



*The Failed Assassin: Tennessee Republican Bob Corker sponsored bipartisan legislation that would have killed Fannie and Freddie, but it never passed.*

In Washington, it's far from clear that the real lessons matter. "I wish it was simply a matter of telling the truth," says John Taylor, the president of the National Community Reinvestment Coalition. "This is a political issue. It means you don't have to rely on facts. You can make up your own." "People have a visceral reaction to [the GSEs]," marvels one longtime mortgage investor. "People want to say 'I killed them.'"

So if everyone wants the GSEs dead, and they were such a bad idea, why aren't they dead? "Making policy on this was one of the hardest things by an order of magnitude for the administration," says a former official. "The danger is that it leads to all kinds of narratives that feel good but ultimately don't lend themselves to reality. It's fucking terrible to explain to the public. Both the politics and substance are much more complicated than anyone expected." He adds, "And if you get the substance wrong, it could be really problematic. This is a major segment of the economy supporting the major asset most Americans have."

One of the narratives, which is appealing to those on the right, is that we can get the government out of the housing market with the flip of a switch. In 2013, Jeb Hensarling, the Tea Party Republican representative from Texas, authored a bill that would kill the GSEs and, with the exception of some support for very low-income housing, not replace them with anything. While no one knows for sure what would happen—Fannie Mae has been around since the 1930s, after all—most analysts and market participants agree that the downside is that a great swath of the middle and lower classes probably would get five- to fifteen-year mortgages with floating rates, rates that would vary significantly depending on income and geography. Homes would be less affordable, so housing prices would likely fall. Consider that with interest rates at 3.75 percent, a \$200,000 home with a 20 percent down payment and a ten-year

fixed-rate mortgage on the remaining \$160,000 would have a monthly payment of \$1,521. With a thirty-year fixed-rate mortgage, the monthly payment is \$752. Mortgage capital might be hard to come by in times of stress. Under the new system, not much would change for wealthy borrowers, but the effect on lower- and middle-income Americans could be significant.

A recent paper by the University of Chicago economist Benjamin Keys shows that when mortgages are guaranteed and turned into securities by the GSEs, the interest rate that borrowers pay doesn't vary much from region to region, even if the economic health of those regions varies. In contrast, the cost of mortgages that are securitized by Wall Street varies much more and is less predictable. This is because the GSEs, with their national reach, engage in cross-subsidization so that, say, borrowers in a struggling region aren't hit with higher mortgage costs.

Whatever the appeal of the "free market," the housing industry, including the real estate agents and the home builders, still has enough clout to scare politicians about the consequences destroying their businesses. In addition, even right-wing politicians are afraid of being accused of decimating homeownership opportunities for their constituents. Real estate agents, who are fairly evenly split between Democrats and Republicans, came out against Hensarling's bill, and it went nowhere.

There's a deeper problem with the purportedly free market approach. Barring a total restructuring of our whole financial system, getting rid of the GSEs would turn over the mortgage market to the biggest banks. But they were bailed out in 2008, too. Dodd-Frank may have addressed (if not fully fixed) the "too big to fail" issue by, for instance, demanding higher capital requirements on larger institutions. But if such big banks control the nation's mortgage market, does anyone think they'll be allowed to fail in the next crisis? In which case, how are they not government-supported entities, as well? Not to mention entities whose political power would make the old Fannie Mae look like a pipsqueak.

There's an argument, most prominently made by the think tank Bipartisan Policy Center as well as some former administration officials and analysts, that we should be able to put in place a perfect new system, one without Fannie, Freddie, or big banks. "It is simply not true that we are forced to choose between one system dominated by Fannie Mae and Freddie Mac and another dominated by a few huge banks," wrote Jim Parrott, a former administration official who now consults for various financial services companies, including Bank of America, and Mark Zandi, the chief economist at Moody's Analytics, who also serves on the board of a large mortgage insurer. ("A Revolving Door Helps Big Banks' Quiet Campaign to Muscle Out Fannie and Freddie" was the headline of another recent piece by the *New York Times's* Gretchen Morgenson.) Newspapers with editorial desks that are opposed to the GSEs, including the *Washington Post*, often opine on how this "new system" will simultaneously get rid of the GSEs, preserve access to affordable housing, not give control to the big banks, and protect taxpayers. In short, nirvana!

It would be nice if we could achieve nirvana in housing finance. But if it is possible, no one has shown precisely how it would work. With the housing finance system, the devil is often in the missing details, and the one bill that Congress did seriously undertake (a bill that was supported by both Parrott and Zandi) shows how difficult those details can be. In 2014, bipartisan legislation sponsored by Tennessee Republican Bob Corker and Virginia Democrat Mark Warner passed the Senate Banking Committee. The legislation would have killed Fannie and Freddie but preserved a government backstop for the mortgage markets in the form of a new entity. Small lenders were opposed to the bill, because despite reassuring language about how this wasn't a big-bank giveaway, they viewed it as precisely that. Affordable-housing activists opposed it because while it offered subsidies for the poor, it did nothing for the bulk of lower- to middle-income Americans because it didn't offer the cross-subsidization created by the GSEs. The housing finance expert Joshua Rosner, who is a managing director at the research consultancy Graham Fisher, noticed that although there was a requirement that private capital bear risk ahead of the government, in the fine print there was a provision that the requirement could be waived—meaning that in bad times, all the risk would go to the government. And, of course, the government was still backstopping the mortgage market. While some in the Obama administration, most notably Gene Sperling, who was then serving as the director of the National Economic Council, worked hard to pass the bill, the administration as a whole didn't put its weight behind it—President Obama didn't make any calls to senators who were on the sidelines. The bill ultimately stalled.

Supporters of the bill insist that it is fundamentally different from the current GSE system—but the key component, which is a government backstop, would remain. Says one Wall Streeter about the bill, “It's like ripping up the whole national highway system just to build another one next to it.” We take for granted the functioning of the highway system, just as we take for granted that the price we're quoted for our mortgages is going to be in place when we go to the closing—indeed, that the mortgage will be available at all. Even if an untested new system eventually worked, there would for sure be glitches along the way.

As a large aside, neither this bill nor any other proposal has addressed how to capitalize the new system, or what to do with the existing \$5 trillion in GSE securities, 15 percent to 20 percent of which are in the hands of foreign banks.



*The Co-Conspirator: Virginia Senator  
Mark Warner joined Corker in trying to  
take down the GSEs.*

In short, it's easy to say we should kill the GSEs until you start thinking about the alternatives. This is why Frank Raines used to say privately in the wake of the crisis, "We might call them Dick and Harry, but give it ten years, and there they will be."

Keeping Fannie and Freddie in any form is an outcome to which many, including the Obama administration, are furiously opposed. Some of it is due to the widespread belief that the bailout of Fannie and Freddie proves that their business model was fatally flawed, even though many of the people who say this don't say the same thing about the big banks. Some is due to the legitimate fear that any entity that has access to any type of government subsidy (even if the guarantee is explicit, rather than implicit), and that operates in an area as politicized as homeownership, will inevitably become corrupt. Some of it is due to the personal animus toward the GSEs that exists in much of Washington. "When they were in their prime, they rolled over a lot of people in [Washington]," one closer observer says. "Now, people are getting even. There's a lot of that out there. I don't care which side of the aisle you're on." And some of it is due to the power of the idea that the GSEs' low- and middle-income housing goals were solely responsible for the crisis.

But some of the opposition to Fannie and Freddie is, ironically enough, a direct function of who it is that is pushing for it. Surprisingly enough, it is some of the most powerful hedge funds in the country.

You might recall that when the government took over the GSEs, they left roughly 20 percent of the common shares outstanding and trading, as well as that preferred stock that had been sold in the run-up to conservatorship. Despite the rhetoric surrounding the GSEs, Lockhart even said that the goal was to return Fannie and Freddie "to normal business operations" and that "both the preferred and common shareholders have an economic interest in the companies . . . and going forward there may be some value in that interest."



*The Profiteer: After making nearly \$4 billion from shorting subprime securities, John Paulson bought up shares in GSEs.*

In the dark years following the bailout, the GSEs appeared to be racking up tens of billions of dollars in losses. But some investors noticed that the situation wasn't nearly as dire as it appeared. Under the terms of their bailout, Fannie and Freddie were required to draw money based not on current cash losses or needs, but on when their net worth fell below zero. Net worth is an accounting concept that takes into account estimates of future losses, so Fannie and Freddie were required to draw money based on estimates that they would lose billions in the future. But these estimates turned out to be way too high.

In addition, the bailout forced Fannie and Freddie to pay a 10 percent dividend back to the Treasury on any money they took. Because the dividend payment further reduced their net worths, they had to draw additional money from Treasury to fill the hole created by the dividend payment. According to a FHFA official, around \$45 billion of Fannie and Freddie's \$187 billion bailout consisted of draws that took money from Treasury only to round-trip it right back to Treasury to pay the dividend. "It was a complete payday-lender situation," says someone close to the situation.

Ultimately, Fannie Mae took almost \$116.2 billion and Freddie Mac \$71.3 billion from the U.S. Treasury, a total of \$187.5 billion. One analysis done on behalf of a major investor shows that most of the losses were caused by non-cash charges such as provisions for loan losses that didn't materialize. During the period in which the GSEs lost money, from 2007 to 2011, the provisions for losses exceeded the actual losses by \$141.8 billion. According to this analysis, the combined equity deficiency of the GSEs was really only about \$10 billion.

A handful of investors realized that when accounting rules required that the estimated losses be reversed, the GSEs would post staggering profits. And so they began buying up those preferred shares, which were still priced near zero. Some of them, like the hedge fund Perry Capital, had made fortunes

betting against, or shorting, subprime mortgages in the run-up to the crisis. Paulson & Co., run by John Paulson, who made almost \$4 billion from shorting subprime securities, bought shares. So did a hedge fund run by the Carlyle Group, a politically connected Washington, D.C.-based private equity firm. “We expected the political rhetoric,” says one investor. “We thought, ‘It’s easy for you to say you want to kill them, and that they are an endless black hole.’ But once they were profitable, we thought the rhetoric would change.”

Rhetoric aside, conservatorship is supposed to be governed by the law, which in essence says that the conservator must either “preserve and conserve” the GSEs and release them back, or throw them into receivership, in which case their assets would be distributed to shareholders. The investors argue that even a few years after the crisis, there were sufficient assets that the preferred stockholders would have gotten all the money they were owed.

But then on August 17, 2012, a sleepy summer Friday, Treasury and the FHFA changed the rules of the game. Going forward, instead of paying a 10 percent dividend, Fannie and Freddie would be required to send every penny they made to Treasury. If everything went to the government, then there was no value left for investors. Both the common and the preferred shares plunged in price.

The official explanation for this change is that the administration had no idea that the GSEs were about to become so wildly profitable, and so they executed the sweep of profits to prevent the GSEs from owing money they couldn’t pay. The sheer amount of money the GSEs started making immediately following the sweep makes it hard to believe this.

Another explanation is that the change in the deal came a year after the huge fight in Congress over raising the debt ceiling. Since that time, battles over spending have become commonplace. The profits generated by Fannie and Freddie, which go straight to Treasury, have at critical times helped buy breathing room, or, as Treasury Secretary Jack Lew said in recent congressional testimony, “As a practical matter, it’s what has helped us to reduce our overall deficit.” Thanks to the GSEs’ profits, federal spending was underreported by a combined \$178 billion in 2013 and 2014, according to a paper by the Heritage Foundation. Not incidentally, there is no accountability for how the profits from Fannie and Freddie are spent; and once the money is spent, it is gone and cannot be used to buffer any losses they might suffer again.

Eventually, investors, including Perry Capital and Fairholme Capital Management, which manages around \$10 billion on behalf of some 180,000 individual investors and a few institutions, sued. To date, around two dozen lawsuits have been filed, some of them by big investors, but others by individual

stockowners and pension funds like the City of Austin Police Retirement System. What's happened in the courts is a drama all its own, but the upshot is that it is impossible at this stage to guess what the outcome might be.

But the lawsuits are in some ways a sideshow to the question of what should be done with the GSEs, and this is the real battleground. What some investors really want is a stake in a recapitalized, albeit reformed, version of Fannie and Freddie, which, they argue, is the right solution—as well as one that would increase the value of their stock.

In response, the Obama administration has made it clear that they will not bring Fannie and Freddie back in any way, shape, or form. Officials refer derisively to the investors' plans as “recap and release,” meaning that the GSEs would be allowed to build capital, and then we'd send them back out, exactly as they were before the financial crisis. At the Mortgage Bankers Association's annual convention in October, Michael Stegman, former counselor to the secretary for housing finance policy at the Treasury and now senior policy adviser for housing at the White House, said recapitalizing the companies would be “turning back the clock to the run-up to the housing crisis.” He added that investors had bet big that the companies would be allowed to exit conservatorship “and they are doing everything they can to make sure those bets pay off.” Other officials speak in broad terms about “comprehensive housing finance reform.” As Antonio Weiss, the counselor to the secretary of the treasury, wrote in a recent op-ed, the administration “wants to transition to a better system, one that provides broad access to housing supported by a sound and robust mortgage market, without exposing taxpayers to another rescue.” Once again, nirvana! But, of course, without any details.

One reason for the unwillingness to consider any plan that releases Fannie and Freddie is that politicians don't want to give up the stream of money flowing into Treasury from the GSEs. It's also clear that the administration does not want to see investors get paid. (A Treasury official even wrote a memo to then Treasury Secretary Geithner before the 2012 profit sweep citing the “administration's commitment to ensure existing common equity holders will not have access to any positive earnings from the GSEs in the future.”)

But everyone involved in the housing finance debate—most notably, the big banks that this administration has done so much to protect—has money at stake. Stegman has repeatedly referred to the “failed” GSE business model. But the idea that the GSEs failed relies on inflated loss figures. And if the bailout means the business model failed, then what about the big banks? Isn't theirs a failed business model too?

The real issue isn't whether investors get paid. It's whether we have a housing finance system that makes sense. The investors aren't the only ones who would like to see Fannie and Freddie reformed rather than eliminated. These include civil rights organizations like the NAACP, who are worried about the plunge in minority homeownership rates since the crisis; affordable-housing advocates, who worry what the world will look like without the GSEs (this summer, the Census Bureau reported that the homeownership rate had fallen to 63.4 percent, the lowest level in forty-eight years); and community banks and other small lenders, who don't want to lose all their business to the big banks.



*The Reformer: The author and analyst Josh Rosner has proposed a solution that would treat GSEs like utilities.*

The best idea, whose most prominent backer is Graham Fisher's Josh Rosner, is that the GSEs would operate as utilities, much like your electric utility, with a cap on the return they are allowed to earn, and regulated as such by a competent regulator with real teeth. The regulator, as Rosner writes, would "ensure that the firms employ their benefits of scale to minimize the costs to end-users while allowing them to earn acceptable, rather than excessive, rates of return." They would be somewhat like the GSEs were in the 1980s, before all public companies faced inordinate pressure to grow their earnings and please investors. They would be well capitalized at a level consistent with that of other large financial firms, and they would no longer be able to hold mortgage securities on their own balance sheet. (Their portfolios of such securities have already shrunk dramatically.)

Rosner also writes that it is important that the GSEs serve as "countercyclical providers of liquidity." What he means is that if the market is going crazy, and Wall Street is happily providing mortgage capital, the GSEs can and should stand back. That way, they will have dry firepowder if there are problems, and private capital flees the market. There's already a taste of how that might work. Today, the GSEs are



selling a portion of the risk they insure to other investors. The current way the GSEs sell risk is not without its flaws, but it is a start to doing exactly what President Obama said he wanted, which is getting private capital in front of the government.

This idea isn't perfect, especially if you believe any government involvement in business opens the door to eventual corruption. It also requires regulatory competence, which is something that has been in short supply in modern times.

One of the major objections is that there's a conflict inherent in the GSE business model, in which they are publicly traded companies that owe a duty to investors, but also have a congressional mandate to encourage homeownership. Critics say that it is impossible for a company to serve two masters. The utility structure would alleviate the issue, in that investors in such a business wouldn't be looking for turbo-charged growth, but rather for stability, but the two masters would remain.

But it's also worth asking whether this conflict is truly the problem that critics make it out to be. There are a lot of evolved companies today that talk about "stakeholder value" instead of "shareholder value." Indeed, you can argue that the monomaniacal focus on shareholder value hasn't served our markets so well. Isn't there a counterargument in which the two mandates—serving homeowners, but with a focus on the bottom line—balance each other? After all, a company with a duty to homeowners but without any responsibility to shareholders could be very dangerous indeed. The bottom-line responsibility, at least theoretically, not only keeps the companies conscious of the risks they are taking but also helps attract a different sort of employee than a pure government bureaucracy might attract. And that is important. The mortgage market is fierce and fast moving. The old Fannie and Freddie could hold their own with Wall Street traders, who are looking for any and every opportunity to make money from slow-moving government institutions. We do not want companies that are completely neutered to serve in this role.

It is true, though, that some wrinkles would emerge in this business model. While requiring the GSEs to get rid of their portfolios will make them less risky, it also means that they will be less profitable, which in turn means less money for affordable housing. While some investors say privately that they support the utility model—and it's worth noting that there are none who advocate for a simple "recap and release"—it's also not clear what sort of value owners of the GSEs' common stock would be able to extract from this model. It's quite possible that the odd alliance between investors and affordable-housing groups would break down in a bitter fight over who gets what piece of a much smaller pie.

But for citizens and taxpayers, it's the right answer. We know that the basic infrastructure of the GSEs works, and worked well for fifty-plus years. On the other side, the argument that we shouldn't settle for something less than perfect sounds a whole lot less compelling once you realize that no one has any vision of perfect, let alone any plan to get there, nor any clue about what glitches or outright corruption might emerge in a new model. And there's this: all the talk about "comprehensive" reform is just empty words. Now, reform is in Congress's hands, and one industry lobbyist says that everyone in Washington knows that after the failure of Corker-Warner, the chance that Congress will act is nil. All the words are a pretext for doing nothing.

Yet there's also a risk to doing nothing. It's impossible for the private market to resume functioning, even if it can, until the government decides what its role will be. More importantly, because the government has been taking all their profits, at this point the GSEs have less than \$5 billion in equity supporting their more than \$5 trillion in liabilities, leaving them with a capital ratio of 0.1 percent. To put that in context, when the Federal Housing Administration, which is fully owned by the government, had its capital fall below 2 percent, there was a political uproar over the potential loss to taxpayers. Indeed, the situation is painfully ironic in that the widespread belief is that capital is the one thing that makes the system safer. The largest banks are now required to have a capital ratio that is close to 5 percent. If there's a recession and housing prices fall again, or if there's a big swing in interest rates, Fannie and Freddie would have to be bailed out by taxpayers again. Don't we deserve more of a plan than that?

In *The Big Short*, there's a moment when Ryan Gosling tells the audience that he knows this stuff is really complicated, and it seems easier not to care, but that's really dangerous, because what you don't know can hurt you. When it comes to housing finance, Americans' best interests have rarely dictated the answer, precisely because too few people care. That's another thing the movie got right.

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