’ is a more accurate description), money that could have been used to recapitalize the entities and return them to their rightful owners. And it is estimated that Fannie and Freddie will continue to fork over \$15 to \$20 billion per year in profits to Uncle Sam *in perpetuity*. In the meantime, however, the firemen, policemen, teachers, doctors, high school principals, clergy, accountants, retirees and yes – hedge funds – who own Fannie and Freddie shares have effectively been wiped out by the government’s perfidious ‘nationalization-without-compensation’ scheme, their property rights confiscated (including, see below, even the right to complain) – in direct conflict with the President’s very own words, spoken on June 4, 2009, about “*respect for the rule of law*” and ‘*not stealing from the people*’.¹³

What are they hiding?

As if that weren’t bad enough, the administration has taken the position that there is

¹⁰ Copies of these emails can be found at <http://www.glenbradford.com/wp-content/uploads/2016/06/01512287199.pdf> at pages 94, 95 and 98.

¹¹ *Why is the Obama Administration Trying to Keep 11,000 Documents Sealed?* Matt Taibbi, *Rolling Stone*, April 18, 2016.

¹² *Untangling the GSE Foolishness*, Richard Epstein, *Forbes Magazine*, June 15, 2016.

¹³ Certain anti-GSE members of Congress are in the habit of characterizing Fannie and Freddie shareholders as being just a bunch of greedy hedge funds “trying to make money at the taxpayer’s expense”. Really? <https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=0ahUKEwizy4-MzJTOAhUMeT4KHvIBvIQFggeMAA&url=https%3A%2F%2Ftimhoward717.files.wordpress.com%2F2014%2F10%2Fletter-from-concerned-parent-and-patriot-re-third-amendment-sweep-3.docx&usq=AFOjCNE02Rw52wFL58KBAAdCvVT76u6P6PA&cad=rja>

absolutely nothing that anyone can do about the situation – *not even judges or the courts*. Oh, and as for transparency? Over 11,000 documents which might shed some light on the government’s actions are being held under seal, for the Obama Administration claims that allowing the public to view them might adversely affect national security and/or perhaps cause another financial crisis. (Richard Nixon would be envious of their chutzpah.)

Meanwhile, virtually all of the banks that received bailout and TARP funds have long since been allowed to pay back whatever they borrowed and move on, while “the taxpayer” (despite the hand-wringing of economic purists who deplored such bailouts at the time) ended up making a fortune. But eight years after the crisis ended, Fannie and Freddie – two of the most profitable companies in the history of the world – remain hostages. As for President Obama, this man who bravely took down Osama bin Laden just doesn’t seem to have the courage to do the right thing in this instance. We’re not dealing with an idiot – or an ideologue – here. After all, he was editor of the *Harvard Law Review* and taught constitutional law at the University of Chicago for many years. No slouch he, but clearly the President and his advisors (are you listening, VJ?) must know that he is in the wrong here – not only legally, but

more importantly (to those of us who have followed his career since he was a ‘community organizer’ working the projects), *morally* and *ethically*. But instead of “manning up”, he’s apparently decided to leave it to the judicial branch to clean up his mess. But when the chickens come home to roost – *and they will* – and when a court judgment in the shareholders’ favor ends up blowing a massive hole in the next administration’s fiscal budget – *which it will* – his legacy will be severely tarnished. As Congressman Michael Capuano (D-NY) put it at a housing industry conference on July 26th:

"Right now Fannie and Freddie are basically being used as a piggy bank for the United States Treasury, and I believe at some point it will lose the lawsuit that's been brought by investors . . . and (the government) will owe somebody an awful lot of money, because there's no justification for us taking it . . ."

So to the President’s speechwriters, I say lay off the “*rule of law*” stuff for the rest of his term. (Either that or get him to practice what he preaches.)

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