

■ *Part I* ■

# The Wizard Calls the Ball

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## Chapter 1

# The Implosion of the Housing Agencies

It was in 1938, during the Great Depression, that the U.S. Congress, in its wisdom, established the Federal National Mortgage Association (FNMA). Its sister agency, also a federally chartered corporation, Freddie Mac, is also a government-sponsored enterprise (GSE), as is FNMA, and to truly understand these housing agencies you must bear in mind that they were created by the government no matter what hallucinations our politicians bring to us so many years later. I would say that, since inception, these two corporations have been mismanaged, used as whipping posts by one party and the other and carefully kept off the books of the country so they will not directly impact America's balance sheet.

These two congressional creations have been a convoluted scheme since inception, and while they do not carry an "implicit" guarantee of the government, they do carry an "explicit" guarantee so that they always trade right on top of United States Treasuries.

This gives them lower costs of funding, but what this guarantee is actually worth has been anyone's guess since the companies were first created.

For 72 years, Congress has been involved with all kinds of shenanigans with these corporations, which has even included allowing the banks to buy them—prodded them to buy their debt, in fact—and gave their bonds a zero risk weighting so that the banking system in America is loaded up to the gills with their debt. Now what happened over time was that these two agencies became quite powerful and had big lobbying organizations, and they have been prime examples of public/private entities, as they had publicly traded stock and their own preferred stock plus both senior and subordinated debt. Finally, in a fit of angst, Congress turned against its own creations, much as the creator in Frankenstein turned against the monster it had created, and in 2008 began severing limbs. What took place, in my opinion, was a travesty that caused not only the unnecessary loss of wealth for individuals and institutions alike, but actually caused the bankruptcy of a number of banks as the result of quite capricious actions by Hank Paulson, then secretary of the Treasury, and others who made decisions that effectively bankrupted these entities as they threw out most of the management of these companies based on the fact that they were losing money, even though Congress and the administration were issuing policies and writing laws that were the cause of the losses.

In some kind of fit of rage and one of the worst financial decisions made in this century, the secretary of the Treasury decided to quit paying the preferred dividends of both agencies, which caused irreparable harm to both of the companies and brought into question, quite unnecessarily, the guarantee of the country which sent a tidal wave of doubt and suspicion throughout the world.

These two housing agencies may not have carried the “full faith and credit” guarantee of the United States, but it had always been thought that the “explicit” guarantee was close enough so that when the choice

was made to quit paying the dividends of the preferred stock issues, some of which were brought to market just months before, all hell broke loose and the denizens of doubt were unleashed on the plains. The situation can only be described accurately by imagining Sauron, in *The Lord of the Rings*, emerging from his black castle and wreaking

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*It is a strange fate that we should suffer so much fear and doubt over so small a thing. Such a little thing.*

—Boromir,  
*The Fellowship of the Rings*,  
J.R.R. Tolkien

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havoc with absolute abandon on all of the people of Middle Earth.

The travesty for the United States, which represents the safest bonds in the world and is the reserve currency of the world, was that our international reputation, centuries in making and protecting, was thrown under the bus by the actions of one man and his minions, who in one fell swoop tossed the reputation of America close enough to the edge to make everyone shudder and to question the financial viability of the nation. If you think I am being too strong in my presentation, I am not; Henry Paulson utilized some of the worst judgment that has been seen in the history of our country. What he did was absolute idiocy, in my opinion, and from that day to this one I hold him accountable for the reverberations that are still being felt from this decision. He may go down as one of the worst secretaries of the Treasury since its inception—and he should!

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# ■ Get Back to Where You Once Belonged

*August 11, 2008*

I would like to take up the issue of the FNMA and Freddie Mac preferred issues once again, along with their subordinated debt. It is my belief that many people have this wrong and that these two federally chartered agencies will make good on their obligations—all of them. The United States can ill afford for any of its agencies to not pay their debts. As I have said all along, the dividend of the common stock is one issue that is not a stated commitment to pay, but all of the other classes of securities that are senior to the equity carry an obligation of the agency and now, perhaps, the government. For the paltry amount of the preferred dividend, do you think America is going to damage its credibility with its citizens and the rest of the world? Secretary Paulson is not that that moronic!

Let me state that I personally own some of these securities, my mother owns some, and there are some in the money I personally manage. Now, if you take the time to look at the indenture of, say, the FNMA 8.25 preferred (FNM.S), you will find that it is stated quite clearly that this preferred is Tier I Capital. You may also wish to note that in the recently passed legislation and in all of the comments from the Treasury, all of the statements refer to backing the agency and there is no discrimination as to the kinds of debt. The ratings agencies may well make proclamations about the financial condition of these two agencies and then look at the various classes of debt and regard the preferred as compared to the subordinated debt or senior debt, but, in my view, that path does not lead to Rome. These are agencies of the government, not private corporations, that were asked recently to expand their lending to help American homeowners, and now we are not going to pay

their obligations? Even in the drop-dead scenario that the United States would take over FNMA and Freddie Mac, it is my opinion that the government would continue to pay all debts—preferred, subordinated, and senior. If you make the assumption that the preferreds would then be trading to the 2010 call at the 5-year +200, then you get a yield of 5.20 percent and a dollar price of \$26.94. While it is certainly true that the preferred dividends are subject to certain capital requirements and a declaration by the board of directors, it would be a travesty for all of the U.S. agencies not to pay the debts of these GSEs, and I believe this card will trump the short-term economic weakness that is taking place in the housing markets. It hardly makes any kind of rational sense to ask these agencies to expand their role and then have them not pay their obligations. It is quite obvious, given the price of the preferred, that there is another viewpoint here, but this is mine, and I see the present pricing as an opportunity to enhance Grant's Rule 2: "Make Money." Over the weekend, Secretary Paulson announced that the government has no need to invest money into either of the housing agencies at this time, and given that there is still a common stock dividend, this is one more sign that the preferred dividend is intact. I would even make the argument, given the scope of problems in the housing sector, that the recent losses reported by FNMA and Freddie Mac are fairly paltry given the size of their portfolios.

Finally, let me make this observation: If I am wrong and FNMA and Freddie Mac do not pay their obligations, then all of the agencies' subordinated debt and preferred debt will be no more than commercial obligations. The federally chartered sponsorship will have lost its meaning, and you can expect to see all of these classes of debt for all of the agencies descend into a sinkhole.

## **Watch the Euro Zone**

The dollar has now appreciated almost 8 percent from its low point against the Euro. Oil is down to \$115.20, and the entire Commodity Research Bureau (CRB) Index is down 18 percent from its highs. The long commodities, long oil, and long euro trades have now turned into major losers. The game is changing as Europe is at the starting blocks for higher inflation, devaluing housing markets, and weaker economies. If you take the conventional wisdom that the equity markets are leading indicators, it is interesting to make some observations.

For the United States the Dow Jones is now down 11.54 percent for the year, with the Standard & Poor's (S&P) Index down 11.72 percent and the Nasdaq is down 8.98 percent. Not good numbers, but let us put this in perspective: The DJ Euro Stoxx is down 22.53 percent, with the Financial Times and London Stock Exchange (FTSE) down 14.99 percent and the CAC 40 down 19.99 percent and the German DAX down 18.66 percent, so America is not doing quite so badly by comparison. Even in the Far East, the Nikkei 225 is down 13.98 percent while the Hang Seng Index is down 21.31 percent.

## **GMAC**

Let me quote from their recent statement released on Friday, August 8, 2008: "There continues to be a risk that the company will not be able to meet its debt service obligations and be in a negative liquidity position in 2008." The rest of their press release was full of hype and hope, and this proclamation, I would certainly guess, came from their legal advisers as a prelude to several possible outcomes of their financial situation and none of them good. On July 31, GMAC posted a \$2.48 billion second-quarter loss, including a loss of \$1.86 billion at ResCap. The mortgage lender has lost money for seven straight quarters, losing \$7.2 billion over that period. *Caveat emptor!*

## **Write-Offs**

In the first quarter of 2008, I said that the majority of the write-offs would be done by quarter three. I have vacillated in my own mind about this since then, but think I will be close—it could be quarter four, but the end is coming soon. The worst of the hits have already been taken, and those are the most severe of the catastrophes, the ones where the bet was leveraged and the equity has already been wiped out. What will happen next is the appearance of markups where the market has stabilized and the value has bounced off the bottom. It will appear first in some bank or investment bank, and you will get the initial look at credits that have begun to appreciate and then all kinds of good numbers will show up. If you wish to profit from the turn, then I think we are very close to a jump-off point to get back into the game!

# ■ The Cost of Not Honoring Obligations

August 19, 2008

The financial world is currently under siege. I am not sure if there is a better way to put it, but it might as well be an economic jihad fostered by some terrorist group. There is certainly no letup in the press, and I wonder who is making what bets after reading some of the commentary provided by the tribal leaders and warlords of the global marketplace. Some of the more recent articles such as the ones recently in *Investor's Business Daily* and *Barron's* struck me as so short-sighted as to lack common sense.

On the agency front, the mistake is this: These are not totally private companies, and yet the mentality of these and other articles are treating them as if they were no different than GE or IBM. The

viewpoint is also so skewed, in my opinion, that they do not understand the ramifications of what they are suggesting. If a GSE were to default on one of its obligations, anywhere in the debt structure, the trust would be broken. This could be at the preferred level or the subordinated debt level because if an agency were to default there, then why would any person think their promise to pay was valid at any other place or point in time? The point is clear to me: If an agency of the U.S. government does not honor its obligations, then there is no value in the federal charter. Further down the path of rational thinking, if one American agency does not honor its commitments, then why would any investor expect any other American agency to honor its commitments? It seems to me that the fallout from FNMA, as an example, of not paying its preferred dividend would be disastrous for not only the credit of FNMA but also

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*Common sense is not so common.*

—Voltaire

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Freddie Mac, Federal Farm Credit Bank (FFCB), and the home loan banks. The violation of a payment of debt by any agency will forever invalidate the meaning of a GSE and, in a larger sense, the reputation and honor of the U.S. government, and yet that is what recent articles have suggested to minimize the short-term difficulties of agencies that support and fund housing in the United States.

In my opinion the viewpoints recently expressed in these and other articles take no consideration of the extreme fallout that would accompany an agency not paying its debts—any of its debts. The price of the equities of FNMA and Freddie Mac were down 22 percent and 25 percent just yesterday, and the falling knife has become the meat cleaver in a nosedive. I have noticed in life that it may seem like the easiest course not to meet one's obligations. There seems to be a rather large group of people who feel that temporary setbacks can allow you

to not stand up to your responsibilities.

I have always felt that our government and the agencies represented by federal charter followed a higher standard, and I pray that I am correct in this assumption because the notion that they should not pay their debts would be a travesty for America—an absolute and final statement that the value of a GSE was null and void.

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*All the perplexities, confusion and distress in America arise not from defects in their Constitution or Confederation, nor from want of honor or virtue, so much as downright ignorance of the nature of coin, credit, and circulation.*

—U.S. President John Adams

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If some U.S. agency does not pay its debts, then the greater sadness will not be in the loss to portfolios but in the loss of common sense of our political leaders and the resultant loss of trust by investors in America and in the rest of the world who will learn quite conclusively that the United States does not honor its obligations. If you think that is too harsh, then so be it, but I choose to believe that a GSE has a meaning and that a federal charter invokes an obligation of the federal government. To be more pointed, I am ashamed and disgusted that Bernanke or Paulson or the president has not stood up and said, unequivocally, that the American government will support, if necessary, all of the debts of a U.S. agency. The rhetoric to date has been jumbled and unclear and misleading, either by attempt or construction, and I find it disheartening as an American citizen. I am happy to share the burden of increased taxes if necessary to support an obligation of my government, any obligation, as I expect the politicians that represent our country to be honorable in

their statements and actions and to pay the bills of the federally chartered agencies as they would pay the direct obligations of the debt that is guaranteed in our Constitution.

Congress has asked FNMA and Freddie Mac to assume a greater role in housing given the current difficulties, and then the government is supposed to abandon them when they have financial issues as a result? There is no claim of fraud or mismanagement beyond the normal political barbs of those of different stripes, and yet supposedly responsible people in national publications are calling for the abandonment of obligation under fire. To be honest, I am greatly saddened by the rhetoric of many of these people and amazed at their lack of judgment and inability to grasp the stark reality of what they are suggesting.

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*Government loses its claim to legitimacy when it fails to fulfill its obligations.*

—Martin L. Gross

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# ■ The Agencies and Uncertainty

*August 25, 2008*

## **FNMA and Freddie Mac: The Uncertainty Principle**

In quantum physics, the Heisenberg uncertainty principle states that locating a particle in a small region of space makes the momentum of the particle uncertain and, conversely, that measuring the momentum of a particle precisely makes the position uncertain. This postulate in the scientific world seems to have some relevance to the present state of affairs with these two agencies. The paradigm is convoluted by the structure, privately owned corporations with federal charters, government sponsorship, and a congressional mandate to provide affordable housing to the citizens of the United States. Allow me to point out that it was Congress that created this structure, which, in my view, makes the government responsible for the obligations of what they have created. The exact location or specificity, then, of these entities' obligations has become increasingly uncertain, as there are large and pertinent questions about what their obligations exactly mean to any and all parties who accepted the notion of a federally backed agency. One could argue, with some validity, that the notion currently being adjudicated and settled involving auction-rate bonds and variable-rate bonds has some bearing on the issues with these two agencies, as securities of all classes were sold with the understanding that they would get paid by these agencies of the government as the auction securities were sold with the understanding that there would be auctions. This is clearly a case where the government has taken the position that false or unwarranted claims or promises cannot be made without consequences, and, at a minimum, that standard should be held when there are governmental representations about the debts of these two agencies.

It seems clear that the right thing to do—the only thing to do as a matter of economic practicality—is then for the government to honor all of the obligations of FNMA and Freddie Mac while making sure it gets paid back for helping them out of their current crisis, which Congress from inception onward helped create. Congress has allowed, if not encouraged, commercial banks to own the preferred stock of these agencies and allowed it to be part of their capital structure, and there are no other preferreds in this class, so one must conclude that Congress was indicating that this class of securities was money good along with the subordinated debt and the senior debt. If, at any point in the financial structure, the government would cause these agencies to not live up to their obligations, then the reputations of any and all of the agencies has just been negated and the trust broken with the commercial banks, the investment banks, foreign governments, and the individuals who bought these securities relying on their federal charter. The government cannot have the Securities and Exchange Commission (SEC) and others mandated to protect the individual investor from unwarranted claims and then take a different tack when it is the government's unwarranted claims that are called into account.

It also seems that there is an argument here centering on the question of supervision. These agencies have had federal oversight since inception, with the presumed blessing of the government each time they issued a securitization, derivative, preferred stock offering, or any other obligation that these agencies have undertaken. The SEC routinely and with vigor pursues those people in supervisory positions who have had people in their capacities who have not lived up to their responsibilities, and have mandated fines for individuals and firms that have not provided adequate oversight for their employees who did not fulfill their obligations—should we now have a different standard, a lower standard, when it comes to governmental oversight? The central government has acted, in fact, as the office of supervisory jurisdiction, and that fact cannot be ignored. If you take the position that certain obligations should get paid and others not paid, then the value of a GSE becomes worthless and void. These two agencies have a supposed exposure of over two trillion dollars' worth of derivative counterparty obligations, and where do these rank in what should be paid? If you start slicing and dicing the obligations, then you negate the supposed responsibilities that come along with a federal charter, and you pronounce the governmental oversight valueless. Each and every day of FNMA's and Freddie Mac's

existence, the U.S. government has overseen their actions; if nothing else, the government must live up to the economic reality of deciding to be in that position.

The uncertainty that now surrounds FNMA and Freddie Mac has become devastating. Everything but their most senior obligations is trading like junk, and the ratings downgrades are only adding fuel to the fire. To date, the inconclusive behavior of the Treasury and the Fed has only increased the worry and speculation that surrounds the Agencies.

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*We're all trying to get our heads above the battle smoke and look for the real meaning of Enron to put it in perspective.*

—Henry Paulson

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This cannot continue and should not continue, as the government's inaction is causing additional suffering for many classes of investors. Chart the course, Secretary Paulson, and then execute the plan, and please leave our country's reputation intact!

# ■ The GSE Agencies as an Opportunity

*August 27, 2008*

I recently talked to a friend of mine who is quite senior at one of the agencies, and the topic was the equity infusion problems. The fear, and understandably so, is that the central government could show up and preempt any new capital, and this would be disastrous for obvious reasons. The idea that I floated was a convertible preferred that was structured in a novel manner. I suggested a reasonable coupon, language providing parity with all of the other preferred issuances, and then a conversion into senior debt if the Treasury interceded. I have spoken with several large institutions who are clients of mine about this concept, and there are a number of people who have expressed interest.

I want to circle back to the agency oversight discussion that I began several days ago. I think this topic is quite relevant to the current situation and has not been discussed anywhere else that I have seen. Freddie Mac and FNMA report directly to the federal government and have oversight or supervision provided by the central government. The government has in fact and without denial approved either de jure or de facto each and every issuance of preferred stock or subordinated debt that has been issued by either agency. These agencies are regulated by federal charter and overseen by the federal government, and I find it then problematical that the American government would not pay all of the obligations of these agencies without massive legal issues that would extend past the agencies and to the supervisory agency (the Office of Federal Housing Enterprise Oversight [OFHEO]) mandated by Congress. The SEC avidly proclaims that those people or institutions in a supervisory role are responsible, and there is a wealth of case law to support this concept, so I ask the pertinent question: How could the SEC not hold

the oversight division of the central government responsible for the exact same criteria if they approved the issuances of these debts and then if the agencies were forced by the Treasury to not pay their obligations?

The instance most often cited when discussing the perils of the junior debt of FNMA and Freddie Mac is the Continental Illinois Bank failure. Let me point out the obvious distinctions:

- The bank was a totally private corporation without federal charter and without government sponsorship.
- The bank was not created by an act of Congress.
- The bank was not requested by Congress to expand its role in providing affordable housing to the citizens of the country.
- The bank did not have congressionally mandated oversight that was specific and limited to the two GSE agencies.

Given the yields presently available for the preferred stock and the subordinated debt, there is a large opportunity to make money with a risk that is de minimis when all aspects of the risk are carefully considered, and I do not think that the rating agencies and others have fully appreciated the legal consequences, much less the economic problems and reputational issues that would present themselves if the agencies, with stipulated federal supervision, did not meet all of their obligations. Let me quote directly from the mission statement of OFHEO so that you can fully appreciate the context of the point I am making here:

*OFHEO's mission is to promote housing and a strong national housing finance system by ensuring the safety and soundness of Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation). OFHEO works to ensure the capital adequacy and financial safety and soundness of two housing government-sponsored enterprises (GSEs)—Fannie Mae and Freddie Mac. . . . Fannie Mae and Freddie Mac are Congressionally-chartered, publicly-owned corporations whose shares are listed on the New York Stock Exchange. Under terms of their GSE charters, they are exempt from state and local taxation and from registration requirements of the Securities and Exchange Commission. Each firm has a back-up credit line with the U.S. Treasury. . . . OFHEO's oversight responsibilities include: conducting broad based examinations of Fannie Mae and Freddie Mac; developing a risk-based capital standard, using a "stress test" that simulates stressful interest rate and credit risk*

*scenarios; making quarterly findings of capital adequacy based on minimum capital standards and a risk-based standard; prohibiting excessive executive compensation; issuing regulations concerning capital and enforcement standards; and taking necessary enforcement actions. . . . In its safety and soundness mission, OFHEO has regulatory authority similar to such other federal financial regulators as the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Board of Governors of the Federal Reserve System.*

Given the strictures of the U.S. Constitution, the arbiter of last resort in the case of the two GSE agencies not paying all of their obligations would be the judiciary. Regardless of any preemptive actions by the Treasury that would erase the obligations of the GSE agencies, which I certainly hope does not become a reality, I find it hard to believe that the courts would side with a cancellation of debts that had been approved by the oversight office mandated by Congress. Given the current yields on the preferred stock and the subordinated debt, I realize I am taking the minority view, but I find much more opportunity here than risk, though I am pointedly aware that there are different viewpoints; but also bear in mind that those viewpoints are what has created the opportunity.

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*When written in Chinese the word "crisis" is composed of two characters—one represents danger and the other represents opportunity.*

—John F. Kennedy

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# ■ What Is Given Can Be Taken

September 8, 2008

**T**he biblical text seems to ring true today, just as it provided the wisdom of millennia past. Here, we have an encapsulated rendition of the crux of the problem at hand and the foundation for the modern-day parable of FNMA and Freddie Mac, who were forced by statute to serve two masters.

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*No one can serve two masters, because either he will hate one and love the other, or be loyal to one and despise the other. You cannot serve God and riches!*

—Matthew 6:24

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One of the amazing parts of this unfolding story—to me, in any event—is that Congress asked these agencies to expand their role in housing and then axed them by Treasury fiat for fulfilling their mission. If that is not problematic on its own merits, consider that they had federal oversight the entire time from exactly the same agency, the Federal Housing Finance Agency (FHFA), that has now taken them over. Did not this same oversight agency tacitly approve the December 2007 issuance of the FNMA preferred stock and the December 2007 issuance of the Freddie preferred stock? Under U.S. securities law and regulation, does the supervisor have no culpability for the actions of what they supervised? The answer, of course, is apparently not, though the capricious exercise of power by the Treasury will still fall to the scrutiny of the judiciary and the Congress, as both will be called to task. I have no issue with the line being drawn at the equity holders, though some very high-powered money managers might disagree, but to draw it to protect the subordinated debt holders and deny the rights of the preferred holders both seems ethically wrong and an injustice to many who relied on the pronouncements of the GSE agencies when purchasing those shares.

One of the more amazing parts of the story here is that banks were encouraged and legally allowed to own the preferred shares of the federally chartered agencies as part of their capital structure, and now they are being rather severely penalized for following the government's lead. Make what argument you like, but the allowance of utilization here was not meant to discourage the use by the banks but rather to prop up and help support the preferred issuances when they came to market, which has now been shown to be nothing more than a governmental fabrication by Mr. Paulson's actions. It is my view that the action of the Treasury to not include the preferred holders as part of the bailout was morally, ethically, and legally wrong, and the last is yet to be determined.

The other problem I have with the entire bailout package is the oversight issue regarding the financials. Clearly, Paulson stated that they had found irregularities and uncovered new concerns; where was this oversight agency, the same agency that just assumed control of FNMA and Freddie Mac, during this whole process? Why should we think that their abilities as operators will be any better than their abilities as overseers? Does not the government as supervisor have legal liability for "failure to supervise" as much as the SEC and others have mandated these responsibilities for commercial and investment banks? So, one must ask if FHFA is above the law.

The large losers in the preferred debacle are some names whose stock and capital may be impaired by the nonsensical line in the sand where the Treasury decided to draw the line. American International Group (AIG) and Hartford Financial Services Group were the largest institutional preferred stockholders of Fannie and Freddie, as of year-end 2007, with AIG holding \$313.99 million in Freddie Mac preferred shares and \$266.73 million in Fannie Mae preferred stock. Of the large-cap banks, M&T Bank, Fifth Third Bancorp, and National City along with Sovereign—which may actually have the largest exposure, though you have to look in several places to find it—it appears as if their ownership equates to about 13 percent of their tangible assets. It appears that M&T has \$120.0 million, or 4 percent of its tangible capital, in the preferred stock of Fannie and Freddie; Fifth Third has \$55 million, or 1 percent of its tangible capital, in their preferred stock, while Fifth Third took \$13 million in other-than-temporary impairments on their stocks in the second quarter. The regional banks have even greater exposures to these preferred shares of Fannie and Freddie. Gateway Financial Holdings has a \$38.5 million exposure to Fannie and Freddie preferred

stock, or 34 percent of its tangible capital. Midwest Banc Holdings has \$62.0 million in preferred shares, or 32 percent of its tangible capital, and Westamerica Bancorp has \$44.5 million, or 16 percent of its tangible capital, in their preferred stock. I am sure that the smaller banks all thought they were maintaining conservative positions given the guarantee of the GSE agencies, but now the Treasury has reneged on its obligations and impaired these smaller banks.

In general, I applaud the plan but decry the execution!

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# ■ We Have Been Grievously Misled

*September 9, 2008*

It is my opinion that the judiciary will weigh in on the FNMA and Freddie Mac takeovers before this is all over. America is a country of laws, and even the government is not above the law. This is what we teach in schools and tell our children, and this is how we hold ourselves up to the rest of the world. Politicians may blunder and err in judgment, and mistakes can be made, but, in the end, the law is supposed to hold to protect the public.

Part of America's legal system rests upon case law, which has a postulate called "reliance." If you can prove that you relied on someone's assertions to do something or that their pronouncements caused you to undertake an action that you would not have otherwise engaged in then, there is legal liability.

Now let us examine the statements of the last 48 hours. Everyone, from Paulson to Dodd to the members of the Fed, is dancing around saying that all kinds of irregularities were just found that necessitated the actions of the secretary of the Treasury. One moment, please—both of the GSE agencies in question have had federal oversight and supervision this whole time. No one has accused anyone at the housing agencies of fraud or hiding anything, and the financial statements have been released quarterly under federal supervision,

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*Reasonable reliance is usually referred to as a theory of recovery in contract law. It was what a prudent person might believe and act upon based on something told by another. Sometimes a person acts in reliance on the promise of a profit or other benefit, only to learn that the statements or promises were either incorrect or were exaggerated. The one who acted to their detriment in reasonable reliance may recover damages for the costs of his/her actions or demand performance.*

—USLegal.com

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so just one moment please—where was the Federal Housing Finance Agency then? All summer long, Paulson, Bernanke, and Lockhart of the FHFA kept repeating that the two agencies were well capitalized and federal supervision was in place. People relied on all of this to make securities transactions and now we are told that the Treasury's actions were taken because of accounting irregularities and lack of capital and the management of these two federally chartered agencies is being turned over to the same group that supervised them and told us everything was fine while we went out and bought their securities based on all of these assurances.

No, no, I can see the smoke; the plain truth as seen by me is that these people either lied to all of us, to the public, or they are incompetent and have no business being in their respective positions. I do not accept the scam that these people are trying to foster upon us. I do not accept the notion that there were new irregularities, when they oversaw and supervised both agencies the entire time. These three people and other people in various governmental positions must be held accountable for either their untruths or their statements of obvious fiction, and the people of the United States and the rest of the world cannot be punished for relying on their fictitious statements when buying the securities approved by the FHFA and GSE federal agencies touted by these men as being financially sound.

The current mess that has been caused by the government must find redress in the courts or Congress, or the theory of reliance and the laws that encompass this concept have no validity, especially—most especially—as these people occupy positions in the government of public trust. It is morally, ethically, and legally wrong to have public officials who supervise the two housing agencies represent the financial soundness of these agencies, thus causing people to buy their securities, relying on their pronouncements, only to be told later that dividends will not be paid because they are protecting the American people, to whom they have been lying this entire time; or, if not lying, then misleading us by their own incompetence either singularly or in collusion, as they were the people entrusted with the oversight by Congress.

What strikes me as incremental parts of the entire agency fiasco were the raising of the mortgage limits for both FNMA and Freddie and then the lowering of the surplus requirements shortly thereafter. “The lowering of the prudential cushion was appropriate in line with the company's progress and with the need to maintain safe and sound

operations,” said oversight director Lockhart. In fact, the FHFA has supervised and directed and approved all of the FNMA and Freddie Mac operations, and they must take at least partial responsibility for the deterioration of these two agencies; yet, in a feast of irrational thinking, the government has now put them in charge of management and oversight and maligned investors worldwide as a result of their unbelievable ineptitude.

You may think I am speaking harshly, but the facts are the facts here, and the supervisors must take responsibility for their charges. This strikes me as similar to the investment bank CEOs who fired everyone in the mortgage department when they had losses, to protect their own behinds. I say loudly and clearly to the Fed, the Treasury, and the FHFA: You were entrusted to supervise the housing agencies, you failed in your duties, you have failed in your prescription for fixing the problems by your poor choice of new management, and you have grievously hurt investors who relied on your characterizations to invest in these two companies.

# ■ One Moment, Please!

*September 10, 2008*

**T**here is a commonality that exists for all children growing up in the United States. From Staten Island to Kansas City, and from Miami to the coast of Oregon, we are taught that America is a democracy and that the voice of a single citizen can make a meaningful difference. This morning, far past the age of my childhood, I shall put this long-held belief to the test.

Following is a letter that I have sent to the members of our Congress and Senate. For those of you who believe, as I do, that the owners of the preferred shares of FNMA and Freddie Mac have been grievously wronged by the actions of Secretary Paulson, I invite you to join with me and send your own letter to the elected officials of our country. Capricious dictates of a single man must not be allowed to injure the citizens of our country or the worldwide investors who relied on pronouncements of the current administration to make their financial determinations. The reputational damage that has been caused by the secretary of the Treasury must not stand.

*September 10, 2008*

*Dear Sir or Madam,*

*My name is Mark J. Grant and I run the structured finance and the syndicate departments for a publically traded investment bank. During my thirty-four year tenure on Wall Street I have run capital markets and served on the board of directors of four investment banks. I have also been president and on the board of directors of a public company in telecom. I currently write a commentary on the financial markets, Out of the Box, that is distributed to more than 5,500 financial institutions in forty-eight countries inclusive of being published by the eminent MTN-I out of London each day. In my entire life I have never written to Congress but today I am*

*relying upon the tenet that we all learned as school children; that one single American Citizen can make a difference.*

*I believe you are being misled by many people in the Administration when it comes to the shameful treatment received by the preferred shareholders in Secretary Paulson's recent takeover of FNMA and Freddie Mac. Many institutions and individuals alike relied upon the pronouncements of the government that these government-sponsored enterprises were financially sound when purchasing their shares. Preferred shares, as you know, do not represent ownership in a corporation but are merely a junior class of security to subordinated or senior debt. A very large amount of the American public are investors and for them to rely upon a federally chartered enterprise to receive dividends and then for them not to receive them as mandated by Secretary Paulson is an American injustice in my opinion and is wrong on moral, ethical and perhaps even legal grounds. These two housing agencies had federal oversight the entire time of their existence and if there were financial problems I ask why the Federal Housing Finance Agency allowed the GSE agencies to issue preferred stock to raise capital in December 2007 and then in May 2008?*

*In fact the FHFA approved the raising of the mortgage limits that the Agencies could purchase and lowered their capital ratios while Chairman Bernanke, Secretary Paulson, Director Lockhart and a slew of other people in government were assuring the American public that these agencies were on solid financial ground. Having a federal charter and having a government sponsorship is now meaningless if Congress does not stand up to the obligations of the agencies they have created and the dividends of the preferred stocks are just as much an obligation of these agencies as the classes of senior debt. One can make a valid argument, in my view, that separates the common stock from the other classes of securities but the line should have been drawn between the common stock and the other debts. To pay the subordinated and senior debt holders while leaving the preferred holder, who relied upon the government sponsorship and statements by many in the administration of financial health and an implicit government guarantee, to be without receipt of the stipulated dividends is equivalent to the U.S. government not paying its stated obligations. If you are unaware of the implications I can assure you that the American public and the world have been severely damaged by Secretary Paulson's actions as the price of the \$25.00 securities are now trading around \$3.00 and the owners are not receiving the income to which they were promised by the two agencies of the government.*

*What I ask for today is simple and straightforward; I am asking Congress to direct Secretary Paulson to pay the obligations of these two government agencies, all of the obligations, based upon federal charter, government sponsorship, federal oversight and the assurances made by those who knew, or clearly should have known, the financial soundness of these two housing agencies. The American public and other investors across the globe relied upon these pronouncements when purchasing the preferred shares and the information provided was, as we all know now, apparently inaccurate. These agencies were created by Congress, had supervision mandated by Congress, were allowed to issue securities under specified federal supervision of the FHFA and now in a capricious and executive dictate Secretary Paulson has violated the specific charters of these two government agencies that have been created by Congress. I take no issue with the overall rescue plan for FNMA and Freddie Mac but I find it inconceivable that Secretary Paulson has mandated a plan that does not pay all of the obligations of these two agencies that were specifically chartered by the American Congress. This is tantamount, in my view, to the United States of America not paying its debts and the reputational damage done to our country by the actions of Secretary Paulson is a travesty for our nation.*

*I thank you for your consideration of this matter.*

*Mark J. Grant*

# Freddie Mac and the Fairy Tale

March 12, 2009

**Y**ou may have seen the announcement, but it may not have struck you quite in the manner that it did me, which is why you are reading this, after all. Freddie Mac announced yesterday that it would book a fourth quarter loss of \$23.9 billion and that it would require \$30.8 billion of new capital from the Treasury. Freddie Mac's new CEO resigned after six months at the helm just as the numbers were released. Now here is the rub: The new capital infusion

will raise the government's position to \$45.6 billion in preferred stock with an annual coupon of 10 percent, which equates to \$4.6 billion and is more than it has earned in most previous years. This is at the same time that Congress is demanding the issuance of more mortgages at lower rates. This is akin to Paul robbing Peter and Peter having nothing but an expired Visa card. In other words, it's not working for Peter and it's not working for Paul, and there is no way, in present circumstances, that anyone can afford to buy bread.

The simple truth is that Congress has created a fairy tale by putting the housing agencies in conservatorship and then demanding the impossible and expecting to get paid back for it. The situation is not only an untenable one but, at some point, the bricks have to hit the mortar and will hit the mortar. You know, sometimes there is just no way around the obvious regardless of everyone's desire to rush around proclaiming otherwise. The reality of this situation is that no Congress has ever been idiotic enough to bankrupt a federal agency before and then scramble

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*I want to talk about political and economic fairy tales.*

—Ronald Reagan,  
40th U.S. President (1911–2004)

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around claiming some kind of ever-changing guarantee that the federal government will continue to pay the debts of two bankrupt agencies so they can continue to borrow. There is a point, and we are awfully close to it, I fear, when people will actually look at the coffee can and realize that it is empty; and let me assure you—it is empty.

With the demands put on FNMA and Freddie Mac for more lending at decreasing rates, these two agencies couldn't pay back the government if the preferred stock coupon were 1 percent and survive economically. You do not have to accept my reasoning alone here; just read what Freddie Mac itself stated yesterday: "The amounts we are obligated to pay in dividends on the senior preferred stock are substantial and will have an adverse impact on our financial position and net worth." On the issue of principal repayment, they said, "We may not be able to do so for the foreseeable future, if at all." There you go, in black and white, so please do not bury your head in the sand and look around like you didn't know what was happening.

Now you may think—and probably correctly so—that the government will be forced to do something, and I agree with that position, but just what they might do is a cause of concern to me. The right thing, of course, would be to just nationalize Freddie and FNMA and make their obligations direct obligations of the federal government, but they don't want the debt on the books, so this fantasy has continued until one day when the world realizes that the emperor has no clothes. Then, you will truly see some "shock and awe." All it would take is for China or Japan or even Bill Gross at Pimco to look at the balance sheets of these two agencies; realize that they were, in fact, bankrupt; and wonder aloud about the fuzzy guarantee, and the game would be up. This situation is not a joke, and each of you should start to ponder the outcome that may be forthcoming as a result of federal agencies that have become insolvent.

It may be that finally these agencies will get taken over and their obligations become direct obligations of the government like the Government National Mortgage Association (GNMA), as an example, but suppose that doesn't happen; now there is a frightening thought and one that must be considered. I had little faith in the government several years ago, and I can assure you that I feel no better about what they might or might not do at this point. What is absolutely clear to me is that the present situation cannot continue without severe consequences because at some point the children's game of the "pretend friend" is ended by their parents. Freddie and FNMA jointly guarantee about 50 percent

of the mortgages in this country, and they are now controlled by the government, which has created a sinkhole for these two entities that just cannot continue, in my view. With no “direct guarantee” and very questionable definitions of some sort of guarantee, does not one have to look at the balance sheets of the agencies at some point? If you do not, then prudent judgment is not being exercised. I have made my thoughts well known enough about the mortgage securitizations and questioned the “political risk” of who is going to actually pay for the losses that will surely be taken in our collective desire to help homeowners, but there, at least, is some kind of collateral for the debt. But in the plain vanilla debt of these two entities, there is nothing but a “promise to pay” by two agencies that are bleeding red ink.

The very structure that is now in place will, without doubt, make it impossible for the agencies to repay their debt without more and more government loans that cannot be repaid, by Freddie’s own admission, so these two companies are now trapped in a death spiral. The bet has now come down to only one thing: whether the government will take them over. If it does not, then someone will surely opt out of the current game of musical chairs!

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*God defend me from that Welsh fairy,  
Lest he transform me to a piece of  
cheese!*

—William Shakespeare

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