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America's Mortgage Crisis: Bailout or "Nationalization" of the Mortgage Giants?

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"Take a load off Fanny, take a load for free;
"Take a load off Fanny, and (and) (and)
"You put the load right on me."

– The Band, "The Weight," 1968

Fannie Mae and Freddie Mac own or guarantee nearly half the $12 trillion U.S. mortgage market. Not long ago, they were the darlings of Wall Street, ranking next to U.S. bonds as among the safest and most conservative investments in the world. They are called "government-sponsored enterprises" (GSEs), although they are entirely privately owned and specifically disclaim government backing on their prospectuses. The market has taken these disclaimers with a wink and a nod and has assumed that the GSEs are "too big to fail," forcing the government to save them from their reckless investment schemes. Fannie and Freddie's preferred shares have been considered so safe that banking regulators let banks count them in the capital required as a cushion against loan losses. This is now proving to be a serious problem, because both the common and preferred shares of the distressed duo are suddenly plunging. Between May 15 and August 25, Fannie's common shares lost 77% of their value, while its preferred shares lost 58.8% in that short time. Freddie Mac's preferred shares plunged even more, down 65.5%.1 That could be a disaster for many banks, which are loaded to the gills with these preferred shares. Banks already reeling from losses on mortgages and mortgage-backed securities are now being hit at the core, shrinking their capital base. Loss of bank capital works as leverage in reverse: at a capital requirement of 10%, $1 lost in capital wipes out $10 in loans.

Ironically, the recent plunge in Fannie and Freddie shares has been blamed on the bailout plan that was supposed to save them. In July, Treasury Secretary Hank Paulson sought and was granted the authority to extend an unlimited credit line to the GSEs, which now have liabilities totaling about $5 trillion; and to capitalize them by buying their stock, effectively nationalizing them. At a July 15 hearing in Washington, Paulson assured a group of Senators that Congress probably would not have to go through with the plan. "If you have a bazooka in your pocket and people know it," he said, "you probably won't have to use it." But bazookas can spook the very people they were supposed to reassure. After the plan was approved, foreign central banks slashed their Fannie and Freddie bond purchases by more than 25%, and shareholders rushed to dump their stock. On August 22, Moody's downgraded Fannie and Freddie's outstanding preferred stock by a full five notches, from A1 to Baa3 (or slightly above "junk"), and their Bank Financial Strength Ratings from B- to D+ (a one-half notch above D, something reserved for companies in default). Since the private sector isn't buying, the Treasury is likely to wind up capitalizing the companies by buying new stock itself, seriously diluting the value of existing shares. A government bailout would be expected to wipe out the common shares, but it is becoming increasingly clear that the preferred stock is in jeopardy as well, jeopardizing the banks that hold it.

There are other aspects of Paulson's bailout plan that could be giving policymakers Maalox moments. As noted in a July 17 Economist article:

> "[N]ationalisation . . . would bring the whole of Fannie's and Freddie's debt onto the federal government's balance sheet. In terms of book-keeping this would almost double the public debt, but that is rather misleading. It would hardly be like issuing $5.2 trillion of new Treasury bonds, because Fannie's and Freddie's debt is backed by real assets. Nevertheless, the fear [is] that the taxpayer may have to absorb the GSEs' debt . . . . That suggests yet another irony; the debt of the GSEs has been trading as if it were guaranteed by the American government, but the debt of the government was not trading as if Uncle Sam had guaranteed that of the GSEs."2

The U.S. federal debt is already up to nearly $10 trillion, putting its own triple-A credit rating in jeopardy. If the U.S. assumes the GSEs' weighty liability as well, the country could lose its own triple-A rating, causing foreign lenders to withdraw their massive infusion of funds.3 But if the U.S. does *not* back the GSEs' debt, the result could be the same. China's $376 billion of long-term U.S. agency debt is mostly in Fannie and Freddie assets. Yu Yonding, a former adviser to China's central bank, warned on August 21:

> "If the U.S. government allows Fannie and Freddie to fail and international investors are not compensated adequately, the consequences will be catastrophic. If it is not the end of the world, it is the end of the current international financial system."4

The Endgame Nears

It sounds pretty grim, but let's think about that. Would the end of the current financial system really be so bad? The international financial system is now controlled by a network of private central banks that print national currencies and trade them with sovereign governments for government bonds (or debt). The bonds then become the basis for creating many times their value in loans by commercial banks. At a 10% reserve requirement, banks are allowed to fan $1 worth of reserves into $10 in loans, effectively delivering the power to create money into private hands. The price exacted by this private money-creating machine is compound interest perpetually drawn off the top, in a Ponzi scheme that has now reached its mathematical limits. The chief role of Fannie and Freddie has been to keep the Ponzi scheme alive by adding "liquidity" to markets, something they do by buying mortgages and bundling them together as securities that are then sold to investors. Old loans are moved off the banks' books, making room for new loans, further expanding the money supply and driving up home prices. As economist Michael Hudson noted in Counterpunch in July:

> "Altruistic political talk aside, the reason why the finance, insurance and real estate (FIRE) sectors have lobbied so hard for Fannie and Freddie is that their financial function has been to make housing increasingly unaffordable. They have inflated asset prices with credit that has indebted homeowners to a degree unprecedented in history. This is why the real estate bubble has burst,

> after all. Yet Congress now acts as if the only way to resolve the debt problem is to create yet more debt, to inflate real estate prices all the more by arranging yet more credit to bid up the prices that homebuyers must pay.
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> ". . . The economy has reached its debt limit and is entering its insolvency phase. We are not in a cycle but the end of an era. The old world of debt pyramiding to a fraudulent degree cannot be restored . . . . The class war is back in business, with a vengeance. Instead of it being the familiar old class war between industrial employers and their work force, this one reverts to the old pre-industrial class war of creditors versus debtors. Its guiding principle is 'Big Fish Eat Little Fish,' mainly by the debt dynamic that crowds out the promised economy of free choice.
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> ". . . No economy in history ever has been able to pay off its debts. That is the essence of the 'magic of compound interest.' Debts grow inexorably, making creditors rich but impoverishing the economy in the process, thereby destroying its ability to pay. Recognizing this financial dynamic most societies have chosen the logical response. From Sumer in the third millennium BC and Babylonia in the second millennium through Greece and Rome in the first millennium BC, and then from feudal Europe to the Inter-Ally war debts and reparations tangle that wrecked international finance after World War I, the response has been to bring debts back within the ability to pay.
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> "This can be done only by wiping out debts that cannot be paid. The alternative is debt peonage. Throughout most of history, countries have found again and again that bankruptcy – wiping out the debts – is the way to free economies. The idea is to free them from a situation where the economic surplus is diverted away from new tangible investment to pay bankers. The classical idea of free markets is to avoid privatizing monopolies, such as the unique privilege of commercial bankers to create bank-credit and charge interest on it."5

Bailout or Conservatorship?

Under current law, if the GSEs' capital falls too far below required levels, the Office of Federal Housing Enterprise Oversight (their regulator) is authorized to take control of the firms and impose a conservatorship, a form of bankruptcy. As former Federal Reserve consultant Walker F. Todd explained in a July 23 article:

> "Traditionally, conservatorship freezes existing bank accounts and then allows limited withdrawals until authorities determine how much of those frozen accounts may be distributed pro rata to the claimants. After the appointment of a conservator, new deposits and other funds received as well as new investments would be fully protected."6

Prior claimants satisfy their claims against available assets according to seniority, with lenders being senior to shareholders. The proceeds from any new business are kept separate. Fannie and Freddie investors would take some losses, but the available pot for settling claims is quite large. As Hudson observes:

> "[N]ot all the mortgages that these two agencies have bought or guaranteed are junk. Most are genuine and are being paid. . . . Let these mortgages continue to back the existing FNMA and Freddie Mac bonds to the degree that they actually receive mortgage debt service. If there is a shortfall, let the bondholders take the usual haircut that is supposed to go hand in hand with

> risk. . . . That is the law for all other bondholders when their investments go south. Why make an exception for participants in the real estate bubble? . . . To keep their activities current, let Fannie and Freddie issue a new series of bonds – the 'we won't fake it anymore' series."

Nouriel Roubini is Professor of Economics at New York University and has a popular website called Global EconoMonitor. He estimates that the haircut for securities holders would be a modest 5% ($250 billion on $5 trillion). Securities holders are getting a subsidy of $50 billion a year over what they would earn if they had invested in U.S. Treasuries, specifically because Fannie and Freddie carry more risk; and risk means the occasional haircut. Roubini concludes:

> "It is . . . time to put a stop to the coming 'mother of all bailouts' starting with a firm stop to the fiscal rescue of Fannie and Freddie, institutions that have behaved for the last few years like the 'mother of all leveraged hedge funds' with their reckless leverage and reckless financial activities.
>
> ". . . [L]et's call a spade a bloody shovel: nationalise Freddie Mac and Fannie May. They should never have been privatised in the first place. . . . Increase taxes or cut other public spending to finance the exercise. But stop pretending. Stop lying about the financial viability of institutions designed to hand out subsidies to favoured constituencies."7

Nationalization Without Taxation: Successful Historical Models

Roubini suggests that nationalizing Fannie and Freddie would require an increase in taxes or cuts in other public spending, but there are other possible funding solutions, ones with quite successful historical precedents. *If the multiple layers of profiteers, speculators, derivatives, commissions, bonuses, fees and general fraud were eliminated from the mix, a nationalized Fannie/Freddie could finance itself*. This was proven in the 1930s with the Home Owners' Loan Corporation (HOLC), a government-owned agency set up to reverse a disastrous wave of home foreclosures. The HOLC was funded by the Reconstruction Finance Corporation (RFC), another wholly government-owned agency that performed the functions of a public bank. The RFC successfully funded not only the New Deal but America's participation in World War II. In a February 2008 article in The New York Times, Alan Binder recommended a return to the HOLC model as a way out of the current mortgage crisis. He wrote:

> "The HOLC was established in June 1933 to help distressed families avert foreclosures by replacing mortgages that were in or near default with new ones that homeowners could afford. It did so by buying old mortgages from banks . . . and then issuing new loans to homeowners. The HOLC financed itself by borrowing from capital markets and the Treasury.
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> "The scale of the operation was impressive. Within two years, the HOLC granted over a million new mortgages. (Adjusting only for population growth, the corresponding mortgage figure today would be almost 2.5 million.) Nearly one of every five mortgages in America became owned by the HOLC. Its total lending amounted to $3.5 billion. . . . (The corresponding figure today would be about $750 billion.)
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> "As a public corporation chartered for a public purpose, the HOLC was a patient and even lenient lender. . . . But times were tough in the 1930s, and nearly 20 percent of the HOLC's borrowers defaulted anyway. So the

> corporation eventually acquired ownership of about 200,000 houses, nearly all of which were sold by 1944. The HOLC closed its books in 1951, or 15 years after its last 1936 mortgage was paid off, with a small profit. It was a heavy lift, but the incredible HOLC lifted it.
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> "Today's lift would be far lighter. . . . Given current low interest rates, a new HOLC could borrow cheaply and should find it easy to earn a two-percentage-point spread between borrowing and lending rates, for a gross profit of maybe $4 billion to $8 billion a year."8

The RFC initially capitalized the HOLC by buying all of its stock for $200 million. The HOLC was then authorized by statute to issue ten times that sum (or $2 billion) in tax exempt bonds. In the same way, in 1937-38 the RFC created and funded Fannie Mae as a wholly government-owned agency, for the purpose of injecting money into the banking system so that banks could increase the volume of home mortgages. The RFC and its agencies funded their operations by selling bonds at a modest interest to the Treasury and the public, then relending the acquired funds at a slightly higher interest. The "spread" was sufficient to cover operating costs and losses from default and still turn a modest profit.

How did the HOLC manage to reverse a far worse foreclosure crisis than we have today and still turn a profit, when Fannie and Freddie – which also raise their loan money by selling securities to investors – have become hopelessly bankrupt in that pursuit? The difference seems to be that the HOLC was *a public institution operated as a public service*. Fannie and Freddie are private, profit-making ventures designed to make money for their investors and political exploiters. As Professor Roubini observes, *"These GSEs were designed to make losses. They are expected to make losses. If they don't make losses they are not serving their political purpose."* When the profiteering is taken out and the business is run as a public service, the math works.

There is another American model that is even older than the HOLC, which presents even more exciting possibilities. In the first half of the 18th century, the province of Pennsylvania completely funded its government *without taxes or debt*, through a publicly-owned bank that issued paper currency and lent it to farmers. The bank did not have to borrow capital before it made loans; it just created the currency on a printing press. The money was *lent* rather than *spent* into the economy, so it came back to the government in a circular flow, avoiding inflation; and interest on the loans was sufficient to fund the government's operations without taxation. Such a public bank today could solve not only the housing crisis but a number of other pressing problems, including the infrastructure crisis and the energy crisis. (See E. Brown, "Sustainable Energy Development: How Costs Can Be Cut in Half," webofdebt.com/articles, November 5, 2007).

Once bankrupt businesses have been restored to solvency, the usual practice is to return them to private hands; but a better plan for Fannie and Freddie might be to simply keep them as public institutions. In the August 8 London Tribune, British MP Michael Meacher proposed this alternative for Northern Rock, a major British bank that was recently nationalized after becoming insolvent. He wrote:

> "[W]hen the banks have failed the public interest so badly and still even now continue to pursue so single-mindedly their commitment to privatise their gains whilst socialising their losses, would not a publicly owned bank be the most effective way of changing the current corrosive financial culture of short-termism, lower investment, house price inflation, and insider enrichment at the

> expense of systemic fragility for everyone else? Perhaps we should not return Northern Rock to the private sector after all."9

Perhaps we should not return Fannie and Freddie either.

1
Martin Weiss, "The Greatest Bailout of All Time," Money and Markets (August 25, 2008).

2
of Illusions," Economist (July 17, 2008).

3
Nouriel Roubini, "How to Avoid the 'Mother of All Bailouts'", Global EconoMonitor (July 11, 2008).

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Kevin Hamlin, "Freddie, Fannie Failure Could Be World 'Catastrophe,' Yu Says," Bloomberg (August 22, 2008).

5
Michael Hudson, "Why the Bail Out of Freddie Mac and Fanny Mae is Bad Economic Policy," Counterpunch (July 15, 2008).

6
Walker Todd, "Receivership or Conservatorship for Fannie Mae, Freddie Mac, and Failing Banks," American Institute for Economic Research (July 23, 2008).

7
N. Roubini, op.cit.

8
Alan Blinder, "From the New Deal, a Way Out of a Mess," New York Times (February 24, 2008).

9
Meacher, "A Bank Too Far?", The Tribune (August 8, 2008) (emphasis added).

Ellen Brown, *J.D., developed her research skills as an attorney practicing civil litigation in Los Angeles. In Web of Debt, her latest book, she turns those skills to an analysis of the Federal Reserve and "the money trust." She shows how this private cartel has usurped the power to create money from the people themselves, and how we the people can get it back. Her eleven books include the bestselling Nature's Pharmacy, co-authored with Dr. Lynne Walker, and Forbidden Medicine.*

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