

Treasury's Fannie and Freddie rip-off

Gigantic government's complexity and opacity provide innumerable opportunities for opportunists to act unconstrained by clear law or effective supervision. Today's example, involving the government's expropriation of hundreds of billions of dollars, features three sets of unsympathetic actors — a grasping federal government, a few hedge funds nimble at exploiting the commingling of government and the private sector, and two anomalous institutions that should never have existed.

The two are the "government-sponsored enterprises" (GSEs) Fannie Mae and Freddie Mac. This maddeningly complex story illustrates the toll the administrative state takes on the rule of law.

The two federally chartered but privately owned GSEs, which [guarantee 80 percent of American mortgages](#), were created because Washington wanted to engineer — what could go wrong? — more homeownership than market forces would produce. What could go wrong did, and in 2008 the two GSEs floundered. [In September 2008](#), the government rescued them with \$187.5 billion and placed them in conservatorship, which is supposed to be temporary and rehabilitative. A conserved entity should be returned to normal business in private ownership.

Fannie and Freddie have recuperated profitably. They also have been nationalized.

The government's original rescue terms were for Fannie and Freddie to pay a stiff dividend on the bailout funds — 10 percent, amounting to \$4.7 billion per quarter. Then, however, the Treasury Department was told of the GSEs' strong recoveries. According to documents recently unsealed, [on Aug. 9, 2012](#), Treasury was told that the GSEs' prospects were for strong profitability, requiring no further government assistance. Eight days later, Treasury negotiated with the GSEs' conservator, the Federal Housing Finance Agency (FHFA), for an astounding revision (called "the third amendment") of policy: Instead of the agreed-upon dividend, and already enjoying a right to 80 percent of the GSEs' profits, [the government would get 100 percent forever](#), far exceeding the size of the original bailout.

So, the government (Treasury) negotiated with itself (FHFA) to achieve a windfall for itself. And the conservator abandoned its duty to safeguard the assets of the entities in conservatorship.

The government claims it changed the terms in order to avoid any need to give the GSEs

additional funds to pay the 10 percent dividend on funds already received. This claim, however, is not credible, given what and when the government knew about the GSEs' profitability.

After the government "negotiated" with itself for the GSEs' profits, the value of their shares cratered. Some hedge funds bet that the government's transformation of the GSEs into a revenue stream for itself would not survive judicial scrutiny. They added to the GSEs' shares they had bought before the "third amendment" when they mistakenly trusted the government to act properly as a conservator. They purchased additional shares for pennies on the dollar.

Legal scrutiny has arrived in the form of lawsuits with enormous stakes. One hedge fund stands to make \$7.5 billion if the government is found to have unconstitutionally taken private property without compensation.

A federal judge has sided with the federal government. (See a pattern here?) He made the "utterly astounding" ([New York University law professor Richard Epstein's characterization](#)) judgment — "without allowing any discovery about the underlying facts" (Epstein) — that a fiduciary (FHFA) can take private assets of the fiduciary's supposed beneficiaries and transfer them to the government. Epstein expects a higher court "to decide that government conservators, like private conservators, cannot loot the corporations whose shareholders they are sworn to protect."

Many individuals and community banks invested in Fannie and Freddie in good faith and have been injured by the government's profit confiscation. Granted, a few wealthy people would become more so from judicial invalidation of the "third amendment." This, however, is at most an argument against creating the moral hazard inherent in GSEs. It is not an argument for allowing the anomalous nature of these institutions to justify lawless discretion by a government as self-interested as those who would profit from restraining the government with law.

After the Revolutionary War, many state debts were bought by speculators at steep discounts from the original purchasers, who feared that the states would not pay face value. The buyers, however, wagered correctly that the federal government would assume the debts and pay at par in order to establish the nation's creditworthiness. [Alexander Hamilton successfully argued for assumption](#). Thomas Jefferson and his allies reluctantly acquiesced in exchange for a more southern location for the nation's new capital.

Which is why Washington is where it is. Fannie's and Freddie's misadventures illustrate why Washington is what it is.

