Chapter 1

The Big Hoist: Will the $700 Billion Bailout of the Mortgage and Credit Markets Work?

(It Had Better)

"It will work."

—Treasury secretary Henry Paulson, commenting after passage of the $700 billion Emergency Economic Stabilization Act

"It should help."

—Überinvestor Warren Buffett, chairman of Berkshire Hathaway

On a Thursday morning in mid-March of 2008, Treasury secretary Henry Paulson called a press conference in Washington to discuss the results of a study done by the President's Working Group on Financial Markets, which consisted of his agency and three others: the Federal Reserve, the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission

(CFTC).* Seven months earlier, Paulson had been pushing the Bush administration's line that the country's subprime mortgage crisis would not spill over to other parts of the economy or world economies. But on this morning, finally, the former Goldman Sachs CEO came clean. The setting: the National Press Club Building in downtown Washington, two blocks east of the White House on F Street, a block away from the Treasury building. Reporters from every major news organization in the United States and several overseas news outlets were there.

The report he was discussing that morning before 50 reporters and TV cameramen (who were broadcasting live) had concluded: "The turmoil in financial markets clearly was triggered by a dramatic weakening of underwriting standards for U.S. subprime mortgages, beginning in late 2004 and extending into early 2007." The report's diagnosis singled out the credit rating agencies (Fitch Ratings Ltd., Standard & Poor's, and Moody's Investors Service) and "those involved" in securitizing subprime. The diagnosis bullet-point section of the report never once used the phrases *Wall Street* or *investment bankers*. As the former head of Goldman Sachs, Paulson wasn't about to gut the beast that he once worked for. He still had good friends there.

The Treasury secretary told the press that securitization had paved the way for lower-cost mortgages to be made to millions of Americans, but also complained about what he called "extreme complexity" of financial instruments—credit default swaps (CDSs), among other instruments—and a lack of transparency for investors. A credit default swap is an insurance contract that allows an investor to bet or hedge against losses. There were $44 trillion worth (that's not a typo) of these

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*The SEC regulates financial disclosures by publicly traded lenders but not necessarily their businesses. The CFTC regulates commodities markets, including the trading of instruments that represent commodities. The Federal Reserve is the nation's central bank, whose job it is to set monetary policy and fight inflation. It also regulates banks.

contracts outstanding in the United States at last count. By comparison, the U.S. government, which is deeply in debt, owes just over $10.2 trillion on the outstanding Treasury bonds sold to finance the nation's debt. The government funds the country's operations, including paying for its defense and cutting all those Social Security checks each month.

Credit default swaps can be written by just about anyone, but usually it's insurance firms or investment banking houses. American International Group (AIG), the large insurance conglomerate (which is now owned by us, the taxpayers), wrote plenty of CDS insurance policies. When AIG—a company with $1 trillion in assets—was taken over by the government (a deal Paulson also helped put together) it had (outstanding) $70 billion in contracts or bets on subprime bonds. Would AIG be able to cover all those bets if the subprime bonds it insured went south? That's a good question, but here's an even more important question: Who regulates the CDS market? The SEC? The CFTC? Answer: *Not one government agency keeps tabs on this market,* which is why no one ever thought to look at AIG—whose primary business is insurance (including annuities to retirees)—to see if it had enough capital to cover its swap policies. (Unbeknownst to most consumers, AIG also owns two subprime lending companies, both of which are not the property of Uncle Sam.)

At the National Press Club, the Treasury secretary also blamed investors for not knowing what they were buying and cautioned that whatever regulatory changes might lie ahead, the Treasury, under his direction, would not stifle "financial innovation" in the marketplace, which meant that the creation of and trading in such instruments as credit default swaps (used to hedge or speculate, depending on what the customer wanted to do) would continue.

The next day Bear Stearns' stock plunged, and within days the government had arranged its sale to JPMorgan Chase. Six months later, President Bush signed the EESA legislation, committing the $700 billion. Ben Bernanke's team at the Federal Reserve had put together the Bear sale, consulting with Paulson over at Treasury. Paulson's former employer, Wall Street giant Goldman Sachs, had smartly avoided getting too heavily involved in financing nonbank subprime lenders and securitizing their mortgages into bonds—also known as mortgage-backed securities (MBSs) or asset-backed securities (ABSs).* But Goldman had been a bottom-fisher in this debacle, buying—for an undisclosed amount—a specialty servicer called Litton Loan Servicing. Based in Houston, Texas, Litton was the brainchild of an industry veteran named Larry Litton, whose son now ran the firm. The company's forte was servicing subprime loans for companies that were stuck with bad mortgages, especially delinquent subprime mortgages. It was a fee-based business. Banks love fee-based businesses.

KEY ISSUE

As for investors not knowing what they were buying—Paulson's words—the Treasury Department under the Emergency Economic Stabilization Act (EESA) would begin buying the very same assets. But will the U.S. Treasury Department have a handle on the troubled assets to which it is committing taxpayer money? Will it know what it is buying? And will the government not overpay for mortgages? Only time will tell.

How the $700 Billion Bailout Machine Will Work and Who Will Enforce It

The last thing in the world Republicans like to do is create permanent government jobs. It drives them crazy. It's part of who they are. Never mind that after 9/11 President Bush and a willing Congress restructured

*A mortgage-backed security (MBS) usually refers to a mortgage bond that is backed by A paper or good credit quality loans. Asset-backed security (ABS) is reserved for subprime mortgages or other receivables.

our federal law enforcement troops, creating the Department of Homeland Security, now one of the largest employers in all of government with 183,000 workers. Full-time government jobs paying benefits and retirement just means more government costs. Republicans hate stuff like that. As I've already noted, the great irony of this crisis is that the back end of the U.S. mortgage market—the companies (Fannie Mae and Freddie Mac) that buy home mortgages from lenders that deal with the public—is now in the hands of the government. The system has been socialized. The $700 billion effort to buy ailing mortgage assets from banks, investment banks, S&Ls, and other financial institutions is called the Troubled Asset Relief Program (TARP).

But, there is more to it than that. Even though the idea is to help ailing banks, the bill is so generally written it appears the Treasury has the authority to buy troubled assets (and not only mortgages) from:

- Counties
- Cities
- Retirement plans
- Foreign banks
- Foreign governments

These last two have not received much play in the media.

And as already covered, Uncle Sam has bought ownership stakes in banks—preferred stock. President Bush's chief economic adviser, Edward Lazear, promised that Uncle Sam would stay away from purchasing voting common stock and taking any seats on a bank's board of directors. (Directors are supposed to advise management on what types of loans they should be making.)

Henry Paulson and two of his top deputies at Treasury—Robert Steel and Neel Kashkari—in early 2008 actually began drawing up plans to create a Troubled Asset Relief Program (TARP) modeled after the Resolution Trust Corporation (RTC), the S&L bailout agency that sold $400 billion worth of assets (mostly commercial real estate and junk bonds) from 1989 to 1994. But Paulson never dreamed he'd ever have to actually use the plan. It was a contingency only. The EESA bill that President Bush signed does not create a new government agency. The TARP program created under EESA will be run out of the Treasury Department, which is a stone's throw from the White House. Its first director is Kashkari, a two-year veteran of Treasury who, like Paulson and Steel, used to work at Goldman Sachs. Before getting the job of running TARP, Kashkari was an assistant secretary of international affairs at Treasury. (At Goldman he did mergers and acquisitions work.) Assistant secretaries are appointed by the president and need Senate confirmation, and the same holds true of the TARP director, in this case Kashkari.

How TARP Will Work

So, the key questions are:

Will the government overpay for troubled mortgage assets so it can help certain banks?

Answer: The strategy is to buy mortgages, MBSs, and ABSs at a fair price. The government is paying cash here. The idea is that the bank selling its troubled mortgages, bonds, or whatever to the government will take that cash and go out and make new loans, whether they are loans to a commercial business like a steel mill or an auto dealership, or more mortgages. This, in theory, will alleviate the credit crunch. The government can buy troubled assets (securities, whole loans, etc.) direct or it can hold what's called a reverse auction where many different banks might bring their similar troubled mortgages to Treasury at the same time. Treasury can evaluate all the assets and offer the lowest price it can. If the selling bank doesn't like the price Treasury is offering, it won't have to sell. However, if Treasury is really serious about helping these banks get back on their feet by taking bad assets off their hands, it probably won't be too tough on price. It has to balance overpaying (to help banks) with being prudent about using the taxpayers' money. Many eyes will be watching.

I'm not sure I understand this. The Treasury is using $700 billion of taxpayer money to buy troubled mortgage assets from banks and Wall Street firms. Where did all these troubled assets come from? What's wrong with them that only the government will now buy them?

Answer: Many of these troubled assets—at least the ones that have been talked about publicly—are bonds backed by subprime mortgages. Some are nonconforming mortgages (non-A paper credit quality) such as payment option ARMs (POAs), stated-income loans, and alt-A mortgages. They were packaged into bonds mostly by Wall Street firms that then sold them to investors. But many Street firms also kept them as an investment for their own balance sheets—or were forced to do so because they could no longer find buyers for these bonds. In the case of subprime, a large percentage of the mortgages that went into these bonds are now delinquent. The nationwide delinquency rate on subprime mortgages is above of 30 percent. Because the loans are delinquent, the cash flow coming off these bonds falls way short of what the investors in these bonds had anticipated. This has caused the value of these bonds to fall—so much so that the banks holding them are forced to mark them down in value (this practice is called mark-to-market accounting) and take losses on them. Because they have fallen in value by so much, in most cases no one will buy them from the firms holding them (investment banks like Merrill Lynch and Morgan Stanley). In some cases there have been potential buyers for these bonds, but the price offered might be so low (20 cents on the dollar) that the banks holding these assets refuse to sell at such a large loss; they think, at worst, these troubled mortgage assets might be worth (for example) 60 cents on the dollar.

Does the government think these bonds will come back in value?

Answer: The Treasury Department is not expected to buy troubled mortgage bonds at 100 cents on the dollar. It has said that publicly. Contractors working for the government will review the troubled loans backing (collateralizing) these bonds and come up with a fair price for the seller. If Treasury thinks a bond is worth only 70 cents on the dollar, it might offer 65 cents to the seller. The government will then hope to sell it for 5 cents more (at 70 cents on the dollar) in a year or so or when prices improve.

Wasn't there insurance on these bonds that Wall Street created?

Answer: Yes. But the bond insurance companies that wrote the policies—firms like Ambac, Financial Guaranty Insurance Company (FGIC), and MBIA Inc.—are now in trouble financially and cannot pay off on all the insurance policies they wrote. (These firms never anticipated that the underlying subprime mortgages would have delinquency rates above 10 percent, much less 30 percent. They also had no history of writing these policies and in most cases got into this business only five years ago.)

What is a credit crunch? The media keep using that phrase to describe this crisis.

Answer: A credit crunch is a situation where businesses (in particular, companies with good prospects of turning a profit) cannot get loans easily or at reasonable rates. The same lack of money to lend can apply to consumers as well. Some banks are making it harder for their customers to obtain credit cards, for instance. Banks have been hoarding cash instead of lending it out. That's what the Treasury Department wants to avoid. The government figures lending out money to businesses will spur economic growth. When the economy regains strength, businesses will hire more workers, and those employees, in turn, will go out and buy things—like houses. That's that the theory, at least. The whole TARP plan rests on that premise, a theory.

Will Treasury use its own employees to buy mortgage assets from Wall Street, banks, and other sellers?

Answer: No. Ex-Goldman vice president Kashkari is the first director of the Troubled Asset Relief Program. He's the boss who has to sign off on asset purchases, but the Treasury does not employ any full-time mortgage traders who buy and sell assets. Until this crisis, Treasury was not in the business of purchasing and selling assets from U.S. banks and Wall Street firms. For years we've been told that the smartest mortgage traders (men and women who buy and sell mortgage bonds and pools of whole loans) work on Wall Street. This includes the big boys such at Bear Stearns (almost failed, but now part of JPMorgan Chase), Lehman Brothers (now in bankruptcy), Merrill Lynch (now part of Bank of America). Then there are the smaller boutique firms like BlackRock Inc. and PIMCO, which aren't exactly household names. These firms are the ones that will be the market makers, the companies buying and selling subprime bonds and mortgage assets on behalf of the government.

An Ugly Fact

One of the first outside contractors the Treasury hired to help it manage the auctions is Bank of New York Mellon, which is one of the nine megabanks it partly nationalized in mid-October. In other words, Treasury gave a government contract to a bank that it owns part of. To some lawyers that might look like a conflict of interest, but EESA—with its Patriot Act–like fail-safes—allows for waivers from what's called the Federal Acquisition Regulation (FAR). Translation: The government can do what it wants.

Will there be any watchdog group overseeing the bailout effort to make sure the government (the Treasury Department) doesn't screw up?

Answer: The bailout bill mandates that Congress must create an oversight panel to keep an eye on TARP's operations. The five-member panel will include overseers appointed by the Speaker and the minority leader of the House, the Senate majority and minority leaders, and one person picked by both the Speaker and the majority leader of the Senate. The bill offers no guidance on what type of people might be appointed to the panel and no prohibitions on political cronyism. If they want, the board can hire outside consultants. There is a cap—based on what is called "Level 1 of the Executive Schedule"—on how much pay the board members can receive annually. That works out to $186,000 a year apiece. Among its powers the oversight panel can:

- Commission staff from other government agencies to work for it.
- Hold hearings on the Treasury's TARP effort and request information.
- Issue reports based on its findings.

The panel will shut down its operations six months after the bailout is completed. The five members are entitled to government expense accounts, too. Even members of Congress can serve on the oversight board, but they cannot receive extra pay for their time.

As an aside, the Treasury has the power to form an office of inspector general inside the agency to keep an eye on how Kashkari and his successors, if any, manage the purchase and sale of mortgages under TARP. The inspector general must be appointed by the president of the United States.

The inspector general's office must:

- Keep a list of which banks, financial institutions, and others the government buys mortgages from.

- Explain why Treasury deemed it necessary to purchase troubled assets from each seller.
- Provide what's called "detailed biographical information" on each asset manager Treasury hires. (This last requirement could be interesting.)

I heard somewhere that the government can spend more than $700 billion. Is that true?

Answer: Even though the government has the authority to use up to $700 billion in taxpayer money to buy troubled mortgage assets from lenders, it actually has the ability to spend more—billions more—but not at once. This is how it could work: Let's say a year from now the Treasury's TARP program is tapped out and has spent the entire $700 billion, including the $250 billion to partially nationalize some U.S. banks. It can actually sell some of the assets it bought, raise money on those sales, and replenish its bailout fund. If it sells $5 billion in subprime bonds it bought from Merrill Lynch to a private investor and clears $5.2 billion on the sale, it now can use that fresh money to go out and buy more subprime bonds, ailing mortgages, and auto loans—whatever it needs.

This replenishment process can be perpetuated for several years as long as Treasury doesn't exceed—at any one time—the $700 billion figure mandated by the EESA law. The legislation signed by President Bush states that the authority (the money) "shall be limited to $700,000,000,000 outstanding at any one time." I'm not sure most members of Congress and senators who voted for the bill (or even President Bush) realized what this means. Representative Barney Frank, the Democrat from Massachusetts who chairs the House committee that oversees banking, once made this fact public in a television interview after the bill passed, but I'm not sure it has sunk in. (Rep. Frank is what's called a policy wonk, someone who actually reads and understands legislation. In years past he was also a big supporter of Fannie Mae and Freddie Mac, so he has his flaws.)

So, why do we need to invest $125 billion in our largest banks, even though most of them have enough capital?

Answer: On Monday, October 13, the chief executives of the nine largest banks and investment banking houses in the country walked into a conference room at the Treasury Department and were handed a one-page document that said they agreed to sell shares in their companies to Uncle Sam. Several of these bankers, who talked to the press without their names being disclosed, said they were floored. Paulson told them they had to sign it before they left the building that afternoon. They all complied, some begrudgingly. The next day when Paulson announced the plan to the world he said, "We regret having to take these actions."

Roughly $125 billion would be used to invest in the nine banks. Another $125 billion would be used to invest in other banks and S&Ls, presumably only institutions that had a chance of surviving the crisis. Credit unions, those nonprofit lenders that are technically owned by their members, aren't even mentioned in the bill.

If the U.S. government is buying troubled mortgage assets, why do we need to also put money into these nine banks, especially if some don't want or need the money?

Answer: There are a few ways to get the economy moving again—that is, to get banks to lend money to businesses. One way is to get someone powerful in government—the president of the United States or, say, the Treasury secretary—to jawbone the markets. A leader with credibility can call up the bankers across the country and tell them to start lending again. This is called jawboning. Sometimes such a move might work. It would appear that Paulson doesn't have that kind of juice in the banking industry. That's why he needed the EESA bill and the TARP program. The U.S. Treasury cannot move markets by just talking. Paulson has tried this in the past and it has failed. He blew his

Key Issue

Just because the government is buying stakes in nine banks—Bank of America, Citigroup, JPMorgan Chase, and Wells Fargo being among the largest—that doesn't mean these banks have to use that money to make new loans. The Treasury secretary is praying that they do.

capital with investors when he predicted that the country's subprime crisis would not spread overseas.

Why didn't Paulson mention this bank nationalization plan earlier when he was talking about the Treasury Department buying troubled assets from banks? Is that supposed to free up capital, too?

Answer: Republicans do not like the idea of the government owning stakes in private-sector financial institutions. It goes against their basic core belief in free markets. Federal Reserve chairman Ben Bernanke, early on, was in favor of the Treasury Department owning stakes in banks, but Paulson resisted. As the stock market continued to spiral downward in October, Bernanke convinced Paulson on one key point: that lending is about leverage. An amount of cash can go a long way. If Treasury, for instance, makes a $10 billion investment in a bank, that gives the bank leverage because that bank can now go out and lend $100 billion on that $10 billion. It's similar to a consumer having a 10 percent down payment and borrowing 90 percent on a home purchase. Why this didn't dawn on Paulson earlier is unclear.

If the government invests in a bank by purchasing preferred stock, what prevents that bank from using the money to buy

other banks instead of lending it out to businesses to spur the economy?

Answer: Nothing. That is one of the sad realities of the $700 billion Troubled Asset Relief Program. There are no strings attached to the money these banks—Bank of America, Citigroup, Wells Fargo, and others—receive. They can even hoard the cash, a move that will not spur new lending to businesses and consumers.

Do we have any idea how many troubled mortgages (the dollar amount) the government (the Treasury Department) will wind up buying under this bailout?

Answer: We do not. When the Treasury secretary first pitched the "we'll buy troubled mortgages" idea to Congress, the thought was that banks would take the cash they received for those troubled assets and go out and make new loans, again to businesses and consumers. However, the plan has been changing constantly since it became law, which might lead some to question whether anyone in government has a clear vision of how to fix the mess. There is even talk about the government writing insurance policies to cover losses on delinquent mortgages that have been modified to help the homeowner. Under a modified loan, the interest rate and/or principal owed could be reduced, making the monthly payments lower for the consumer. Presumably, some of the $700 billion TARP money might go toward this effort.

Will the Taxpayers Ever Get Their $700 Billion Back?

If you watched the unraveling of the credit and mortgage crisis—and the ensuing stock market collapse—you may recall that when Henry Paulson first proposed the bailout plan he promised one thing: that the government *should* be able to get most of that money back for the taxpayer, all $700 billion worth.

The plan is supposed to work like this: Bank of America, which owns one of the biggest junk heaps of the mortgage crisis—that would be Angelo Mozilo's Countrywide Home Loans, which it bought back in July 2008 just before it headed for an almost certain bankruptcy—goes to Treasury and unloads $10 billion worth of delinquent payment option ARMs (POAs), the "I'll cry tomorrow" loans where consumers keep their monthly payments low by adding onto their total debt. Treasury pays 70 cents on the dollar ($7 billion), because its outside contractor analyzing the loans for the government (an investment banking firm, perhaps a boutique firm like BlackRock Inc.) thinks that in time housing values might flatten out and the loans aren't all that delinquent, so maybe that's a fair price. (The contractor will make its assessment based on huge databases that track home prices in every single zip code in the United States.)

If housing values do flatten out or even rise and the payment option ARMs that Treasury bought from Mozilo's old institution do not go sour in greater numbers, then that 70-cent price could hold water. Two years down the road Treasury sells the old Countrywide portfolio (which it bought from Bank of America, Countrywide's new owner) to, say, a large bank like Wells Fargo for the same 70 cents. The government breaks even—except when you factor in what it pays its asset manager, BlackRock. Any sale price under 70 cents on the dollar on the Countrywide portfolio results in a loss for the government; anything over, a gain. But it's all academic whether it's going to play out that way.

No one—including the Paulson, the Treasury Department, and any of its asset manager contractors in the private sector—have any idea where home prices will be six months or a year from now (take your pick). Their hope is to make money for the taxpayer. Their profits will rest on two things: what price they pay, and whether the mortgages or bonds purchased do not get any worse in terms of delinquencies.

Right now, a bank like Bank of America cannot unload its crummy mortgages to another bank in the private sector, because no bank will pay a fair price for those assets.

So the logical follow-up question is: Will speculators be able to buy troubled assets from ailing banks and flip them at a higher price to the government?

According to details of the bill, investors who want to sell assets to the Treasury Department cannot do so at a price higher than what they paid for them. In other words, an investor who buys discounted MBSs from a seller cannot turn around and then unload the bonds to Treasury at a higher price. However, the legislation leaves a loophole: If a seller of bad assets took control of mortgage bonds through a merger/acquisition or bought them out of a conservatorship, they are exempt from the Treasury's "unjust enrichment" clause. This means Bank of America, potentially, can flip assets to Treasury because when it bought Countrywide it did so by discounting the ailing mortgages that Countrywide held.

Lewis Ranieri, the well-respected former head of Salomon Brothers who helped invent the A paper mortgage-backed security (the one that's not likely to default), once opined that "mortgages are about math." So let's talk about the arithmetic of the crisis. There is roughly $1 trillion worth of outstanding subprime loans in the United States. Let's say half of them go bad, causing $500 billion in losses. There is roughly $400 billion worth of alt-A mortgages, which are like subprime mortgages but the borrower had a higher credit score. These aren't quite as risky as subprime mortgages, so let's say 25 percent or $100 billion worth of these go south. And there are home equity loans, which are going delinquent at a rapid rate, too. There's about $800 billion worth of those, and maybe $200 billion wind up worthless. Then there are the good credit quality A paper loans that are suffering, too. That could be another $100 billion, which brings us to $900 billion in losses. Let's add in another $100 billion just to be conservative. We're at $1 trillion in losses. To date, institutions (banks, Wall Street) have taken $500 billion in losses.

We're halfway there. But we haven't added in, yet, all those credit default swaps—those insurance contracts that were written to cover losses on mortgage bonds. Insurers like AIG have to pay off on those claims only if the underlying mortgages go bad, but we don't know how many really will go bad. We know only that there are $44 trillion worth of credit default swap contracts in the United States. But we don't know how many of those are on mortgages. There can be several bets against the same bond, extrapolating those losses out exponentially. Why don't we know the losses on credit default swap contracts on subprime loans? Answer: because not one government agency is in charge of the swaps market. You might say that this is the Death Star or black hole of our financial system. There is one thought that could make all those swaps nil: Treasury could order the contracts null and void. This would stop the huge payouts on these bets—but it will not stop home mortgages from going bust. The consumer is still on the hook.

But will we get the $700 billion back like Paulson said? Then again, the TARP program involves more than just buying troubled loans and bonds. If Treasury is spending at least $250 billion of taxpayer money to buy preferred stock in banks, S&Ls, Wall Street firms, insurance companies (and others potentially), it stands to reason it will get that investment back—at least that is the plan as explained by the Treasury secretary to the public. At the very least, the preferred stock Treasury holds in these firms pays a 5 percent dividend. That's money in the bank for taxpayers. Let's just hope that none of the banks the government "owns" a piece of goes south.

Pick the very first day the government buys a batch of mortgage assets. (By law, the sale price of assets bought by the government must be posted on the Treasury Department's web site within two days.) Mark that point in time. Pick the very last day the government sells its last troubled asset. Calculate the average home price drop between those two points in time. If the government program is run properly and home values decline 20 percent going forward, taxpayers will lose $140 billion of the $700 billion. It's all about home values. Homes are the collateral for mortgages.

Should Fannie and Freddie Be Eliminated?

Up until this financial crisis came to a head in the summer of 2008, most Americans probably couldn't even tell you what Fannie Mae and Freddie Mac were, much less what they do. When they were taken over by the Treasury Department and the Federal Housing Finance Agency (their regulator) on September 7, they become front page news, not to mention the butt of jokes on *Saturday Night Live, The Daily Show with Jon Stewart*, and numerous other comedy programs. In short, they had arrived—and they were close to being broke because they owned between them $180 billion in mortgage bonds backed by subprime loans.

Fannie and Freddie are two odd financial animals in the sense they have government charters but also are publicly traded stockholder-owned companies. They were created by Congress (with the permission of the president) many decades back to provide liquidity to the mortgage market. Because they were created by Congress, they often are referred to as government-sponsored enterprises (GSEs). They purchase home mortgages from savings and loans, banks, nondepository mortgage companies, credit unions, and the like. Once these lenders sell their loans to Fannie and Freddie, they receive cash and can use that money to go out and make more mortgage loans.

The thing is, if Fannie and Freddie didn't exist, lenders would be forced to keep mortgages on their books or securitize them through Wall Street or some other source. If a bank holds loans on its balance sheet, they must be offset with a liability—a funding source like a deposit account. Banks gather deposits from consumers and businesses and then lend that money out. It's just like in that Christmastime movie, *It's a Wonderful Life*. Without deposits, there would be no source of funds to make loans, at least at the banks and S&Ls. That's how banking works. The difference between a bank's cost of deposits and what it makes on a loan is its gross profit.

The reason the government bailed out Fannie and Freddie is their size. They hold $1.4 trillion in home mortgages or bonds on their books and they guarantee (put their insurance or backing) on another $4.2 trillion of home mortgages. Their cost of funds is debt—bonds that they've sold to investors. Fannie and Freddie do not take deposits from the public. They are needed in the housing finance system because given the current mess we're in, there is no one else of their size to absorb or perform their function.

But what do we do with them? The first thing to be done is to officially nationalize them. Prior to their takeover by the government there was only an *implicit* guarantee backing the two, which meant Uncle Sam, as a technical matter, did not have to make good on any of their obligations (their borrowings in the capital markets) if they went belly-up. They had government charters but were not government institutions supported by taxpayers. Even though the guarantee was perceived, it was not etched into law. Still, everyone on Wall Street believed if they went belly-up Uncle Sam would make good on at least some of their financial obligations, which is exactly what happened.

Various ideas have been floated by academics and politicians to either merge them into one or eventually fix them and sell them to the private sector. Given the depth of the financial crisis, the best immediate plan might entail breaking them up into four regional federal housing finance agencies that continue to buy mortgages from lenders. They would be tightly regulated and have caps on what they could pay their executives. They, more or less, would be run like public utilities and their profits (if I had my way) would be used to pay down the deficit each year.

Key Issue

Even though Fannie and Freddie are now wards of the government, their regulator, the Federal Housing Finance Agency, is running them through what's called a conservatorship, which means they cannot spit without talking to their regulator. Their common stock still trades on the New York Stock Exchange, for around a $1 per share. Do not buy the shares thinking someday they will come back. They will not.