The Past, Present and Future of Fannie and Freddie: Government Intransigence on the Current Lawsuits Could Make It Impossible to Reprivatize the Residential Mortgage Market

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Today, the momentum is growing for fundamentally restructuring the national residential mortgage market in the wake of the earlier collapse of the Federal National Mortgage Association (FNMA, or "Fannie Mae") and Federal Home Loan Mortgage Corporation (FHLMC, or "Freddie Mac). These two government-sponsored enterprises (GSEs)--so-called in recognition of their hybrid public/private nature--have long written large chunks of the residential home mortgage market, to the tune of trillions of dollars. The current legislative fixes now on the table include a bipartisan proposal from Tim Johnson and Mike Crapo, coupled with an earlier entry by Maxine Waters. The Johnson-Crapo proposal follows on earlier entries from Jeb Hensarling on the House side and Bob Corker on the Senate side. Each of these proposals seeks simultaneously to unwind the past and to redefine the future. To evaluate them requires understanding the historical linkage between past events and future prospects.

To begin, some background. In response to the brewing subprime mortgage crisis in 2008, Congress in late July of that year passed the Housing and Economic Recovery Act (HERA). That legislation, inter alia, created a new Federal Housing Finance Agency (FHFA), which on September 7, 2008 placed into a conservatorship both GSEs. These conservatorships were intended to keep both entities alive in order to facilitate their return to the private market. They were not receiverships whose object is the orderly liquidation of the two businesses. The basic plan called for an infusion of up to $200 billion in fresh cash into Fannie Mae and Freddie Mac under a Senior Preferred Stock Purchase Agreement (SPSPA) that gave the government warrants, exercisable at a nominal price, to acquire a 79.9 percent ownership stake in each

enterprise. In exchange for that advance the senior preferred stock carried a 10 percent annual dividend payment, which went up to 12 percent if the GSEs delayed their dividend payments on the senior preferred.

The terms of that deal were radically altered in August 2012, when the United States, acting through the Treasury Department, imposed, through the Third Amendment to the 2008 SPSPA, a "net worth sweep" that entitled the government to 100 percent dividends on future earnings. That one bold stroke effectively made it impossible for the GSEs to repay their loans and rebuild their capital stock. Both the junior preferred stockholders and the common shareholders could under this agreement never receive a dime from either GSE, even after the entities returned to profitability. Assessing this gambit requires understanding two things: first, the relationship between the Third Amendment and the original 2008 SPSPA; and second, the relationship between the Third Amendment and efforts to revitalize the housing market. Both relationships are widely misunderstood today.

Prior Writings In July, 2013, I attacked the Third Amendment for its refusal to allow for any pay down of the $188 billion in advances made under the 2008 SPSPA. The government did so on the dubious ground that it could repudiate its obligations in the name of "taxpayer protection." At that time, the Third Amendment meant that some $59 billion in designated dividends should have been recharacterized first as a payment of accrued interest, and afterwards as a return of capital, which necessarily would reduce the interest payments going forward, and speed the path toward reprivatizing Fannie and Freddie. As I wrote then, "even if the 2008 transaction stands, the 2012 transaction should be nullified, and the private and common shares restored."

Thereafter in November, 2013, I attacked the position that the government took in its litigation with Washington Federal, where it sought by a variety of procedural devices to prevent the case from being heard. There is no question that many legal and factual obstacles stand in the path of any suit under the 2008 SPSPA, especially in comparison with the Third Amendment. But it hardly follows that those plaintiffs do not deserve their day in court, as the government has claimed by insisting that they do not have standing to bring this lawsuit.

Finally, in March of this year, I attacked the government position in the strongest possible terms in light of the recent revelations by Gretchen Morgenson's *New York Times* article, "The Untouchable Profits of Fannie Mae and Freddie Mac." As Morgenson revealed, the Treasury and FHFA had decided as early as December 2010 to block Fannie and Freddie shareholders from sharing in the profits of the newly revived entities.

The current attacks on the Fannie and Freddie shareholders have not in my view come to grips with the key implications of the 2008 SPSPA and its August 2012 Third Amendment. Hence this further commentary on the topic.

The 2008 SPSPA In 2008, the government explicitly decided to keep both Fannie and Freddie alive in a conservatorship, which it was allowed to do under HERA. That decision may well have made sense for a whole variety of reasons. Forcing both companies into premature liquidation could have further roiled the financial markets. Even if it did not, there was an ongoing dispute--a dispute that remains, and on which I take no position--as to whether the stock of Fannie and

Freddie was totally worthless or whether the liquid assets of both companies would have allowed them to ride out the storm without going bankrupt. Indeed, even in liquidation, shareholders have the right to claim their residual equity in their shares, thus opening the door to extensive evidence on valuation--evidence that could be highly sensitive to the time that is chosen for liquidation.

Avoiding these issues made perfectly good sense, but the conservatorship itself presented a new round of issues on just how to value the contribution to equity made under the SPSPA. On this point, Senator Bob Corker thinks that Fannie and Freddie and their shareholders have no beef at all stating, "While I'm always glad when taxpayers see a return on investment, we can't forget that Fannie and Freddie wouldn't be earning one penny today without the government guaranteeing their transactions."

To this argument there are two replies. The first is that Fannie and Freddie may never had gotten into the mess if the United States had not insisted that it make high-risk loans to low- and moderate-income housing, first under the Housing and Community Development Act of 1992 (HCDA), as amended in 2007. In 1992, 30 percent of GSE loans were devoted to these programs. By 2007, that target had been raised to 55 percent. The conditions attached to the 1992 Act could be satisfied only in some financial Nirvana, for the legislation announced that Freddie and Freddie "have an affirmative obligation to facilitate the financing of affordable housing for low- and moderate-income families in a manner consistent with their overall public purposes, while maintaining a strong financial condition and a reasonable economic return . . . ." No one can do both simultaneously. It is a financial impossibility to increase the number of high-risk loans, without courting disaster in the event of a market downturn. Yet nothing in the Corker calculations takes this heavy obligation into account. Instead, he focuses exclusively on the government's implicit guarantee of Fannie and Freddie, later made explicit, which kept them afloat.

The deep danger in his approach is that it makes it impossible to determine the relationship between the heavy costs under the HCDA against the implicit government guarantee. But it is assuredly a wrong answer to count the implicit guarantee while ignoring the correlative duties that Congress imposed. In my view, a first-best world removes both of these requirements so that market-based housing becomes the norm. It might be said in response that without government intervention, the number of Americans that will own their own homes will decline. But that proposition is not the same as saying that the number of Americans with a roof over their head will decline. Instead it will lead to an increase in rental housing, which reduces radically the risk of major financial dislocations. Landlords run businesses and in general will not engage in the kind of borrowing and leasing that are likely to cause a financial disaster.

The second response in this instance is that the 2008 agreement is water over the dam. Before that agreement was entered into, the government had the option under HERA for the FHFA to close down Fannie and Freddie. But legal consequences follow once it takes the decision to go the other route. It is critical to remember that the shares of both companies traded in the market after the 2008 date marking the onset of the conservatorship, and the share prices in those transactions rested on the assumption that the Fannie and Freddie could not be stripped of future profits by government fiat. One cannot defend the Third Amendment in 2012 by announcing

after the fact--and following and in the midst of active trading--that the 2008 SPSPA was, well, a mistake. That brazen approach gives the government two bites at the apple, and a free option to switch from one system to another with the benefit of hindsight *after* events have played themselves out. One might as well let gamblers place their bets in a horse race after the race has been run, and not before.

The Third Amendment The previous discussion sets up the analysis of the Third Amendment. In dealing with this issue, the government in its briefing in a shareholder lawsuit challenging the government's move took the strong position that the value of the government commitment in 2008 was "incalculably large," so that Fannie and Freddie shareholders had no expectation of being repaid. In and of itself, that statement is odd because in a financial situation it should always be possible to calculate the size of a bet, whether it be large or small.

In response, I wrote, "the level of the Treasury commitment was not 'incalculably large': it was $188 billion, all of which will shortly be repaid." A detailed criticism of this statement was prepared by Larry Wall, of the Center for Financial Innovation and Stability of the Federal Reserve Bank of Atlanta. He graciously amended his account in response to some comments that I sent to him, so I shall examine the criticisms of my position only in his revised version.

Wall's first argument is that the $188 billion was not the only financial commitment; there was also the interest. I agree of course with that point, and thought that it was too obvious to say in that context. As should be evident from the discussion above, the government is entitled to recover that interest in full. The government surely took a larger risk at the earlier date. But by the time of the Third Amendment, which was the focus of my writing, the principal was on the road to being repaid, and all interest obligations were current.

Wall's second and more serious point relates to the obligations, if any, to absorb further losses in the portfolio, which could be a large sum, albeit one that was limited by the ability of the government not to make further advances if it chose not to. But however these residual risks of 2008 are calculated, they are not beyond calculation. Indeed, the applicable limits on how much the Federal Reserve had to commit to this venture were twice raised. By the time the Third Amendment came about, no additional commitments would be needed, so that these contingent liabilities were not a serious factor in figuring out whether the Third Amendment was fair to the shareholders--which given its wholly one-sided nature it was not.

Wall's third point relates to the decision of the Treasury to take for nominal consideration an option to purchase 79.9 percent of the common stock. That option today would be worth billions of dollars if the Third Amendment had not been adopted. At this point two questions arise. The first is how we value that particular option as of 2008. Wall assigns to it a modest value, which is again disputable. To be sure, the odds that it would come into the money may have been low, but if the housing market did recover, as it did, chances are that it would be worth a substantial sum. The high rate of return is thus in tension with the low probability of its occurrence. Working out these numbers does not lead to the conclusion that the warrants should have been ignored in calculating the value of the government's stake.

More critically, once it is settled that the action is over the Third Amendment, all of Wall's calculations, as noted, are irrelevant. The proper time to evaluate the fairness of the Third Amendment is when it is made, not sooner. Indeed, ironically, the Third Amendment, if allowed to stand, wipes out the value of the government option to buy 79.9 of the common because Fannie and Freddie shareholders will never receive any payments either by way of dividend or liquidation ever. No analysis of the 2008 deal gives any insight into the Third Amendment.

Going Forward My last point is brief, but critical. There are all sorts of ways in which to reform the housing market, in order to avoid the mistakes of earlier periods. To do that, any workable reform, critically, would involve removing the deadly combination of an implicit government guarantee coupled with a mandate to make high-risk loans with small down-payments to low- and middle-income individuals who lack sufficient capacity to repay.

Unfortunately, the major reform proposals advanced to date, including most recently the Johnson-Crapo proposal, essentially double down on the old, failed model. The Johnson-Crapo bill is, I think, highly flawed. Its dangerous willingness to have the federal government guarantee about $5.2 trillion of mortgage debt is well-exposed in a recent Cato Institute Working Paper by Ike Brannon. Its dangerous similarity to recent health care reform is the centerpiece of James Glassman's pieces in the *Weekly Standard*, which characterizes the bill as the Obamacare of real estate. Here is not the place to go examine the Johnson-Crapo bill's complex structure and perverse incentives. Quite simply, the new bill repeats most of the old mistakes with Fannie and Freddie in the form of a new Federal Mortgage Insurance Corporation that has the same cross-subsidy to high-risk borrowers, now called "equitable access." Because the political pressures to service low- and middle-income groups will be as great now as they have ever been, it is an open question, at best, whether the new reforms will be able to prevent a slow decline in underwriting standards under the proposed new regime.

Complicating the uncertain prospects for Crapo-Johnson, and all future proposals, is the aftermath of the government's extraordinary actions under the Third Amendment. There is a tight connection between the past obligations to Fannie and Freddie and the creation of any new facility in which private parties are asked to risk capital, given the very real risk that private capital will stay away from facilities that are empowered to make foolish loans under federal oversight that will, almost inevitably, cave with time. The short answer is that if the Third Amendment holds up in court, private parties will in fact stay away in the future. There are just too many possibilities to wipe out private investment if the government has the power that it claims here and everywhere else. (If the executive branch can rewrite the ObamaCare legislation repeatedly, it can rewrite any legislation including regulation for the residential mortgage market.) Indeed, the situation is worse: even if the shareholder suits against the various government agencies prevail, private investors would rightly perceive an ongoing risk that they could be tied up for years in litigation brought to enforce their contractual rights. That grim prospect will certainly deter private participation in any new mortgage-loan facilities being contemplated.

What is clear is that the "protection of taxpayers" motif is bipartisan. Both parties see every reason to ignore contractual and constitutional obligations to Fannie and Freddie shareholders. What reason is there in this political climate to think that the Congressional leopard will lose its

spots anytime soon? On all these issues, any defense of the Third Amendment, such as that offered by Larry Wall, only makes matters going forward worse.

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