

Fannie Mae and Freddie Mac:

THE MYTH OF "PRIVATE GAINS AND PUBLIC LOSSES"

(Turns out the opposite is true.)

If you repeat a lie often enough, lots of people will end up believing it. As **Joseph Goebbels**, the German Government's Minister of Propaganda and Public Enlightenment advised during the Nazi era, "*when one lies, one should lie big, and stick to it.*" And thanks to the internet, the number of times a lie can be repeated and spread around the world has increased exponentially, making it even more believable to the masses. As an example, consider **Fannie Mae** and **Freddie Mac** (hereinafter, the "GSEs" or "the twins"). Even though it has been disproven, many people have been snookered into believing that they caused the 2008 financial crisis. Pure bunk.¹ (Or as **Joe Biden** would put it, "*malarkey*".)

There has also been a constant drumbeat out of Washington that the two mortgage insurers had been operating under a "*broken business model*" of "*private gains and public losses.*" Unfortunately, with few exceptions, this

shibboleth has also been accepted pretty much without question by numerous journalists (think the *Wall Street Journal* editorial page), as well as politicians, most notably, U.S. Sens. **Bob Corker** (R-TN); **Mark Warner** (D-VA); U.S. Rep. **Ed Royce** (R-CA), and, sadly, even **President Obama** himself.

Except it isn't true.

As I explained last month², the so-called "bailout" of Fannie Mae and Freddie Mac during the financial crisis of 2008 was anything but: it was actually a "stick-up". Using the then-raging financial crisis as cover,³ Treasury Secretary **Henry Paulson** put into effect a carefully-crafted and highly-confidential plan to nationalize the two companies without compensating their owners. Contrary to widespread belief, it was hardly a "fog-of-war" decision; it was meticulously pre-planned. And there can be no

¹ "We conclude that these two entities contributed to the crisis, but were not a primary cause. Importantly, GSE securities essentially maintained their value throughout the crisis and did not contribute to the significant financial firm losses that were central to the financial crisis." Report of the Financial Crisis Inquiry Commission (at page xxvi). See https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cad=rja&uact=8&ved=0ahUKEwib-IL3g7rOAhXmIcAKHW0EAX4QFgggMAA&url=https%3A%2F%2Fci-c-static.law.stanford.edu%2Fcdn_media%2Ffcic-

reports%2Ffcic_final_report_conclusions.pdf&usg=AFQjCNELzKqgbHant83M5fXhV7IRCYQ1Zw

² (HINDESight, August 4, 2016

http://delawarebayllc.com/images/Physician_Heal_Thyself.pdf

³ As then-U.S. Rep. **Rahm Emanuel** put it at the time, "*you never let a serious crisis go to waste. And what I mean by that (is) it's an opportunity to do things you think you could not do before.*"

doubt that President **George W. Bush** was himself in on the scheme.⁴

70 years of profitability no longer counts.

Prior to just a year before they were seized by the government, Fannie and Freddie were consistently profitable. However, with 2007 came the most serious nationwide decline in home prices since the Great Depression. Fannie posted its first full-year loss in 22 years while Freddie booked its first since becoming a public company. Nonetheless, both were well-positioned to weather the storm, generating more than enough free cashflow to easily pay their debts. They also had billions of highly liquid assets which could be used to cover any future losses. In fact, if the twins actually were in trouble and needed assistance, they could have been given fully-collateralized loans at *absolutely no risk to the taxpayer*. Indeed, just weeks before muscling out their boards of directors and replacing their managements with government appointees, both Paulson and Office of Federal Housing Finance Agency director **James Lockhart** (the GSEs' regulator) assured the markets that Fannie and Freddie were financially healthy. For example, on July 8, 2008, Lockhart told CNBC that:

“both of these companies are ‘adequately capitalized’, which is our highest (rating) criteria.” (Emphasis added.)

And on July 10, Paulson testified before a congressional committee that: “(their) *regulator has made clear that they are adequately capitalized*”.

Three days later, on July 13, Lockhart issued another statement, emphasizing that:

“the enterprises’ \$95 billion in total capital (i.e., the highest capital levels in their history), their substantial cash and liquidity portfolios and their experienced management serve as strong support for (their) continued operations.”

In short, until the government seized control just *56 days* later, all losses at Fannie and Freddie (such as they were) were borne by their private shareholders, not – as the *Wall Street Journal* and the heretofore described/named persons would have you believe – by the American taxpayer.

There were no public losses.

As I described earlier⁵ – and as is more fully detailed at <http://www.housingwire.com/blogs/1-rewired/post/34280-the-three-card-monty-accounting-of-fannie-freddie-conservatorship> (a must-read), the ‘losses’ which the Treasury Department – once it had obtained control – ordered the GSEs to book were all non-cash accounting entries. In so doing, the government artificially created negative equity of \$189.4 billion which had to be replaced by a new class of super-senior Preferred Stock issued to (*voila!*) Treasury. However, four years later, when the housing market had turned around and the ‘cookie jar’ accounting entries had to be reversed, the resulting earnings went back not to Fannie and Freddie so that they could use them to recapitalize their balance sheets, but, instead, to the government in the form of a massive ‘dividend’. Which begs the question: who borrows \$189.4 *billion* and is then in a position to pay it back in full within four years? Answer:

⁴ “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.’” Henry M. Paulson Jr: *On the Brink* © 2010 Hachette Book Group, excerpted at <http://abcnews.go.com/GMA/Books/book-excerpt-brink-henry-paulson-jr/story?id=9713451>. To his credit, the President may not have known the

full extent of what Paulson and the Treasury Department had in mind, for he also reports that Bush’s final words were “we have to make clear that what we are doing now is *transitory*, because otherwise it looks like *nationalization*.” (Emphasis added.)

⁵ HINDESight, *ibid*.

someone who never needed the money in the first place.

So . . . let's do the math: the GSEs were forced to accept \$189 billion from Uncle Sam. When the on-paper-only accounting losses were reversed, the GSEs repaid the government \$245 billion. But they still owe \$189 billion? How does that work? Like a restaurant owner who borrows money from a mobster, the GSEs have found themselves in an un-severable relationship. The government has so far been paid more than \$55 billion than it 'invested'. Moreover, it estimates that it will collect additional 'dividends' of \$10 to \$15 billion every year – *in perpetuity*. Where are the "public losses"? They don't exist – and never did. Instead, the reverse is true. The private shareholders of Fannie and Freddie have been effectively wiped out, while the government has reaped a windfall.

In courtrooms all over the country, the Obama Administration is arguing that no one – not even the courts – has the right to challenge what it has done. Really? At the end of the day, I believe the shareholders will win, for there's nothing new here. Recently, I came across this Opinion in which the U.S. Supreme Court addressed the very same issue many years ago. There, as here, the government took the position that the courts had no right to interfere when it confiscated the land which is now **Arlington National Cemetery** without compensating the landowner. Writing for the court, Associate Justice **Samuel Freeman Miller** (1816-1890) emphatically disagreed:

The (government's defense) stands here solely upon (its) absolute immunity from judicial inquiry...

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however clear it may be made that the executive possessed no such power. Not only no such power is given, but it is absolutely prohibited, both to the executive and the legislative, to deprive any one of life, liberty, or property without due process of law, or to take private property without just compensation ... no man in this country is so high that he is above the law. No officer of the law may set that law at defiance with impunity. All the officers of the government, from the highest to the lowest, are creatures of the law, and are bound to obey it. It is the only supreme power in our system of government, and every man who by accepting office participates in its functions is only the more strongly bound to submit to that supremacy, and to observe the limitations which it imposes upon the exercise of the authority which it gives. Courts of justice are established, not only to decide upon the controverted rights of the citizens as against each other, but also upon rights in controversy between them and the government ... and shall it be said ... that the courts cannot give a remedy when the citizen has been deprived of his property by force, his estate seized and converted to the use of the government without lawful authority, without process of law, and without compensation ... because the President has ordered it and his officers are in possession? If such be the law of this country, it sanctions a tyranny which has no existence in the monarchies of Europe, nor in any other government which has a just claim to well-regulated liberty and the protection of personal rights". (Emphasis added.)

President Obama is a former editor of the Harvard Law Review and taught constitutional law at the **University of Chicago** for many years. United States v. Lee (106 U.S. 196, 1882) has been on the books for 134 years now. You'd think he'd be familiar with it.

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