NEW YORK UNIVERSITY
JOURNAL OF LAW & BUSINESS

VOL. 10 Spring 2014 No. 2

PANEL ONE: THE REORGANIZATION OF FANNIE AND FREDDIE

PANELISTS: ADAM BADAWI, ANTHONY CASEY, DAVID SKEEL, PETER WALLISON
MODERATOR: TROY MCKENZIE

DEAN TREVOR MORRISON: Thanks, Richard, and good morning, everyone. I'm really pleased to welcome you to this conference. It's a great collaboration between the *NYU Journal of Law & Business* led by its Editor-in-Chief Peter Horn who is here—there he is right in the front—and the new Classical Liberal Institute here at NYU which, as you know, aims to examine the role of sound systems of property rights and contracts in advancing human welfare within a framework of limited government.

So the Institute is being launched just this fall, of course, under the spectacular leadership of our Professor Richard Epstein and co-directed by Professor Mario Rizzo. I really couldn't be more pleased to have the Institute here at NYU. Starting with this important conference, it's certain to be a vital contributor to a wide range of critical issues in law and policy today.

Although, of course, the Institute does have a distinctive agenda and perspective, it shares one critical goal in common with all of the centers and institutes here at NYU Law School—and there are many of them, I assure you—that is to encourage the kind of debate necessary for the public to make informed decisions about important issues of the day and to help further our understanding of law and its impact on people, policy, and institutions by engaging those very pressing issues of the day and bringing academics then in contact with current and pressing issues of public policy and with those working on those issues beyond the walls of the academies. I think the new Center is spectacularly well situated and equipped to perform outstandingly at those tasks.

For this event I'm really grateful to the *Journal* and the Institute for bringing together leading practitioners and scholars in law, finance, and economics to explore the challenges faced by Fannie and Freddie and the potential future of these government sponsored entities. I'm also grateful to the moderators and the panelists participating in today's event. The depth and diversity of knowledge and expertise in this room is really quite extraordinary.

Over the course of the day panelists will examine the reorganization of Fannie and Freddie, as well as the recent litigation surrounding Treasury's decision to wind down government sponsored entities. They'll also examine the economic policy of and future prospects for Fannie and Freddie in light of proposed legislation in the House and the Senate. The stakes in these debates, I don't need to tell you, are high and affect us all, so it really is terrific that they're getting such close attention here today.

Now to Richard Epstein, who, as you know, is the Laurence A. Tisch Professor of Law here at NYU. Richard, as we all know, is an intellectual force of the truest and best kind. Today's conference bears his wonderful imprint, and we are thrilled that he's running the new Institute here. Richard joined the NYU faculty full-time in 2010 from the University of Chicago Law School where he was the James Parker Hall Distinguished Service Professor of Law for over two decades. Prior to his joining our full-time faculty, he was a visitor here from 2007 through 2009.

Over the course of his career, Richard has taught an incredible, indeed, I would say preposterous, array of courses and has lectured and written on everything from jurisprudence to patents. Richard is, as I'm sure you all know, an incredibly productive scholar. In addition to writing dozens and dozens and dozens of articles on a wide range of legal and related subjects, he publishes a new book just about every year, putting all of the rest of us to shame. His latest book, *The Classical Liberal Constitution: The Uncertain Quest for Limited Govern-*

ment, will be out later in the fall, and we will feature it in a conference here later in the academic year.

To top it all off Richard is a truly ideal mentor and colleague. You will not encounter someone to whom ideas matter more or who is more willing, indeed eager, to engage in debate and discussion for the sake of those ideas. Yet at the same time Richard cares deeply about his students and his colleagues and, in this way, he elevates everyone's game.

I could go on and on, but that's more Richard's task than mine. I will close by thanking you all again for being here and for participating in what I'm sure will be an outstanding day. It's now my honor and pleasure to introduce the Institute's Faculty Director and the impresario of today's events, Richard Epstein.

PROFESSOR RICHARD EPSTEIN: Thank you.

[Applause]

PROFESSOR EPSTEIN: Actually Trevor and I have spent a fair amount of time together on the basketball court where I have height, he has youth—I don't know whose counts for more—and I hope one of the traditions that he will be able to revive now that he's become Dean is our morning games to which you would all, of course, be invited.

The center in the conference, and I do want to say something, which is basically the greatest magnet for discussion is failure. And so therefore when you come to Fannie and Freddie, we should have a frenzy, indeed an orgy, a good time. The issue I think has the following characteristics: There is nobody who thinks it has been done right. And there's nobody who's quite confident as to how it ought to be done some time in the future.

So as the situation started to disintegrate over the summer, what I did is I went to my industrious former research assistant Peter Horn, and I played the game which we all like to play: let's make a deal. And the deal that we tried to make was one in which we at the Classical Liberal Institute would help fund a conference which the proceeds of which would then be published in the *Journal of Law & Business*.

The great bottleneck at the NYU Law School when it comes to the organization of conferences is finding rooms. That's actually a great sign, a tribute, because it means the level of intellectual activity here is in fact extraordinarily high, and we are in constant competition and cooperation with all sorts of other institutions in trying to figure out exactly what we can do.

The game plan for today is I think best described as organized chaos. What we did is we tried to partition people into panels with some vague sense as to what it is that they would do, but our sense of order from the center is offset by our demands for initiation from the periphery which means that each author is a full and complete sovereign over the remarks that he would like to make upon the said occasions. This leads to a certain amount of inconsistency and confusion, but the alternatives are there. You could either have decentralized creativity on the one hand or centralized stagnation on the other, so I vote for a little bit of incoherence. And there is no man better to lead incoherence at this institution than my friend Troy McKenzie who spends most of his time—

[Laughter]

PROFESSOR EPSTEIN: —basically putting his glasses askance as I come forward with another one of my all too meritorious ideas. So I'm going to turn this thing over to Troy, and we will let the ceremonies and the activities begin.

PROFESSOR TROY MCKENZIE: Thank you, I think, Richard, for that lead-in. Good morning, everyone. We have, as our first panel, a panel entitled "The Reorganization of Fannie and Freddie," and with this we have a mix of scholars and observers who are going to comment on some of the issues raised both leading up to 2008, the events of 2008, and also more recently through the recent changes in 2012 in the structure of Fannie and Freddie, and perhaps some thoughts about going forward along the way.

I'm just going to do a very quick introduction of the panelists so that we can jump right into this discussion. Starting all the way over on my right, on your far left, is Peter Wallison from the American Enterprise Institute who has thought and written about these government sponsored entities for longer than many other people have and has a true wealth of knowledge about the area—certainly far more than my knowledge.

Next to him and next to me is Professor David Skeel from the University of Pennsylvania Law School who is visiting here at NYU this semester. David is a corporate scholar and also a bankruptcy scholar who happily has written quite extensively on the history of reorganization law and reorganization schemes in this country.

On my left is Adam Badawi from Wash. U. in St. Louis. He is a law professor who focuses on corporate law topics. His co-author, on my far left, is Professor Anthony Casey from the University of Chicago who is another bankruptcy scholar who will be commenting with Adam as well.

So we have lots of folks who focus on human misery and failure, and that's always a good sign. I like that. And to lead us off, up to the failure, is Peter Wallison.

[Applause]

MR. PETER WALLISON: Thanks very much, Troy. I'm going to stand up and do this because there's a whole crowd over here. They don't want to just hear an unembodied voice coming from this table. We'll try it from here.

The interesting thing about this conference to me is that we're talking about Fannie Mae and Freddie Mac. I'm now a denizen of Washington. I've been there for many years, and now I'm involved in public policy involving Washington.We don't think Fannie and Freddie are a live issue in Washington. I mean, at least, that's the way people look at it.

Fannie and Freddie are doomed according to the Washington way of thinking about it. We're going to get rid of them somehow, so why even bother thinking about things like this. In New York I find it's completely different because there is a really significant lawsuit relating to what Washington is planning to do with Fannie and Freddie, and, as a result of that, there's a lot more interest in New York. But it's a strange discrepancy between the two major cities on the East Coast that we have completely different views of Fannie and Freddie.

For example, the President has endorsed, now, some way, probably he's endorsed the Senate bill—which I'll get to in a minute—to eliminate Fannie and Freddie, and there is a House bill that would do exactly the same thing. So, in Washington we said, well, the House and the Senate want to eliminate Fannie and Freddie. It's going to happen—not necessarily true because of this lawsuit.

Let's talk about this a little. I think one of my assignments is to talk about the history of things and sort of bring you up to date, and so I'll try to do that. First of all, I ought to say what Fannie and Freddie are. Fannie and Freddie are—some of you may not know—Fannie and Freddie are government-sponsored enterprises. They were, still are, shareholder owned but now under the control of a conservator, a government conservator. But their business before they fell under the control—became insolvent and fell under the control of this conservator—was to create a secondary market in mortgages.

A secondary market means someone buys these mortgages and trades them. That's what Fannie and Freddie did. They bought mortgages. They created packages of mortgages and sold mortgage-backed securities based on these—backed by these mortgages. And they also held portfolios of their own, that is, mortgages that they had bought that they wanted to keep and profit from.

So that was their function. They were only engaged in the secondary mortgage business. They were not able to make loans directly to the homeowners, homebuyers, just bought mortgages from the originators, the lenders, of those mortgages.

Now Fannie was founded in 1938. It was originally only involved in the business of buying and holding mortgages that had been guaranteed by the government, principally FHA mortgages. The Federal Housing Administration was insuring mortgages, and Fannie would buy those. That was a good policy because what it did is it took those mortgages out of the banks, provided them with money to make additional home loans, and that would increase home ownership in the United States.

They were privatized in 1968. Originally they were a government agency. Fannie, in 1968, was privatized. That is, it was allowed to sell common shares to the public which it did. Now the important thing here is that was the time in 1968 when the government actually lost control of Fannie and Freddie. And the reason they lost control of Fannie and Freddie is that once they got into the business of securitizing and buying and selling conventional mortgages. which is what was allowed in 1968—that is, they were allowed to buy the mortgages that weren't government guaranteed—as soon as that happened they were able to start building the kind of private sector support that is so powerful in Congress. After that they became an independent organization, independent of what the executive branch wanted to do, and became much more able to defend themselves against any kind of serious regulation.

In 1992, the first serious regulation was imposed on Fannie and Freddie, but, as I was suggesting, it was not a very tough regulation. A regulator was established within the Department of Housing and Urban Development, but all it was able to do, really, was to observe them. It was not able to even adjust their capital if they were taking greater risks. It could not do things like that. It was more able to just report on Fannie and Freddie, but within that legislation, that 1992 legislation, there was a provision for a conservatorship for Fannie and Freddie, not a receivership, but a conservatorship. That has some implication, I think, for whether a bankruptcy would have been appropriate for them. That's not something I will discuss, but I'm sure my fellow panelists will. Congress did provide for them to be taken under the control of the government in case they have any kind of difficulty in 1992.

At the same time in 1992 there was something called the Affordable Housing Requirements that were adopted for Fannie and Freddie. The Affordable Housing Requirements required them, when they bought mortgages from banks and other originators, to acquire only, not only, but to acquire a quota of mortgages that were made to people who were at or below the median income in the places where they lived. That originally was at 30%, but the Department of Housing and Urban Development was given the authority to administer this law, and they raised that requirement to 56% by the year 2008.

And by the year 2008—and I think there's an article by me in your materials at the end that explains some of this—but, by the year 2008 about half of all mortgages in the United States, that would be 28 million mortgages, were subprime or otherwise weak mortgages. Seventy-four percent of that 28 million were held by government agencies, principally Fannie and Freddie. So, in my view, the reason we had a mortgage meltdown in 2007 and 2008 was because of the fact that Fannie and Freddie were directed to make loans that were ultimately going to be very weak loans.

In 2008 they began to suffer losses. In August of 2008 their stock price completely collapsed. That gave a signal to the Treasury Department that the investors had finally caught onto the fact that they were in very bad financial condition.

Treasury then stepped in, directed their regulator which is called the Federal Housing Finance Agency to take them over under a conservatorship.

Why a conservatorship rather than a receivership? As I said at the beginning, the original law that set up Fannie and Freddie allowed for a conservatorship. There had been a new law adopted in early 2008, a little bit earlier, about July of 2008, which allowed for a conservatorship or a receivership. But the Secretary of the Treasury who was really in charge of this, Hank Paulson, decided that it would be a conservatorship.

Why? His explanation, as far as I've been able to understand it, is that he was very much afraid of international complications, people losing confidence in Fannie and Freddie, and, that is, foreign investors being afraid to invest in Fannie and Freddie if they were actually in a receivership. They could have been dealt with exactly the same way by the Federal Housing Finance Agency if it was a receivership, but he thought that signal would worry foreign investors, and they would not put money into Fannie and Freddie and that would make it much more difficult to operate the U.S. housing system because Fannie and Freddie were still the dominant players, the significant buyers, of mortgages from originators and other lenders.

So that's a decision that might be criticized because it left the shareholders in place. The shares weren't worth very much of course. The institutions were both insolvent, deeply insolvent. The government ultimately had to put over $180 billion into them in order just to keep their capital at zero because they had lost all their capital plus about $180 billion. And so they could not have survived without the government's intervention in the form of new capital for them.

That is the story of what happened with Fannie and Freddie. Now what do we do in a situation in which we have these two very substantial, very powerful organizations that are at the center of our housing system? They are still in operation. They still have shareholders. Shareholders could, under the normal receivership provisions, have been wiped out; after all, their company was insolvent. They had no remaining value, but they still have their share holdings. And now those share holdings have been bought, both the preferred stock and the common stock have been bought by new investors, a lot of people speculating that they will eventually come out of the receivership and get back into the business of making money. They are now making a lot of money.

In August of 2012 the Treasury Department decided that it would be compensated for what it had done to keep Fannie and Freddie afloat, the $180-odd billion that I said had been contributed. The Treasury Department decided in August of 2012 instead of receiving a normal dividend on that preferred stock that the Treasury Department got for making these contributions, which paid about 10% on the stock annually and it's cumulative, instead of that, what they would do is require Fannie and Freddie to send them all of their earnings. They modified the stock in other words so that Fannie and Freddie were going to be sending the Treasury all of their earnings.

Why did they do this? Now I'm not privy to all the internal discussions, but the reason that many people like me thought they did it is that the then-Secretary of the Treasury Tim Geithner was always a strong opponent of Fannie and Freddie, and he was afraid that if they became profitable as they have now, if they became profitable and began to have earnings, they would recapitalize themselves. And the more capital they had, the more they looked like a profitable, a successful, corporation, the more likely it would be that Congress would be pressured into letting them out of the receivership and to return to the market probably as government-sponsored enterprises again.

For all the people in Washington who want to eliminate Fannie and Freddie, who agree that the business model is wrong and should not have been established in the first place, that is, private companies engaged in what is essentially a government mission, those people were concerned that the way things were working out without intervention would result in Fannie and Freddie eventually coming back into play.

That, I think, is the reason they modified the preferred stock payment, but we may hear more about it from other people who are participating in this conference today. So that's all I have to say that sort of brings you up to date. I hope if you have questions, we'll have a chance to answer them after the rest of my colleagues give their views. Thank you.

[Applause]

PROFESSOR MCKENZIE: Thank you, Peter. I will now turn it over to David Skeel who will speak from the, yes, lectern—

PROFESSOR DAVID SKEEL: [Interposing] From the lectern, from wherever you want me.

PROFESSOR MCKENZIE: No, that's—

PROFESSOR SKEEL: Peter has shamed us into speaking up here at least at this part—

MR. WALLISON: [Interposing] What about all these folks over here, you know?

PROFESSOR SKEEL: I don't think these folks really want to see me, but we'll let them. So thanks to Richard and to the organizers for inviting me to participate in this panel. It really is a who's who of everybody who has been involved in this debate and spoken about it from a variety of different angles.

Anyone who's had the misfortune of encountering some of my work on Dodd-Frank and the financial reforms and some of the issues we've been worrying about over the last few years would be very surprised to quickly learn that I don't have strong opinions about the Fannie and Freddie stuff. I think it's a really hard set of issues. I have very strong opinions about everything else. I think bankruptcy is better than bailouts for troubled financial institutions. I think bankruptcy is better than Title II of the Dodd-Frank Act and the new resolution rules.

But the question of what do to with Fannie and Freddie going forward is a really, really difficult question both from the political perspective, which Peter has already alluded to and, I believe, from an intellectual perspective as well. So my remarks are going to be more tentative than I typically am.

As is already becoming apparent and will become even more apparent through the course of the day, there really are two different but interconnected sets of issues that we're going to be talking about. The first issue is the question of what to do with the old shareholders and the old preferred stockholders who are now called junior preferred stockholders of Fannie and Freddie. Going forward what ought they get out of all of this?

Then the second issue is what should be the future of how we regulate the housing market. What should be the future of Fannie and Freddie or whatever the alternative to Fannie and Freddie is? What I'd like to do in my opening remarks is just say a couple of things about each of those issues. We'll, I think, talk more about them on this panel and also throughout the rest of the day.

With the first issue, what should we do about those old shareholders and old preferred stockholders, the private investors in Fannie and Freddie? One thing that's really struck me about the recent debate is that question has kind of made everybody crazy. The folks who have proposed new legislation for Fannie and Freddie, Bob Corker on the Senate side and Jeb Hensarling on the House side, have sort of given the old investors the back of the hand and have not really taken their claims to some sort of a return seriously which has made the investors crazy, and neither side seems to be willing to think seriously about the other of the two issues.

So the folks who are investors who are concerned about their returns are kind of rejecting all of the proposed legislation as deeply flawed without really considering whether either of the two bills makes sense, and the opposite is also true. I think you could speculate on reasons why the authors of the legislation have so little love for the private investors, and I have some thoughts on that, but I'll save them for the time being.

One comment I'll make generally is, it does seem to me that what is done with the private investors is very important for our overall confidence in our regulation of the housing market going forward to the extent that the resolution or the treatment of the old shareholders, common and preferred shareholders, is consistent with some version of the rule of law. I think, that's going to have implications for whatever solution we end up with going forward.

So how should we think about the old investors and the winding up of the old Fannie and Freddie? It seems to me, and I think that Adam and Tony are going to talk a lot more about this in a couple of minutes, but it seems to me a useful analogy for thinking about the private investors and the pre-crisis capital structure of Fannie and Freddie is the railroad receiverships in this country in the nineteenth century. In the nineteenth century the railroads were the first giant corporations that we had. They had some glancing similarities to Fannie and Freddie. The government was deeply involved with their success. There were subsidies of various sorts for the railroads.

The railroads were also thought to have a public interest. They were thought not to be purely private corporations.

What was the solution for the railroads when they ran into trouble? The solution was what became known as equity receivership or railroad receivershipwhich over time ultimately gave way or morphed into current Chapter 11, our current restructuring rules. How did these restructurings work? Well they worked on a basis that we now refer to as relative priority. And the idea was we sliced up the capital structure, we wrote down each class of investors, but gave them a stake in the ongoing enterprise. So the preferred stockholders would have gotten something. The common stockholders would have gotten something. We restructured them and moved forward.

When you apply this kind of a model to Fannie and Freddie, it gets quite complicated on a couple of dimensions. One is, unlike with the railroads that we knew we were going to be restructuring, there's a pretty strong argument for shutting Fannie and Freddie down. A lot of people want to do that, so there's a question of what is our model for going forward. It's further complicated by the fact that if we shut Fannie and Freddie down—if we completely privatize this market—it's not because the market's not profitable; it's because we don't like the way Fannie and Freddie have operated which sort of further complicates this. It's not that this is a business that is not viable; therefore it should be liquidated. It's a business that we don't like the way it's run. It seems to me that this is at the heart of a lot of the uncertainty with what to do with the old investors.

As a first cut, my own instinct, and as I said I don't have really strong opinions about this or conclusions about this, is that probably the best solution would be to treat the old investors as if we are restructuring Fannie and Freddie, as if we are continuing them, but to shut Fannie and Freddie down. And one of the problems right now is that the government, to me, to my eyes at least, seems to be doing precisely the opposite. It seems to be treating them as if they are going to continue. There's no evidence that they're going out of business any time soon. But it wants to treat the investors as if it's a liquidation.

To me that's a big part of what that Third Amendment, that sweep that Peter talked about, is all about. It's about a lot of things. It's about reducing the amount the taxpayers are on the hook for the bailout. But part of what it's about, I think, is pretending that we're liquidating Fannie and Freddie, shoveling all of their profits into the Treasury, out of the market, even though we're not actually liquidating Fannie and Freddie, which seems to me to be somehow backward. So probably the ideal would be to actually shut them down but to recognize this as a profitable business in the same way the railroads were profitable businesses in the way that we do the shutdown.

Just for a couple more minutes I want to say a few words about Fannie and Freddie going forward. What should we do with them or what are the options going forward? Here I was tempted to ask Peter to say what he thinks we should do with Fannie and Freddie going forward, which I assume is completely privatize them. I'm going to assume that's what Peter would say. Then I'm going to say I think I agree with Peter for the most part, but I want to play devil's advocate in this sense: I don't see the way from here to there. I just do not see how you get a fully privatized mortgage market. So it seems to me the realistic set of options is a set of options that involves a governmental role. The question is what should that governmental role look like.

We have two different kinds of visions for that governmental role. One is the Senate vision which is a partially privatized mortgage market with private investors taking the first 10% of any losses. The other is the House version which is, as I understand it, kind of an assumption that mortgage securitizers will be like utilities but that much more fully privatizes the market, more fully than I think is realistic in the current political environment.

My own first cut preference in all of this might be to forthrightly treat mortgage securitizers like utilities and analogize them to what we're trying to do with clearinghouses right now. That's been a sort of mixed experiment so far. It's not working out perfectly, but I would be sympathetic, I think, to an approach that treated the securitization process for conforming mortgages like a utility: license the utilities, regulate them heavily, but also include a government guarantee, either a complete guarantee or more than 50% which is what the House bill calls for. But, as I've said a couple of times now, I don't have strong—I don't think there's an easy first best solution here. I may well change my mind over the course of the morning.

The final thing that I would want to say is I also think it's important not just to focus on the securitization point in the process, the process that the GSEs have been most heavily involved in but the other dynamics of the market. There is a credible argument, it seems to me, that part of the problem was not just the GSEs but also an increasing concentration in the originators' side of the market which is also, in my view, something that we should be paying attention to.

So that's kind of a 30,000 foot first cut at all of this with just a couple of comments about each of the two issues we'll be talking about in the course of the day.

PROFESSOR MCKENZIE: Thank you, David.

[Applause]

PROFESSOR MCKENZIE: For a more granular look at some of the issues, I'll turn it over now to Adam and Tony who are going to, I think, stay right here.

PROFESSOR ANTHONY CASEY: Yes, and to kind of pick up on the points that David brought up, I think in asking what to do with the shareholders, and I think that's kind of what we're going to focus on, how that would look in a bankruptcy and how that affects the lawsuit. If you're shutting down Fannie and Freddie or if you're keeping them going, in some sense, the rule, the outcome there doesn't matter. It's a question of looking back: do we pay these shareholders based on where the company's at? You can hand a company over to new owners and wipe out shareholders. You can hand a company over to new owners and pay off shareholders.

The question then becomes, given that we have a direction we're going to decide on with Fannie and Freddie, how do we then deal with this, and what does it matter? I think the reason it really matters is what I'll call analogy creep. So if we start analogizing to bankruptcy and fiduciary duties and corporate governance, we have to worry about what we're saying in those contexts: if what we do here is just a political decision or if it actually is violating some rule of law the way we normally think of things.

The analogy to the railroad receiverships is an interesting one because the relative priority would pay out the shareholders based on the option value of the company going forward.

The issue with that, I think, I've written elsewhere that that's probably the way bankruptcy should think about priority, and I think David has as well. There may be five or six people who have written extensively about this but have also been rejected and criticized that that's not the current law, right?

Currently we don't have relative priority bankruptcy. We have absolute priority. I think that unless we're willing to say we're going to redo bankruptcy law, we should think about reorganizing companies under the current rule of absolute priority and under current rules of corporate fiduciary duty.

Then we have to look at the two transactions and say, well, if these are private entities, what would have happened to the reorganization if it was either a debt out-of-court restructuring or a bankruptcy—

PROFESSOR MCKENZIE: [Interposing] Tony, could you just explain—

PROFESSOR CASEY: [Interposing] Oh sure.

PROFESSOR MCKENZIE: Absolute priority—

PROFESSOR CASEY: Well I was going to get to that a little bit, so that's where I was going to go now. So the idea of absolute priority is that you pay creditors in order of—strictly in order of—priority. Senior creditors get paid first, junior creditors get paid second, and the most junior usually don't get paid. Now that's true if you're liquidating the company or you're restructuring it to go forward. We often think of bankruptcy as a snapshot to say, well, what's the company worth today. Here's what everyone gets in the new entity, right? So the idea is that it might be that shareholders have this chance of winning something in the future, but what's that chance worth today only? Is the company worth more than its debt?

So in 2008 directors are faced with this company that is insolvent or at least arguably in the zone of insolvency. I don't think anyone would say that a director would be wrong to think that the company was in the zone of insolvency. And in the zone of insolvency, a director has to have duties toward creditors, toward junior creditors, and toward equity altogether. So, if we treat the conservator like a director, they have a company that needs to be restructured.

They have two choices: they can put it in bankruptcy or they can take on new debt, and they can finance the out-of-court restructuring. I think we can look at the 2008 preferred stock purchase either way. The government comes in and says we are the only lender in the world right now, and we're the only lender that can give you the money you need. Here are our terms. Now the terms are more onerous than any terms in any other private lending agreement, but, again, they are the only lender in the world willing to do this. I don't know what fiduciary duties would say about a director taking on those terms. That's an open question. I think if the lawsuit goes forward, question one is: did I really have to take these terms? Could I have pushed back? Now there's a problem because I was negotiating with myself, right? That said, they were the only lender in the world, and they were willing to take on a lot of the risk; otherwise, the company was going to go under, and the shareholders weren't going to get anything.

Then the question is or we could just reorganize the thing, wipe out the shareholders, and the only way we would pay them is if the company is worth something more, more than the debt. That turns on a valuation that we never had. Adam's going to talk about valuation a little more. I think in that sense if the company was worth more than the debt, wiping out shareholders was fine and anything short of wiping out share—I'm sorry, if the company was worth less than the debt, wiping out shareholders was fine. Anything less than that, letting them have out of the money warrants—which might look in 2008 like that—is consistent with bankruptcy law. You say, listen, we're going to reorganize the firm. If it turns out to be wildly profitable, you'll get 20% of the most junior, junior interest in the company. But that doesn't happen, so those are out of the money warrants.

Or we could look at it like this is a financing deal with really, really strict terms. No bankruptcy court has ever approved this kind of financing deal to bridge its way through a reorganization, but again we've never seen any company needing money in a world where there's only one lender who can provide the liquidity.

That's the question. Then you get to 2012, and now you're coming close to your limit on how much you can borrow. Every quarter until August of 2012, every quarter you've had to borrow money to pay your dividend. And now, for once, you've been able to pay your dividend, right? We, the lender, say this doesn't look like a good deal for us. Creditors senior to us bear the risk every day the company continues.

The lender says, and this is in the private world, I want this reorganized. Now the directors, again, within this zone of insolvency, owe a duty to all creditors. And no one would question the duty, the ability of those directors then to file bankruptcy voluntarily.

You could say that 2012 just looks like a voluntary bankruptcy with a prepackaged deal that wipes out equity. And given that they were having trouble complying with the terms of the 2008 agreement that seems reasonable. The only question then is, when we wipe equity out, do we have to pay them anything at all. Is the company worth more than its debt? We don't have to allow the company to go forward, but if the company's worth more than its debt, they get some payment of that value.

So if we think the 2008 agreement was onerous terms that were allowable because of the crisis, then the renegotiation in 2012 really looks like a prepackaged bankruptcy. The only question then is, well, what was the company worth because in the prepackaged bankruptcy if the company's not worth its debt, shareholders get wiped out.

I think that looking at the lawsuits and the rule of law, we want to really think about that and say, we don't want to create a new rule that we can give money to equity when they're out of money. We don't want to create a new rule that we can choose which equity to give money to which some argue that GM was about. We want to have a rule that says this is what bankruptcy looks like, and this is what a reorganization would look like, and here's how we're going to apply it subject to fiduciary duties which later panels are going to talk about.

The real question then is simply, what was the company worth in August of 2012. If it was worth more than its debt, that's what the shareholders are entitled to. If not, then they're not entitled to anything. I think that's the way to think about it to make sure we're consistent with reorganization law.

On what the company was worth, Adam, I think, is going to jump on.

PROFESSOR ADAM BADAWI: Yes. The question we're asking is what was the equity worth in August of 2012 contingent on the 2008 agreement. Okay? Now we're going to get very granular and try and figure that out.

In doing that I'm going to be very generous to equity and make very generous assumptions about what the companies were going to make going forward. By doing that, I put aside a couple of issues. So they've both been making a lot of money both in late 2012 and the first half of 2013. One issue that has come up is, well, they're making a lot of money because they're releasing their loan reserves because house prices are rising at a pretty high rate. As I think we've learned, house prices don't go up forever, so we can't assume that that degree of profitability is necessarily going to stay in place.

There's also a current accounting controversy. Some of you may have seen this. They've been waiting three years to characterize loans as bad, and that's a way to simplify it, but that may change. That would also impair their profitability going forward.

Perhaps most importantly I'm going to assume that the guarantee would stay in place, right, because their profitability, their cost of capital, depends on that guarantee. As I think we all expect, the guarantee is going to be modified in some way. It may go away entirely. It may be diminished. But the plaintiffs in the lawsuit have an interest in thinking that the guarantee would stay there because that really is the value of their equity, right? It depends on that guarantee.

Under those assumptions what are Fannie and Freddie worth? Let's start with Freddie first. The liquidation preference of Treasury was roughly $72 billion at the time of the 2012 agreement. The dividend that they have to pay is 10%, roughly, so every year they have to pay $7 billion going forward. Okay? I'm just kind projecting 2013 out; going forward, that's roughly $20 billion in income a year. They have a deferred tax benefit, and I'm taking that into account. If we just think of a discounted cash flow evaluation of Freddie, we get something on the order—and this is taking into account the dividend payments—of roughly $73 billion, right?

When that happens we have to compare that to the liquidation preference of $72 billion, right? What does that mean for equity? There's not a lot left over, right? I mean maybe $1 billion which is a rounding error for this problem. This is an inexact science. There are a lot of assumptions baked in, but to my eyes it doesn't look like Freddie is worth a lot going forward. That is especially so for the common stockholders because Treasury has warrants for 80% of the common stock, right? So they would get 20% of what would be left over after the liquidation preference is paid off. It's a little different for the junior preferreds because they have priority over the common stock, but, still, we're talking about not a lot of money.

The harder case I think is Fannie. Fannie has been making more money, and there may be a case that the equity is worth something depending on the assumptions, right? So let me briefly give you those numbers.

The liquidation preference for Fannie is about $117 billion. That means they're paying a dividend of roughly $12 billion a year. They made roughly $10 billion in the second quarter of 2013, so I just assume a run rate of $40 billion per year. Again I think that's very generous. If we think about the tax benefits, incorporate all of those, our discounted cash flow there is on the order of $190 billion. Again, assuming they've been paying their dividend. After they pay off Treasury liquidation preference, under those assumptions, we have $70 billion left over for equity, right? So there's a better case for Fannie that equity deserves some sort of payout, had they done a restructuring, if we think of this as a restructuring in 2012.

As I said at the outset, I think some of these assumptions are quite heroic, right? Housing prices could start going down again. They're going to have to start increasing their loan losses so that assumption of making $40 billion a year starts to look pretty suspect. Again the accounting rule change could have a dramatic effect on the way they account for their income, so that's something to keep an eye on. And the biggest question, as I said, is what happens with this guarantee. We all think that the guarantee's going to be modified in some way. Consequently that would affect the value of equity in 2012, right? If there's no guarantee, it's worth less. We think Fannie makes the better case. I would not—I'm just somewhat skeptical about the value of equity at all given those assumptions.

PROFESSOR MCKENZIE: So I will exercise the moderator's prerogative and pepper the panel with a few questions before we open it up for cross talk. I want to turn to Tony and Adam first because it was a very interesting presentation.

One thing that's odd about this situation though is that in 2008 the decision was made not to wipe out equity. The structure of the agreement that was made to Fannie and Freddie was not what would look like an ordinary DIP loan. It looks like it's more complicated than that, and it didn't include what you would normally think of in say a Chapter 11 or a case where a deeply insolvent company has its equity wiped out.

The government didn't do that in 2008. Isn't the counter-argument to your picture that in 2012 we have to treat equity separate from the situation of 2008? We have to sort of take the picture in August of 2012 as if we now have a stand-alone entity because the decision was made in 2008 not to completely just cancel out equity.

PROFESSOR CASEY: I think my view on that when I was going was that I very puzzled by why they didn't wipe it out. I think we got some meat on that in the first talk. Here's the thing: if we think of it just as a restructuring in '08, all kinds of bankruptcies are settled by giving the junior creditor equity way out of the money warrants, right?

So usually in a bankruptcy you're going to have a huge valuation trial. You're going to be arguing the company's worth—this is obviously larger numbers—but whether a company's worth $1 billion, worth $5 billion, at some point before the trial, the parties settle, and they say let's call it $3 billion, but the junior creditors, if it ever turns out to be worth $4 billion in the next 2 years, you can buy shares. You can exercise your options. We saw this in Calpine which was this huge bankruptcy; the warrants never came due, end of story. You could say, wait, this looks just like a restructuring where we gave the juniors way out of the money options. They never materialized. Time's up, right?

Now at the same time you could say, well, no, we're going to look at this like a loan transaction because you didn't wipe them out. Again this is the analogy—what analogy we use is hard. The loan transaction, it's weird, because at one point if you could have wiped them out, you should be able to do anything short of wiping them out, but we've never seen a loan that looks like this.

In particular the term in it is they have to pay this dividend, and they're not allowed to pay down the liquidation preference which makes the dividend at the level it's at. That I don't think a judge in a bankruptcy would look at that and say that's a fine DIP financing. I don't think the argument to the judge that, oh, but we could wipe these guys out would pass muster, so I—that becomes a really difficult question of how we look at that analogy, and I think some of it turns to later panels on fiduciary duty. You're negotiating with yourself, and you're deciding whether or not to wipe people out or whether or not to give these out of money options, maybe in that instance we want to hold the assumptions as hardly against you as we can, as forcibly against you as we can.

Then we fast-forward to 2012, and what does that tell us? Well it's still the question of, we kept you around, but now you've had trouble paying your dividends, now we want to wipe you out. So now we start from fresh and say, well, can we have a prepackaged bankruptcy that wipes you out. Then we really turn to valuation. I think that's why Adam focused on the valuation into 2012, not in 2008. If the valuation in 2008, it's going to be lower, but you've kept them around, all right, bad on you if you wanted to wipe them out, what's the valuation in 2012?

That's my intuition. Again, I'm a little agnostic on it because it's such a strange set of options in 2008. Obviously politics were driving a lot of it. That we don't see as much in the restructuring.

PROFESSOR BADAWI: I would just reiterate. When we're thinking about the valuation, we're taking the 2008 terms. They could have wiped them out. It turns out they didn't. But the value of what was left under that agreement in 2012, at least with Freddie, it looks very low, probably nothing. With Fannie, who knows? There might be something. That's under the 2008 agreement.

PROFESSOR MCKENZIE: Peter, you actually mentioned why in 2008 the conservatorship approach was taken. I don't know if you can speak to this, but why not in 2008 simply say, you know what, these are deeply insolvent entities, and we're simply going to say bye-bye common shareholders and maybe the preferreds as well. There's not enough to go around. What possible impact would that have had on the markets? If it was obvious to people that these entities were insolvent, they were being taken over and bailed out, why wouldn't that have been a cleaner approach at the time? And if there was this view of keeping around equity, why go through all of the song and dance of a conservatorship at the time?

MR. WALLISON: I think a lot of mistakes were made in 2008 by Hank Paulson at the time. One of them was to leave the shareholders in place. As I said in my opening statement, he apparently thought that if they were put into receivership, many people abroad would not understand the difference between the conservatorship and the receivership and believe that if they were in receivership they would not be paid in the future if they bought the securities of Fannie and Freddie.

PROFESSOR MCKENZIE: So the debt obligations.

MR. WALLISON: The debt obligations. Under those circumstances, you can't really argue with that very much. We didn't really know what the views were of all these people abroad and so forth. That was the reason he gave.

I also should mention that he also stopped payments on another set of preferred stock that Fannie had issued to banks in the United States. A set of preferred stock that banks were encouraged to buy, especially small banks, those payments were stopped at the same time. That stock is still outstanding. Many of those banks have failed, but nevertheless, the stock is still outstanding, and there are probably legal rights associated with that preferred stock also.

I don't think there's any way to judge whether he made the right decision at the time. I wrote at the time that it was a mistake that you had to get rid of the shareholders right then and there. They would be trouble in the future no matter what you tried to do with Fannie and Freddie.

PROFESSOR MCKENZIE: So this is a question jointly for Peter and David. It sounds to me as though in hearing the history, the problem was, in 1968, privatizing these things in the first place. If that was the source of trouble, then the answer is to just have a government agency do this market-making function, secondary market function, not even a utility. Just do the way we did back before 1968 when all was halcyon and happy.

MR. WALLISON: Do you want me to try that David?

PROFESSOR SKEEL: Well let me say something and then pass it to you. I think there is a case for that. I'm a little unsympathetic to it by instinct, and so I think it's a little bit of a hard case to make. There are some arguments in favor of it. It would make it easier to continue standardizing the market if you think that having standard mortgages for consumers is a good thing. You would have that. It would be easier for that agency to negotiate effectively with originators. I think there are some arguments for it. Unfortunately you end up with the same kinds of political ballgame, the same political ballgame that we've had for the last—since before 1968. So there are some huge downsides. I'm sure Peter's going to say let's set up this agency to take charge.

[Laughter]

MR. WALLISON: One of the things David said in his opening statement was that he doesn't see a way to get to a private system, a political way to get to a private system. In fact that's a really serious problem because we have two different, very different views in Congress today. The Senate view is likely to be—can't be sure—but it looks like, the Senate view is going to come out with a government controlling the housing finance system again, like it did with Fannie and Freddie. The House view is that it can be a completely private system.

There's an easy way to get to a completely private system without restructuring everything. That is simply to reduce the conforming loan limits of Fannie and Freddie. The conforming loan limit is the size of the mortgages that they are allowed to buy. That had been going up under some kind of formula that was in the law. Now the FHFA is in charge of that. They could reduce the conforming loan limit—

PROFESSOR MCKENZIE: [Interposing] As a resident of New York, that's a terrible idea by the way. I just want you to know that—

MR. WALLISON: [Interposing] Well actually—

PROFESSOR MCKENZIE: —I will fight to the death to stop that.

MR. WALLISON: —you would end up in a better place I think. Because if you reduce the conforming loan limit then when they are withdrawn from portions of the market, the private sector would come in and fill those areas from which they've been withdrawn. Right now the private sector can't compete with them, doesn't even try, but we did have a very viable and very effective JUMBO mortgage system before this whole thing happened where people were offering mortgages that were only about 25 basis points more than what Fannie and Freddie were offering. And today, now, Wells Fargo is offering a JUMBO mortgage that is not connected with a government guarantee of any kind that is less expensive than the Fannie and Freddie mortgages.

It is entirely possible for the private system to produce a perfectly good mortgage without any federal intervention. The easy way to solve this problem with one big exception is that you just reduce their conforming loan limit until it is so low that they are no longer a factor in the market at all. The private sector would then move in and take over those activities because it's a profitable activity.

The one problem is that the Dodd-Frank Act has provisions in it, technical provisions, but has provisions in it that make it very difficult for a private securitizer to come back into the market. That's why there has not been very much of that happening since the Dodd-Frank Act was passed.

PROFESSOR SKEEL: Just a couple of things really quickly. One is—I'm not sure if anyone on this panel will know, someone out there probably does—I'm curious as to whether in conservatorships, absolute priority typically is followed or whether relative priority is followed. I know there are some folks out there who know the answer to that. The other view, the question that I would have for Tony and Adam and, that is, do you take the too big to fail subsidy into account in any way in your valuation? You've talked about the guarantee, but there's also an implicit, a bigger implicit governmental subsidy. Are you just pushing that to one side and if so why? Or are you not?

PROFESSOR BADAWI: We are pushing it aside just because it exists now or, at least, we think it does, the reason we don't push it aside is because we don't know what it would look like in the absence of it. In any event it would increase their cost of capital very substantially. Their profitability would decline. That's what we think is going to happen, but it's just a matter of what sort of guarantee it looks like going forward. If you have that kind of really high risk insurance that is being debated in one of the bills in Congress, that really is much less of a guarantee. That makes things look particularly bad for equity in 2012.

PROFESSOR MCKENZIE: I actually wanted to follow up on the conservator question because I don't know if anyone out there has dealt with say an insurance conservatorship—

PROFESSOR SKEEL: [Interposing] That would be Randy.

[Crosstalk]

PROFESSOR MCKENZIE: One thing that I—this is from just sort of little snippets I've gotten from others—that very often there's not a very thick case law when, in some of these—and they come in waves, it'll be a bunch of Pennsylvania insurers that go under—then no one knows what law to look to, so what do you do? You start borrowing from bankruptcy without necessarily thinking what is the best analogy which ends up becoming an issue? Randy, do you want to?

MR. RANDALL GUYNN: So let me just give a quick answer to David's question about the conservatorship sort of priority scheme. I can't figure out how to raise this.

PROFESSOR MCKENZIE: They think I'm going to be asking the questions.

[Laughter, crosstalk]

MR. GUYNN: It's very important. There are not always perfect analogies, and people often sort of analogize a conservatorship to a reorganization, but it's not really. A conservatorship is probably better analogized as sort of open bank assistance. I mean the thing is just continuing to be run. If you look at the provisions in both the Fannie and Freddie provisions and the bank resolutions provisions, there is no claims process for a conservatorship. That's only in the case of a receivership. So the way it works is the conservatorship goes along, it's either successful and the institution becomes recapitalized, healthy, and continues on and then the conservatorship is terminated and off goes the conservator or you convert the conservatorship into a receivership at which point you do a liquidation and have the priority rules under the liquidation.

PROFESSOR MCKENZIE: Interesting. So it's almost like a stopgap in a way than it's either we do this until healthy or do this until we wind you down and have a claims resolutions process and so forth—

MR. GUYNN: [Interposing] Yeah, and I'm going to talk—I'm going to talk about this a little bit more on the panel that I'm on later on. But it's interesting because with the conservatorship, one of the points is that the Freddie and Fannie conservatorships are really, at least in my view, the first genuine conservatorships we've ever seen in the United States. So when you've seen conservatorships in the past, you heard about them with thrifts and banks in the past, say during the S&L

crisis, they really weren't conservatorships like we see with Fannie and Freddie. They are what are called pass-through receiverships or pass-through conservatorships. They really just used conservatorship to create what is now known as a bridge bank device because in the old provisions that applied to thrifts there was no bridge bank option the way there is in the Federal Deposit Insurance Act. So to create sort of the functional equivalent, the FDIC and the FSLIC sort of invented this thing called pass-through receivership or pass-through conservatorship. All of those conservatorships were never intended to sort of get the institutions back on their feet and healthy. They were designed to hold onto them like a bridge bank, sell the institution or liquidate it, just convert to a receivership.

PROFESSOR MCKENZIE: Peter?

MR. WALLISON: Yeah, I just wanted to add one thing. Just so people understand a little bit more about a conservatorship. A conservatorship you could think of as the board of directors still running the firm; in fact, the board of directors of both Fannie and Freddie are still there, and their managements are still in place.

But above them is the conservator who is a government official, who sets policies for them. The only thing he can really do is conserve their assets. That's why it's called a conservatorship. He cannot wind them down or take major steps like that, but he can conserve their assets. That's the position he's been taking now for five years. He's saying, my role is to conserve their assets for the taxpayers who have put them in being by supporting them all these years, and I'm not going to allow them to do anything that reduces what ultimately will go to the taxpayers. That's one of the reasons why this is somewhat complicated.

PROFESSOR MCKENZIE: I think we can open it up for questions.

MR. HUGH MCCULLOUGH: I'm Hugh McCullough, recently retired from Ohio State's Economic Department. I'm all in favor of reorganizing and privatizing Fannie and Freddie, probably they will survive or maybe they won't. We should let the market decide that. In a receivership and a bankruptcy, I mean they're apparently insolvent, so they should go through a bankruptcy, and then maybe it will survive, maybe it won't. But in evaluating their assets, they've got like $1 trillion of shaky mortgages each on their balance sheets which are worth somewhat less.

In addition they each have about $1 trillion's worth of mortgage-backed securities that they have pooled and guaranteed and sold to the market. So this is kind of a contingent claim on them. What would be the priority of these contingent claims which are no longer on their balance sheet but which they are liable for in the ordinary course of business? If they stayed alive, they would be liable for that. Are those junior or are they senior? What would be their—now maybe the Fed owns all those and so the taxpayers may be on the hook for all those anyway—but how would those be evaluated?

PROFESSOR CASEY: I think with these structures, you have the debt and the bondholders and the recipients of the guarantees are going to be treated as creditors above any shareholders. The idea right now is that and partly why I think the conservator is taking the position is that if we wipe out equity now and tell you what, we can make sure everyone above us gets paid, I think that's their theory, that all creditors—all creditors above equity get paid. I think that's the way they're looking at this is to say we're maximizing the estate because we're making sure we can make good on all of these obligations.

Now I want Adam to talk to this. There is a bit of a problem with this because they're selling the obligations, and to guarantee that goal of winding down and flooding the market with them, I think creates other issues.

PROFESSOR BADAWI: Yeah, we've been thinking about it as a going concern, but if they're actually getting rid of those assets, as you suggested, they're not going to get their current value for them. If we think back to the savings and loan crisis, when they tried to get rid of those assets, it was a long, slow grind with a lot of impaired value.

MR. MCCULLOUGH: But that was stuff on their books, but this is stuff that isn't on their books, but they're liable for it nevertheless. They've written options which might get exercised five years down the road. I mean they have a mortgage-backed security full of subprime mortgages. Maybe they're still paying right now, but if they put their guarantee on it in five years from now it defaults, they're going to pay it, which is worth something, but it's not really a creditor claim, it's a contingent; it's an option claim for an option they've written.

PROFESSOR SKEEL: In a bankruptcy process you can handle a contingent claim. It's just a claim against the assets. Randy is saying it's going to—they're just going to disappear which I don't—

[Off mic comment]

PROFESSOR SKEEL: I think it would be a claim, and my guess would be the government is planning on making good on those claims, but I don't know. Peter?

MR. WALLISON: Yeah, this is a 30-year claim. It's a 30-year contingent claim because these mortgages are out there for 30 years.

MR. MCCULLOUGH: Those are a tiny portion of them though.

MR. WALLISON: A portion of them.

MR. MCCULLOUGH: Most of them will be gone by 10 years.

MR. WALLISON: [Interposing] Most of them, yeah. People will move, and the mortgages will be repaid and so forth. But in theory, there will be a lot of mortgages still outstanding 30 years from now.

MR. MCCULLOUGH: [Interposing] And we do not yet know whether they're in default and whether—

MR. WALLISON: [Interposing] Right, exactly, so I've always thought when they are finally wound down to the point where they have to be liquidated or whatever, what the government will do is defease them, that is it will put U.S. government securities in a trust. The trust will then be used to pay off anyone who has a claim within that 30-year period, and the remainder after it's over would go back to the Treasury Department. I can't see any other way to cover those claims if they themselves are going to be out of business.

PROFESSOR CASEY: [Interposing] I also think—I mean I think every time we guarantee a loan, and there's an asset and liability, right? So when they brought—so they were getting paid to guarantee loans, right? So this is the idea.

MR. MCCULLOUGH: They got a commission for it, yeah.

PROFESSOR CASEY: Yeah, and so they have assets and liabilities on the book. So part of it is they're having the government take over some of this, but they're keeping some of it. The odd thing about this is the Treasury is buying debt, buying securities, and guaranteeing things, right? So they're serving three different roles, right? They're a guarantor, they're a purchaser, and they're running the company. But I think the way to think about it is you have assets and liabilities, and these are just creditors, but ultimately if the company gets wound down they're just going to push this to the government. I think the whole view of the conservator is we've got to—we're not going to let the market collapse, and that's why we're wiping out everyone below us which I think they view these as creditors.

PROFESSOR MCKENZIE: Randy, you were going to comment on the?

MR. GUYNN: [inaudible] So this may be one of the other reasons they actually chose Fannie and Freddie to a consevartorship – receivership because if you look at Section whatever it is, whatever the provision for the resolution of Fannie and Freddie, it is only just the market – and the FDIC has always taken the position that contingent liability, when you put an institution in receivership, it just disappears. It wipes out—

PROFESSOR MCKENZIE: [Interposing] They don't have a reserve for it or anything?

MR. GUYNN: —no, the point I'm trying to make is that the contingent plays like guarantees are wiped out, they're totally unenforceable, and to the extent they passed – 16 provisions – the damage – by wiping out contingent claims being zero because they're limited to direct compensatory damages, and you don't have any on the day that the receiver is appointed. Now the reason this is such a big issue, and we focus on it – big issue in Dodd-Frank, and you look at how Dodd-Frank is unlike the bank receivership provisions, there's actually provision that defines the word claim which includes the contingent claims that's taken out of bankruptcy code because we didn't want the contingent claims to be wiped out. The update is now made it for the default might wipe those out, and it's been a little bit fuzzy about that. So at least with traditional banks it's – if you put Fannie and Freddie into receivership, all those guarantees – at least they felt the FDIC which is based on exactly the same set of language.

PROFESSOR SKEEL: Do you think there's any chance they'll do that? That they'll really just let all those go?

MR. GUYNN: —receivership.

MR. MCCULLOUGH: Well would this be your absolute versus relative valuation? The absolute valuation is that it doesn't exist yet so it's gone. Relative is we try to—

[Crosstalk]

PROFESSOR CASEY: [Interposing] No, no—

PROFESSOR SKEEL: [Interposing] This is not absolute priority. This is—

PROFESSOR CASEY: [Interposing] Certainly bankruptcy would have it. I was going to say bankruptcy has—they deal with contingent claims. You can value those—

MR. MCCULLOUGH: [Interposing] But the relative valuation tries to estimate the option values?

PROFESSOR CASEY: Well so the difference between the relative and absolute priority, so absolute priority will say what's it worth today. I did relative priorities. If you snapshot it today, you're cutting out my chance of an upside, right? So relative priority is simply saying even though it's worth $100 today, someone could get paid if it was worth $150, and it might be worth $200. We need to pay them something for that increment over $100, right?

So I don't think—that doesn't answer this question. A Contingent claim is simply if I have a contingent claim, what's it worth? I get paid that today. The relative and absolute is when you have layers of claims. You have someone who gets paid the $100, and someone gets paid the next $100. That's just a question of do I say it's worth $100 today, so you get paid $100 or do I say, well, it might be worth $150, so you get $75, and you get $25.

MR. WALLISON: I can add one point here and that is that the difference between what Randy was talking about and this situation is that the contingent claims of banks are not or never were seen as guaranteed in any way by the federal government, whereas in Fannie and Freddie's case it's seen as guaranteed by the federal government, implicitly, but the government has certainly suggested that those were claims that it would take care of.

[Crosstalk, off mic comments]

PROFESSOR MCKENZIE: Yeah, the bonds explicitly say that—

MR. WALLISON: [Interposing] Of course they explicitly say that the government—

[Laughter, crosstalk]

MR. WALLISON: —has always and the Treasury Department has always said we are not going to cover these. We are not going to cover these until they have to be covered in which case they covered them. And so the market was always correct that the government was going to rescue anyone who was an investor in Fannie and Freddie. But in this case, it would be very damaging, I think, to the credibility of the U.S. government if they simply let the contingent claims on Fannie and Freddie go poof.

PROFESSOR MCKENZIE: It reminds me of a great moment in Simpson's lore, a fake commercial where AdMan says, "I guarantee it," and then the voiceover says, "Not a guarantee."

[Laughter]

PROFESSOR MCKENZIE: There's another question back there.

DR. MARK WILLIS: I just want to make a sidebar comment here. Peter could make the same one which is one of the big issues I thought about conservatorship is it didn't require putting all this debt and all these promises, contingent liabilities, on the federal balance sheet. We can discuss the legal pieces here, but there was this whole political issue, Peter may want to comment more, that I think was driving because we see that as a very important issue in Congress as to how big the balance sheet is. GAO has their own opinions about all this. So there's a whole other non-legal discussion going on here that I think affected the political decision. The decision was affected by politics.

AUDIENCE MEMBER: Just a quick point of clarification. It's my understanding, and I don't actually remember which amendment to the preferred stock approach agreement actually clarifies that the obligations of the GSEs will continue to be supported by Treasury on a go-forward basis. There was an expiration date at one point, and then in the second or third amendment, it was made clear because, frankly, there was uncertainty particularly for some of the foreign investors—

PROFESSOR MCKENZIE: [Interposing] The debt obligations would be—

AUDIENCE MEMBER: [Interposing] Well it says the obligations.

PROFESSOR MCKENZIE: The obligations.

AUDIENCE MEMBER: So arguably the contingent liability in the guarantees are debt as well for them. Just one other comment I'd like to make. It is I think in Peter's opening comments, he said one of the reasons that there's a lot of focus on this topic now in New York is looking at particularly the interest of the junior preferred shareholders. I would respectfully submit that one of the other reasons there's lots of interest here in New York is looking towards the stability of the mortgage marketplace, the second largest fixed-income market in the world and what the implications are for what the future state will or won't be.

I happen to be at BlackRock, one of the largest asset managers who has lots of exposure on behalf of our clients to this sector, so while it's fascinating about sort of what the future state is relative to the existing shareholders of Fannie and Freddie, I would respectfully submit that part of the broader conversation is what are the implications for the mortgage market going forward in what replaces them.

PROFESSOR MCKENZIE: Other questions? Richard?

PROFESSOR EPSTEIN: Yeah, I'm going to ask the following question. Why is it you just called on me at this point—?

[Laughter]

PROFESSOR MCKENZIE: Because you were twitching, Richard.

[Laughter]

PROFESSOR MCKENZIE: And you looked like you were about to explode.

PROFESSOR EPSTEIN: No, no, no, I never explode. 'm a genial, happy fellow. But one of the questions that I'm going to sort of talk about this afternoon as everything starts to slop into everything else is you've always talked about the guarantee on the one side, but the question is the guarantee at some point becomes paired with the affirmative obligation to issue subprime mortgages that the government is going to put. So let's just ask the question What's the legal status, if in fact the government says to a private corporation, you must enter into losing transactions and doesn't give a guarantee either express or implied.

PROFESSOR MCKENZIE: Were these losing transactions?

PROFESSOR EPSTEIN: Well let me put it this way. Subprime mortgage, right? The government has to command private parties in order to engage in these sorts of things. They are kind of encouraging them to do that and to engage in them. Doesn't that sort of suggest that they're going to be losing transactions unless it's a guarantee? You put this money out there and lend it to people that can't repay it. And the government says we want you to enter into these things. We want you to lend $1,000 today. We understand what the interest rates are on the default risk, and we confidently expect you'll get $750 back at the end of the day. Why isn't that a $250 loss? And if so and the government then requires you to do that, can't you understand the guarantee is the quid pro quo for the obligation to lend?

PROFESSOR CASEY: So the question would be so who are they guaranteeing, right? You could say it is a guarantee to all the creditors because the creditors then give a lower interest rate. Shareholders are getting compensated for it at that moment. It's not—I think you're right to say there's an implicit guarantee, but the question is how deep does the guarantee go? It doesn't necessarily mean that it's a guarantee all the way to the bottom—

PROFESSOR EPSTEIN: [Interposing] Well therein lies the question. I didn't write these guarantees.

[Laughter, crosstalk]

PROFESSOR CASEY: Well let's put it this way though. If you have a guarantee that costs less—I don't think people were saying you're getting a totally risk-free investment—so someone has to be bearing the risk, and I think if the shareholders are getting a lower cost of credit because you're guaranteeing debtors, that's a guarantee, right?

PROFESSOR EPSTEIN: Well if they are doing that but there's always the question of what the relative value is of the risk that they have to—

PROFESSOR CASEY: [Interposing] But the price of the shares suggested that they thought that it was a guarantee of the creditors, right?

PROFESSOR EPSTEIN: Why is that it? But what's the point? If the price of the shares stays up, right? Isn't that kind of a sign that it's a thick guarantee?

PROFESSOR CASEY: Well but we don't know—I said it's a guarantee but not where we draw the line—

PROFESSOR EPSTEIN: [Interposing] There is a joke about the social contract which carries over to this particular case.

PROFESSOR MCKENZIE: I want to hear this one.

PROFESSOR EPSTEIN: Well the joke about the social contract is it's not worth the paper it's not written on.

[Laughter]

PROFESSOR EPSTEIN: Essentially what the argument means is we know there's an obligation, but we can't find it, we can't locate it. I think the fundamental problem here is that you cannot monetize the guarantee, and you cannot monetize the obligation running in the opposite direction to issue these subprime mortgages. So therefore when you're trying to figure out what the relative values are, if, in fact, it turns out that the obligation is more onerous than the guarantee, that transaction becomes terribly suspect by the government. If it turns out it's the other way, then it turns out that it's a rip-off of the United States. Nobody at the time that these things happened knows. I just don't understand how anyone could be so confident as to what's going on when everybody seems to agree with me.

[Laughter]

PROFESSOR EPSTEIN: That there are difficulties in running valuations both ways.

[Crosstalk, laughter]

DR. MARK WILLIS: The Professor succeeded in creating chaos for the day. We will be talking about this as I thought at the last panel, but the basic assumption—he asks a very good question —but the basic premise was that somehow Fannie and Freddie were asked to do bad loans. There is no evidence of that. Peter will disagree, right? For the affordable housing goals, which are—CRA is one thing that's blamed, and for disclosure here, I ran Community Development at JPMorgan Chase for 19 years; so there may be some expertise in that or you can question that as well.

In the CRA area the amount of subprime loans that were done by banks that were eligible for CRA credit amounted to six percent of the market, a ridiculously small amount to argue that that somehow caused it. The affordable housing goals, the Fed and others have done studies here that show that they did not have any major impact and maybe none at all. I'm kind of in the middle camp here that maybe it helped accelerate it by buying the AAA pieces of the subprime securities. The AAA pieces have not lost any money. Fannie and Freddie did not lose money on the AAA pieces.

The B pieces, the subordinate, were kept by the issuers, the private sector investment bankers that somehow we forget mispriced risk, they kept that risk. They were the ones that if no one was willing to take the subordinate piece those securities never would have existed. I have no problem, Fannie and Freddie should not have run a hedge fund as we sometimes refer to it, so even buying the AAA pieces, even if those were wise, we shouldn't have allowed them to do that with low cost funds that were low cost because of the federal guarantee.

There just is no real evidence here that the government forced the private sector to do what they did. Fannie and Freddie, what they did lose money is on the Alt A, no doc loans, and those were non-goals rich if you look at them—

PROFESSOR MCKENZIE: [Interposing] No doc loans?

DR. WILLIS: No documentation, sorry. Income, job, wealth, whatever assets. But those were non-goals rich. If you look at them they actually hurt their ability to meet the affordable housing goals. This is, forgive me Peter, this is all a myth created by some statistics that his colleague at PIMCO does. We could get into the details of that but thinking that the government, which when the government's involved it can politicize something, and I'm not arguing that, but whether that's what led to this crisis, I think is quite honestly requires a deeper look. Thanks.

MR. WALLISON: Let me just respond.

PROFESSOR MCKENZIE: Peter, I think you have a personal prerogative here.

MR. WALLISON: Yeah. I've really done a lot of work in this area, and I have a book coming out, hopefully, next year, or maybe in 2015 because it takes a while to get these books out. But I can assure you there's plenty of data which we did not just hear. We just heard a statement that there's no evidence. But there's plenty of evidence by things that Fannie and Freddie said, and by the numbers of subprime mortgages outstanding as a result of what Fannie and Freddie did under the affordable housing requirements. That will all be made clear, and the important point is this will be the first time that the evidence is actually in the market, so people can look at it. I assure you there's plenty of it, and it's a very compelling case.

I want to just respond to what our boss here said because the point that was—

[Crosstalk, laughter]

MR. WALLISON: Richard. The point of Richard's remarks was it was correct that there is an implication of a government guarantee when you require people to buy low quality mortgages, and that's what was happening under the affordable housing requirements. But no one would have bought the securities that Fannie and Freddie were guaranteeing or insuring, however you put it, without the sense that they had that the government was guaranteeing them. And that the government never successfully countered.

PROFESSOR MCKENZIE: But does the government have an obligation to counter that though?

MR. WALLISON: Yeah, I think it did. I personally had many visits from people in foreign central banks that were buying a lot of government guaranteed securities, Fannie and Freddie guaranteed securities. They were asking me, well, will the government stand behind this? I said I don't know, you should go and ask Treasury. And Treasury would never respond to that. They would say publicly that they were not guaranteeing these securities, but they would not communicate with the foreign central banks and say do not buy these securities because we are not standing behind them.

PROFESSOR MCKENZIE: So I'm going to jump on that for a moment then because there's a suggestion then that the role of the government in all of this is to take the tender, toddler hands of sophisticated parties and walk them through all of their investment decisions and tell them let me make this very, very clear. Here's what you should do. Here's what you shouldn't do. I mean on some level we're dealing with big boys here, right? If the government will never say explicitly we're giving you a guarantee, well you should know what that means.

There's obviously a political price that would be paid for totally withdrawing from the market. And sure enough when 2008 came along the implicit guarantee was concretized because of the foreign policy and the internal political ramifications, but this is partly a provocation of you and also of Richard's point. I mean what more was the government supposed to do? Once it's in this mess, what more was the government supposed to communicate to the world?

MR. WALLISON: I can't imagine. I mean they made the mess.

PROFESSOR MCKENZIE: Yes.

MR. WALLISON: But the fact is that every time a government sponsored enterprise has gotten into trouble, and this is not the first time, the government has stepped in and bailed everybody out. Still they say they are not responsible for government-sponsored enterprises; that that's what the law says. But they have done it. And the market doesn't, correctly, does not believe what the government says. It believes only what the government actually does, and that's one of the reasons why we had a financial crisis because after Bear Stearns the market assumed that they were going to bail out every institution at least larger than Bear—

PROFESSOR MCKENZIE: [Interposing] Until they didn't.

MR. WALLISON: Until they didn't.

PROFESSOR MCKENZIE: Until they didn't. A question.

AUDIENCE MEMBER: Yes, this is for the bankruptcy professionals in the room. I have made many DIP loans. It's called rescue loans, pre-bankruptcy rescue loans. All of those loans entail some sort of financial projections from the debtor or the borrower. In this case the borrower and the conservator share the same information. None of those DIP loans or rescue loans had any clause that I'm aware of that allowed me as the lender to unilaterally change the terms of the loan. Nor did any of them ever require that I could change the form of my loan in that if I'm going to make a loan I own a certain type of security, I don't get to change that type of security.

Then the last question—that's part one—part two is because I'm receiving financial projections, I know the value of the firm going forward. It seems somewhat suspect that the terms were changed one month or two months prior to these firms becoming profitable. Any valuation looks forward. I'm lending at a certain rate. Then all of a sudden I change the terms based upon my private information that I have. That seems unlike anything I've ever seen.

PROFESSOR CASEY: So I guess I would push back a little. The agreements never have that in them, but they factor when someone defaults. You renegotiate, and you very forcefully—and I know they had—

[Crosstalk]

AUDIENCE MEMBER: [Interposing] You're only allowed to renegotiate when you have a default on a covenant. So if I make a DIP—

PROFESSOR CASEY: [Interposing] Well.

AUDIENCE MEMBER: —well, no, I do this for a living. When I make a DIP loan, I am not allowed to call them and say I changed my mind a month later and you make—

PROFESSOR CASEY: [Interposing] But when they file bankruptcy, and they want more financing from you—

[Crosstalk]

AUDIENCE MEMBER: [Interposing] Right, but they didn't.

PROFESSOR CASEY: —so here's—I think just to think about it's a de facto, not legal, so when a company has been borrowing from you, getting close to their limit, and they say, listen, we the directors have a duty to other creditors than you. I think that's the way to think about the conservator in 2012 to say, yeah, we've had one quarter of profit, but you project out the last 12 that we've lost record amounts of money, that's not showing us—and Moody said this, this not showing us able to pay our dividends.

So the duty for the directors would be we have to keep the estate from just collapsing and having the other creditors lose money. So we're going to file for bankruptcy, and we need financing. And at that point DIP lenders always say, well, you liked the terms we had before, but now the interest rate is much higher, and I have senior priority. Let's roll it up so I have super priority so all my loans get taken first. I mean, when a debtor is sitting in bankruptcy—

AUDIENCE MEMBER: [Interposing] I would agree with that except for in a bankruptcy there's a judge—

[Crosstalk]

PROFESSOR CASEY: [Interposing] Yeah, I agree. Absolutely. That's the thing about the valuation, right. So the analogy simply is, you know, you said you do this for a living, when I was a debtor's lawyer, you made my life horrible, right? You were saying, hey, you know what, you have to do this, you have to do this, you have to do this right? You're right; the only difference here is we don't have a judge.

And that's why I think Adam's point about the valuation is right.But it looks a lot like what would happen if you had a loan, you changed the terms when the company files bankruptcy, and they want—because otherwise you're going to force me to accelerate the loan and say pay me today. I'm not going to do that, I'm going to renegotiate, and I'm going to do whatever you want.

AUDIENCE MEMBER: Right. But in this case the debtor and the lender were the same person.

PROFESSOR CASEY: Absolutely right. That's the—I think that's the later panel. So I think the analogy I think holds, the question is simply given the politics of it, do we think it's allowable but I think really in the private sector you would wipe out equity here. They're not changing the terms. They're just prepacking it for bankruptcy.

PROFESSOR MCKENZIE: So actually there's a second point you made about when the terms were changed in August 2012, and it looked as though there is now going to be a profit stream coming in. If you go and read the complaints relating to the August 2012 amendment, the complaints very nicely captured that point that there's this moment in time when the amendment occurs and that it looks as though there's now a projection of profitability. So the point you made is one that the plaintiffs are actually picking up on—

[Crosstalk]

AUDIENCE MEMBER: But it's not just a projection of the profitability. Part of what happened was that the revenue line was going to go up no matter what. And the reason is because the revenue line is based upon a future cash flow for the guarantee. So we already see housing prices start to rise. But more importantly they increase the G-fee. So an analogy, in a bankruptcy, would be I raise my prices and the price—so I'm a commodity company, and the commodity price just doubled. So the value of the firm in a snapshot all of a sudden goes up. To your Calpine example.

PROFESSOR CASEY: But they still—the issue is though that they still view the DIP loan—they still have to pay into the first $20 billion they make. And if you're a creditor, between equity and you, you say wait a second, so this all looks fine because you've now been able to pay your dividend for the first time and let's say you can do that for the next three years but you can't pay me or the junior creditor at all. And what if the market tanks in a year?

Then I, the junior creditor, between equity and DIP lender am bearing all the risk. This is where the director, again, putting aside—so the director has as duty to say we have our senior creditors, they're fine. They're getting paid $20 billion every quarter or every year on a quarterly basis. We have preferred; they're happy. But wait, the bondholders are bearing all the risk. If the market, if the real estate market collapses in 2014, who gets hurt? The bond-holders. So the conservator says I'm going to reorganize this to guarantee all the creditors to maximize the value of the estate.

AUDIENCE MEMBER: But they're not because what they're doing is they're stripping all the value out of the estate. If the—

PROFESSOR CASEY: [Interposing] No, no, no, they're stripping all the value out of equity.

AUDIENCE MEMBER: No, if they were recapitalizing, how's that? How are they dividending money to a senior preferred which doesn't reduce any liability whatsoever—

PROFESSOR CASEY: [Interposing] That's under the previous terms.

AUDIENCE MEMBER: —and—that's on the default—

PROFESSOR CASEY: [Interposing] But they waived those terms. So the dividending money—

AUDIENCE MEMBER: —in 2012. So the dividends—if the dividends weren't paid, if it were a 10% dividend, and all the capital were left in the companies to recapitalize the companies, then I would agree with you.

PROFESSOR CASEY: Oh, but that's the point about the obligation. So when they amended they say we're going to take all the profit but we now are going to make true on all the future obligations to the creditors. So what they're saying is—the preferred is saying, it's basically the managing director going in the room and saying, "listen, we have to reorganize this." And a lender walks in and goes "if I get the company, I'll guarantee all your creditors." You actually—I think you have a fiduciary duty to take that deal, putting aside the private thing, if you're a director and someone says I'll guarantee all your creditors—

AUDIENCE MEMBER: [Interposing] No, you don't.

PROFESSOR SKEEL: Can I just jump in on that Tony? Two things. One is my understanding of the duty is the duty is not that you make sure that you pay your creditors—

[Crosstalk]

PROFESSOR MCKENZIE: —the duty is to maximize the value of the assets which is—

PROFESSOR CASEY: [Interposing] Which is the same when you're insolvent.

PROFESSOR SKEEL: Not necessarily—

PROFESSOR CASEY: [Interposing] No.

PROFESSOR SKEEL: —I mean maybe we can quibble about that. I think it's a duty toward the assets not towards the claimants but—

[Crosstalk, inaudible]

PROFESSOR CASEY: [Interposing] Yeah, but I think those are equal to each other when you're insolvent.

PROFESSOR SKEEL: I think they're connected but I think it's a different focus. The question I wanted to ask is what were the consequences if Fannie and Freddie just didn't pay the dividends? I mean ordinarily in corporate law if you don't pay your dividends they just accumulate and there are no remedies. So it's not a DIP lender in that sense unless there was something in the preferred stock that created revenues—

PROFESSOR CASEY: [Interposing] Well it kept—the preferred stock had it so that it would keep accumulating beyond the limit.

PROFESSOR SKEEL: So why is that a problem?

PROFESSOR CASEY: Because then their cash flow would go to zero and they would default on their junior loans.

PROFESSOR SKEEL: Ah.

PROFESSOR CASEY: That's the key. That's what the—

PROFESSOR SKEEL: [Interposing] so how does it go?

PROFESSOR CASEY: —so when they don't pay their dividend, the preferred preference goes up which makes the dividend go up.

PROFESSOR SKEEL: The preferred what goes up?

PROFESSOR CASEY: The preferred preference. So if they had a liquidation preference so they had to pay $20 billion which was 10% of the liquidation preference. If they don't pay the $20 billion, then it becomes $220 billion and they have to pay $22 billion so it would go up—

PROFESSOR SKEEL: [Interposing] A percentage because—

PROFESSOR CASEY: —forever. Way beyond the limit. And so at some point the dividend would hit a number where they wouldn't be able to draw money to pay the dividend because they've hit the limit on the preferred agreement. The amount is so much they can't pay any of their other creditors so they can't operate. They can't pay their bills or anything like this so they default and they go into bankruptcy.

So as long as that's accumulating over time, it's all the junior creditors bearing the risk and this is the point where a director says, well, someone's offering me to waive that dividend that's pushing me way, way, way out. If I don't do it, my junior creditors are bearing all the risk, that's where I was saying you might have a duty to maximize the estate, which, is to make sure you're not wiping out the juniors—

[Crosstalk]

PROFESSOR MCKENZIE: So we are out of time, actually.

PROFESSOR CASEY: —the terms of the preferred never—didn't allow you to repay.

PROFESSOR MCKENZIE: I want to thank our panel. We've had a wonderful discussion, we've had a great discussion, and please keep this energy for our future panels.