The Takeover and the Terms

FEBRUARY 23, 2016 ~ JTIMOTHYHOWARD ~ 57 COMMENTS

Late last week Fannie and Freddie announced their full year 2015 net incomes, with Fannie reporting $11.0 billion and Freddie posting $6.4 billion. And on February 9, lawyers for Washington Federal *et al* filed a motion in the Federal Court of Claims—asking for a status conference to discuss contracting the timetable for the related cases pending there—which served as a reminder that this suit seeking to overturn the 2008 conservatorships, stayed during discovery in the net worth sweep actions, still is very much alive. There is a link between these events.

The companies' 2015 results heralded the third stage of their conservatorships. In the first stage, which lasted through 2011, mammoth non-cash accounting losses put on the companies' books by FHFA forced them to draw $187 billion in senior preferred stock, which, at a dividend rate of 10 percent, required them to pay $18.7 billion per year to Treasury. During the second stage—2012 through 2014—the companies earned $183 billion when a large portion of the earlier losses reversed themselves, but because of the August 2012 net worth sweep all of those earnings went to Treasury, not the companies' shareholders. Now, in this third stage, the non-cash entries that dominated the first two stages have waned, and Fannie and Freddie's annual net incomes are down to levels more reflective of the fundamental earning power of their businesses. Significantly, however, their combined 2015 earnings of $17.4 billion fell short of the $18.7 billion in annual senior preferred stock dividends the companies were required to pay before the net worth sweep, and their earnings in future years likely will fall short of that amount by even more.

For those who believe that some reconfigured version of Fannie and Freddie is the best alternative for the mortgage finance system going forward, the fact that their earnings have returned to levels insufficient to cover their pre-sweep dividend obligations highlights the importance of prevailing not just in the net worth sweep cases but also in the Washington Federal lawsuit. That suit challenges both key actions of the conservatorships: the takeover ("the Government's decision…to appoint the FHFA as conservator for Fannie Mae and Freddie Mac)" and the terms ("the action by the Government…to enter into senior preferred stock agreements… with Fannie Mae and Freddie Mac"). It is well argued, and only will get stronger as it is amended for facts unearthed or brought to light through discovery in the net worth sweep cases, and as more facts emerge.

Conventional wisdom is that it will be difficult to successfully challenge Treasury's decision to take the companies over, because of the deference courts give to regulatory actions during times of crisis. But this instance should be an exception. As we have detailed elsewhere, Treasury's decision to take Fannie and Freddie over was not a rescue, made amidst the "fog of war;" it was a well-planned and meticulously executed strategy to expropriate the assets of two shareholder-owned companies for policy purposes, including ensuring that banks and other lenders had reliable outlets for their mortgages, and buying time for Treasury to do true rescues (or "bailouts") on an advantaged basis for the troubled institutions that it favored.

Evidence of such policy calls abounds. One sequence that has not been adequately highlighted involves inconsistent actions regarding Fannie and Freddie's capital and preferred stock. Paulson notes in his book, *On the Brink*, that he wanted some "good news" to give to the market prior to announcing Bear Stearns' acquisition by JP Morgan in March 2008, so he overrode the objections of OFHEO Director Lockhart and reduced Fannie's and Freddie's surplus capital percentages (giving them more lending capacity) in exchange for non-binding promises by the companies to add capital. Fannie did raise $7.4 billion in two separate issues of preferred stock in May. Then, four months later, in anticipation of coming bad news from Lehman Brothers, Paulson took Fannie and Freddie over, citing their lack of capital—which exceeded regulatory standards and hadn't been a concern for Paulson when he'd intervened to reduce their surplus capital percentages in March. Among those wiped out by this second action were purchasers of the preferred stock Fannie issued in May, at Paulson's urging.

At the time Fannie and Freddie were taken over, the serious delinquency rate on their residential mortgages was about one-third that of prime mortgage lenders, and less than one-tenth that of subprime lenders. Treasury took the companies over not because they were weak, but because they were strong. Paulson said it best himself, when he told the Financial Crisis Inquiry Commission, "[Fannie and Freddie], more than anyone, were the engine we needed to get through the problem." Treasury needed Fannie and Freddie to help keep the financial system afloat, and it simply took them, under pretense of a rescue. That should be evident to judge Sweeney.

Yet even if the takeover is not successfully challenged (and I believe it will be), its terms most certainly are vulnerable. Treasury imposed the highly punitive terms of the preferred stock purchase agreements on Fannie and Freddie only after they had been pressured into agreeing to conservatorship. In conjunction with FHFA, an agency it controlled, Treasury in these agreements gave itself warrants to purchase 79.9 percent of the companies' common stock at a nominal price. It also invented a financial instrument unique to Fannie and Freddie—senior preferred stock that was not repayable without Treasury's explicit permission—which enabled it to capture huge amounts of the companies' future earnings by having FHFA run up their non-cash accounting losses and force them to pay an annual dividend of 10 percent after-tax in perpetuity to Treasury on senior preferred stock they did not need.

Treasury's justification both for giving itself the warrants and for requiring Fannie and Freddie to pay it $18.7 billion per year prior to the net worth sweep is that it took "enormous risk" in "rescuing" the companies, and it points to their $187 billion in senior preferred stock as the embodiment of that risk. But that explanation does not withstand factual scrutiny.

The $187 billion in senior preferred stock Fannie and Freddie had outstanding at the end of 2011 was the consequence of $151 billion in non-cash losses put on their books by FHFA during the first stage of the conservatorships, and the $36 billion in dividends they had to pay on that stock. The irrefutable proof of the artificiality of those $151 billion in non-cash losses is the speed with which they were recouped. From the time of Fannie's creation in 1938 and Freddie's in 1970, their cumulative combined earnings through June 2008 totaled less than $100 billion. Yet in just 18 months, from the fourth quarter of 2012 through the first quarter of 2014, the two companies somehow came up with enough income to pay $158 billion to Treasury. How could Freddie and Fannie possibly have earned in 18 months half again as much as they'd earned in all of their respective 38 and 70 years of existence? The question answers itself. Real economic losses must be repaid with real economic income; artificial losses can be repaid by reversing the losses. Neither the large majority of the losses booked by FHFA in 2008-2011 nor the subsequent recoveries of those losses were real.

Because of Treasury's blatant self-dealing, prior to the sweep Fannie and Freddie had to earn more than $28.7 billion pre-tax—all of which went to Treasury as $10.0 billion in Federal income taxes and $18.7 billion in senior preferred stock dividends—before their preferred or common shareholders could be paid a penny. Treasury insists on saying, "That's because we gave them $187 billion to keep them solvent." Judge Sweeney should say, "No, that's because you abused your regulatory power by taking Fannie and Freddie over without statutory authority and for your own policy purposes, then conspired with a conservator you controlled to run up their non-cash losses, forcing on them senior preferred stock they didn't need and you wouldn't let them repay, whose purpose was to transform massive, temporary and artificial book expenses you'd created for them into massive, perpetual and real cash revenues you're taking for yourself."

But it may not even come to a judge's ruling. Now that the facts about what Treasury did with Fannie and Freddie are out, they can't be re-hidden. It therefore is entirely possible that officials either in the current or the coming administration will realize that the positions Treasury has taken on Fannie and Freddie are untenable, and they will change course. This course change could include their position on mortgage reform, with a realization that seeking to replace the two companies that produced the best performance records prior to the crisis with a new and untested alternative, or "private market" entities or mechanisms that did demonstrably worse, is folly.

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