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DISCOURAGING PRIVATE CAPITAL BY CHANGING THE RULES AT THE FINISH LINE: FANNIE MAE AND FREDDIE MAC

Getting the banks to pony up $33 billion
and then pulling the rug out from under them.

"Screw the hedge funds (*but let's sell them our stock first!*)"

The easy way out: *"Let the courts handle it".*
(Tell that to the S&L owners who had to wait 20 years the last time Congress punted).

'Fool me once . . . '

The Obama administration and the leadership of the Senate Banking Committee seem to be hell-bent on wiping out the private sector shareholders of Fannie Mae and Freddie Mac (collectively, the 'GSEs'). Indeed, the administration's utterly lawless action of changing the terms of the original GSE Conservatorships – which would actually be codified under legislation proposed by Chairman Tim Johnson (D-SD) and Ranking Member Michael Crapo (R-ID) – is an unprecedented violation of private property rights. It may sound hyperbolic to compare the U.S. to 'rogue' nations, but if North Korea, Venezuela, Cuba or Russia confiscated all the profits of a private company without compensating its owners we would be (and have actually been) at the U.N. howling about the 'rule of law'. The situation here really is no different.

At the same time during the 2008 financial panic that it was injecting $700 billion of TARP money into the banks and bailing out General Motors; Chrysler; AIG; Citibank, and the money market funds, the government seized Fannie and Freddie, placing them into a 'Conservatorship'. As plain English would allow, the purpose of a 'conservatorship' is to 'conserve' a company's assets and restore it to financial health so that its creditors can be repaid in full and the business can go on; if there is anything left after that, it goes to the owners.

The 2008 deal.

In exchange for $187 billion that it advanced to the Conservatorship, the government was issued 'super senior' preferred stock in both GSEs which paid a 10 percent cash dividend (a very high rate of return both then and now). It also received a 'sweetener' in the form of warrants to purchase 79.9 percent of the *common* stock of both Fannie and Freddie for exactly one cent. It was obviously a <u>great</u> deal for the government and still is: In addition to getting all of its money back (with interest), the dividends on its 'super

senior' preferred stock going forward will amount to an additional $190 billion over the next 10 years. Further, analysts project that the government's effective ownership of 79.9 percent of the GSEs' *common* shares will be worth yet another $140 billion during that same time frame (and even more beyond that).

The 2012 amendment.

But apparently the administration decided that wasn't enough. (And Senators Johnson and Crapo seem to agree). In the early summer of 2012, two things were becoming apparent. First, real estate prices had finally stopped going down, allowing Fannie and Freddie to return to profitability and begin repaying their loans. Second, there were serious threats in Congress to shut down the government when it hit the looming debt ceiling limit. As a result, the Treasury Department was frantically looking for ways to manage the government's cash flow so as to not run out of money and no longer be able to pay the government's bills. So in August of 2012, Treasury unilaterally changed the rules: instead of paying the government the 10 percent dividend which had previously been agreed upon, Fannie and Freddie were required to fork over *100 percent of their profits* – none of which could be used to reduce the $187 billion loan balance. In actuality, the August 2012 'net worth sweep' was nothing but a government sleight-of-hand which instead of 'conserving' Fannie and Freddie assets, *confiscates* them instead. As none of the profits paid to the government can ever be used to pay off the government's loan, the GSEs will be permanently in hock to the tune of $187 billion. So much for 'conserving' their assets.

Banks to the rescue.

The government's duplicity and self-dealing gets even worse. Until the 2008 financial panic came along, Uncle Sam had never put a penny into the GSEs; they were 100 percent owned and entirely funded by the private sector. Indeed, at the government's urging during the run-up to the crisis, private investors poured another *$33 billion* into Fannie and Freddie in order to shore up their finances, most of which came from community banks whose regulators actively encouraged them to purchase preferred shares in the two institutions. But when both were seized and placed into Conservatorship, the value plummeted, forcing the banks to take write-downs of up to 90 percent. Coupled with the nationwide collapse in real estate values, those write-downs threatened the very solvency of many banks and not a few actually ended up being seized by the FDIC.

The hedge funds step up.

Having been appointed Receiver of the seized banks, the FDIC suddenly found itself the proud owner of tens of millions of Fannie and Freddie shares. So in the spring of 2011, it aggregated its holdings and sold 31 million preferred shares on the open market in a series of block trades. The buyers? A consortium of hedge funds lined up by the FDIC. Just as 'speculators' had provided liquidity to ex-soldiers who (unwisely) wanted to dump their Continental 'greenbacks' after the Revolutionary War (remember that story from your eighth grade U.S. History class?), the hedge funds provided the FDIC with 'liquidity'; i.e., *cash* which the FDIC used to reduce its losses on the banks whose deposits it had insured. It is clearly unfair for the government to now come along and say that those same hedge funds not only should not be allowed to make a profit on their investment, but that the value of the shares *it sold them* should be rendered worthless. The hypocrisy is indeed breathtaking.

Relying on the courts not the answer.

A few members of Congress have suggested to me that they don't feel it necessary to address the concerns of the private sector at this time because *'the courts can always sort it out'*. For starters, this is particularly disingenuous as Treasury has included language in Johnson/Crapo which would foreclose such lawsuits. In addition, a few of us who have had a bite out of that apple remember what happened the last time Congress decided to 'punt' to the courts. Back in the late 80's and early 90's, there were 120 savings and loan institutions which were well

capitalized – until Congress tightened capital requirements by passing the Financial Institutions Reform, Recovery and Improvement Act of 1989 (a.k.a. 'FIRREA'). At the time, Rep. Henry Hyde (R-IL) offered an amendment to 'grandfather' healthy S&Ls which had earlier been issued 'supervisory goodwill' by their regulators as consideration for taking over sick S&Ls; they had done so at the urging of the FDIC and FSLIC – both of which would have been insolvent had they been forced to honor their deposit guarantees. The amendment failed after the (first) Bush administration convinced Congress that the aggrieved shareholders could always sue. So what happened? Eventually the Supreme Court did rule that FIRREA was, in fact, a breach of the thrifts' contracts. But in the meantime, a huge chunk of the industry immediately lost a significant portion of its regulatory capital and dozens of otherwise healthy S&Ls were seized and put out of business by the very same regulators who had encouraged them to enter into the transactions in the first place. (Sound familiar?) The survivors ended up collecting but a fraction of what they were owed (with no interest) – but even then only after litigating for as long as 20 years. Congress could and should have helped them when FIRREA was originally passed instead of (as some would prefer to do now) taking the easy way out.

Paid in full.

Freddie has already paid back the taxpayer in full, with interest and it is estimated that Fannie will make its final payment in the fourth quarter of this year. Uncle Sam has also received the proverbial 'pound of flesh' in the form of the 79.9 percent of their ownership equity which the private sector shareholders were required to give up. On that basis alone, the government stands to earn yet another $340 billion from the GSEs over the next 10 years. *Isn't that enough?* Why are Fannie and Freddie shareholders to be wiped out entirely when those of all the other bailout beneficiaries were left intact? And finally, after what Congress did to the S&Ls and now this threatened obliteration of private property rights, how can anyone expect the private sector to invest in any new housing entity when there is absolutely no assurance that a later Congress will not pull the rug out from under them again? The old adage *'fool me once, your fault; fool me twice, my fault'* comes into play here and if private sector investors participate at all, they will at the very least demand a significantly higher price than otherwise in order to compensate for the risk.

If we want to debate whether or not to promote home ownership and what the federal government's role should or should not be, fine, let's have at it. But there cannot be housing 'reform' that does not respect the rule of law or fairly compensate the private sector shareholders of Fannie and Freddie. They should not be forced into the courts for relief; the administration and Congress can and should do the right thing – now.

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