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Without Freddie and Fannie, could 30-year mortgage be a thing of the past?

The Gutierrez family sits for a portrait on their back patio in Miami. Oswaldo Gutierrez and his parents bought a townouse between Sweetwater and Doral using a 30-year mortgage. He said they never could have afforded the home, where he now lives with his wife, parents and three children, without one. From front left: Jose Gutierrez, 89, Lucia Gutierrez, 51, Oswaldo Gutierrez, 53, and Daisy Gutierrez, 85. Oswaldo Gutierrez holds family dog Honey. From back left: Andrea Gutierrez, 23, Oswaldo A. Gutierrez, 26, and Kelly Gutierrez, 21. Oswaldo A. Gutierrez holds family dog Chiquita.

BY NICHOLAS NEHAMAS

Miamian Bruce Berkowitz has taken on a fight few would dare: He’s suing Uncle Sam.

Berkowitz — whose mutual fund Fairholme Fund owns 14 percent of Fannie Mae and Freddie Mac preferred stock — is among a group of investors suing the U.S. government over the two government-backed mortgage insurance giants. They claim the U.S. Treasury Department illegally confiscated the companies’ earnings after their bailout, gutting the firms when it was supposed to rehabilitate them and setting a dangerous precedent for shareholders’ rights.

The contest has turned into a war, with salvos fired in a half-dozen states where Fairholme and other plaintiffs have filed suit. One critical case will come to a head in August when a federal appeals court in Washington, D.C., is expected to rule.

At first glance, the lawsuits sound like an esoteric battle of accountants, policy wonks and politicians. But the stakes could be as close to home as a three-bedroom, two-bath house in the suburbs and the typical 401K retirement account.

Here’s why: Investors like Berkowitz say the Obama administration’s big-picture plan to wind down Fannie and Freddie poses grave dangers to home buyers and the real estate market — and sets up a potential windfall for the nation’s largest financial institutions. Without Freddie and Fannie, they argue, the fixed-rate 30-year mortgage that makes home ownership affordable for middle-class Americans could get significantly more expensive or even disappear. That would make it difficult for first-time and other buyers to afford a home. It could also crater the equity many people have invested in their homes.

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>
> Guy Cecala, mortgage industry expert

For its part, the White House has argued reform is needed to protect taxpayers against the systemic economic risk posed by Freddie and Fannie. Banks and private companies — not government-backed firms — should shoulder more of the risk of the mortgage market, and going back to the pre-crisis way of business could lead to another meltdown, say officials and some analysts. Eliminating Fannie and Freddie won't disrupt the housing finance system in the United States, which is one of the only countries in the world to offer fixed-rate 30-year mortgages, they argue.

But the administration can't act without comprehensive legislation from Congress, a mighty task for a lightning-rod issue like Fannie and Freddie — meaning change will wait until after the election.

If the investors win in court, and Congress stays gridlocked, it could force the next president to release Freddie and Fannie from Treasury's grip and continue operating as they were originally designed, experts say.

Some housing industry watchers believe Berkowitz and fellow investors have a point, despite financial motivations.

"The first thing to note about Fairholme is that any position they have, whether it's right or wrong, even if it's very right, is suspect in many people's eyes because they are viewed as a hedge fund looking to capitalize on the situation, and the last thing on their mind is the housing finance system in the United States," said Guy Cecala, the CEO and publisher ofInside Mortgage Finance, a popular weekly newsletter on the mortgage industry. "That puts them in a bit of a tough situation to advocate anything."

(Fairholme is actually a mutual fund with an average investment of $30,000, meaning many of its backers are middle-class investors, according to the firm. Hedge funds — which typically accept sophisticated, high-net worth investors — suing the government include Pershing Square Capital Management, run by Bill Ackman, and New York-based Perry Capital.)

But the critical question remains. "What would happen to American consumers if Fannie and Freddie were wound down?" Cecala said. "It's very unclear we could come up with a better model that would provide the same benefits we're currently providing, such as the 30-year-fixed rate mortgage and relatively low mortgage rates."

Pillars of the housing market

Fannie Mae and Freddie Mac are deeply unpopular for their perceived role in the financial crisis. But they perform a key function: seeding the residential mortgage market with capital by buying up mortgages issued by banks and private lenders. Fannie was established by Congress in the aftermath of the Great Depression to encourage lenders to originate stable, long-term mortgages, instead of more profitable, short-term loans. Freddie was created decades later to compete with Fannie.

The two companies are privately owned and publicly traded but backed by the government, an unusual position in corporate America. They are the best known of a half-dozen types of government-sponsored enterprises, or GSEs, created by Congress to reduce borrowing costs for farmers, homeowners and community development.

WHAT COULD REPLACE FREDDIE MAC AND FANNIE MAE?

By law, the GSEs can only buy loans that conform to certain size limits. That's because their political mandate is to help the middle class. In most of the continental United States, the limit is $417,000 for one home.

Now the banks want a piece of their business. And the White House and many members of Congress, who agree on so little, seem to think it's a good idea.

"Working together we need to build a more durable and fair system that promotes the American dream of homeownership, while preventing the nightmare of another crisis," the White House said in a 2013 statement.

The administration's position remains unchanged. It says it is committed to affordable mortgage rates, widespread homeownership and a more stable foundation for the housing market.

"Taxpayers remain on the hook for losses at Fannie and Freddie, and the best way to responsibly end conservatorship of the GSEs is through comprehensive housing finance reform legislation," a Treasury spokesman told the Miami Herald in a statement.

> **"IF FANNIE AND FREDDIE DIDN'T EXIST, THERE WOULDN'T BE A 30-YEAR MORTGAGE, THERE WOULD BE A MORE PROFITABLE, FIVE-YEAR, ADJUSTABLE-RATE PRODUCT.**
>
> Bruce Berkowitz, investor

The plaintiffs disagree.

“I think the banks see a way to grab lots of profits,” Berkowitz said. “If Fannie and Freddie didn’t exist, there wouldn’t be a 30-year mortgage, there would be a more profitable, five-year, adjustable-rate product. You can’t blame banks for wanting that.”

It’s an odd alliance: ultra-wealthy investors saying they’re sticking up for the little guy against the big banks.

In Berkowitz’s view, Freddie and Fannie should function like public utilities, with shareholders receiving a moderate rates of return capped by an independent commission. It’s an idea that’s been floated by analysts but hasn’t picked up much traction with lawmakers.

“People in the United States should expect affordable mortgages like they expect the lights to turn on,” Berkowitz said. “It’s one of the cornerstones of the great American dream.”

The shareholders, of course, have billions of dollars at stake. Just as Freddie and Fannie returned to profitability in 2012, the U.S. Treasury Department announced it would sweep profits — now totaling roughly $250 billion — from bailed-out Freddie and Fannie toward the government’s own bottom-line in the form of quarterly dividends, but without counting the payments against the debt the companies owe. The government says it’s operating under the rules of a 2008 bailout law that placed the GSEs under the supervision of the Federal Housing Finance Agency.

The fight could be worth $33 billion — roughly the value of the preferred shares held by private investors.

The investors, who snapped up the stocks when they plummeted after the financial crisis, believe Treasury and FHFA unfairly wiped out their share of the profits and nationalized the companies. That means a government conservatorship that was supposed to be temporary has now dragged on for eight years, even though Freddie and Fannie are now profitable. Instead of rehabilitating the firms, the arrangement has reduced capital, bringing it to zero in 2018. The suits claim the decision to drain Freddie and Fannie of capital violated the law that placed into conservatorship.

And the plaintiffs point out Treasury eventually released bailed-out auto companies and financial institutions back to shareholders. But not Freddie and Fannie.

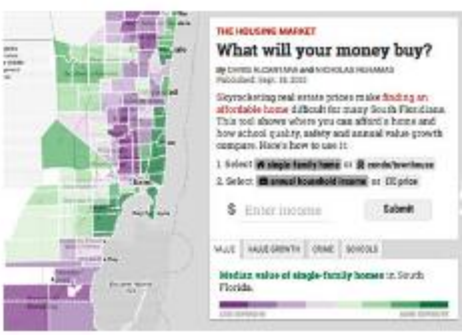
$250 billion Dividends paid by Fannie and Freddie to the federal government

“We’re not fighting for a better deal or more money,” Berkowitz said. “We’re fighting for the principle that you can’t unilaterally change a contractual deal, even if you’re the government.”

It’s not just big investors who have money on the table. Thousands of Americans also own shares of Freddie and Fannie through retirement funds — some without even knowing it. One Kentucky judge, for instance, recused himself from hearing an investor lawsuit because he didn’t realize his wife owned shares. (The exact number of shareholders isn’t known because regulators ordered Freddie and Fannie to delist from the New York Stock Exchange in 2010. The shares have hovered between $1 and $2.50 over the last year.)

A decision in Treasury’s favor could set a precedent that other companies could also be nationalized, said David Thompson, an attorney for Fairholme.

“If left unchecked by the courts, the government’s seizure of these two companies establishes a dangerous precedent – all investors and utilities and financial institutions would run the risk that the government could nationalize such companies with impunity,” Thompson said.



Interactive tool: Where can you afford to buy a home?

Whether the government has the power to strip profits from Freddie and Fannie is at the heart of the lawsuits, which have been filed in federal courts around the country. (A related suit filed in Miami accuses Fannie’s auditing firm of making the company’s financial statements look worse than they really were in order to justify a federal takeover.)

One sign of the eventual outcome could come in August, when a federal appeals court in Washington is set to rule on whether the government overstepped its bounds in the case of Perry Capital vs Jacob J. Lew. A lower court judge earlier dismissed the investors’ claims.

Treasury has argued the case is without merit and that the profit sweep was allowed by the 2008 bailout law.

The Fairholme case was filed separately in the U.S. Court of Federal Claims and has produced thousands of pages of never-before-seen government documents — recently released by judicial order — that outline plans to take the companies over and eliminate them. When the bailout was announced, Treasury officials did not publicly say they planned to prevent shareholders from regaining control of Freddie and Fannie. But internal documents — which the government fought to keep private, even invoking presidential privilege to shield 45 of them from public view — show the move to swallow Fannie and Freddie's profits was always meant to keep the companies captive.

In one email from 2012, Jim Parrott, then a top White House housing official, wrote the companies would not be able to "repay their debt and escape as it were."

In another, he said: "We've closed off [the] possibility that [Fannie and Freddie] ever go (pretend) private again."

What Freddie and Fannie do

To understand their the role in the economy, you have to understand what the companies do — and many Americans don't.

First and foremost, Freddie and Fannie don't issue mortgages. Instead, they buy up loans from banks and private lenders that meet certain credit and underwriting standards, then package them together — a process known as securitization — and sell them to investors. By buying up loans, the companies provide the capital that keeps the wheels of the mortgage market spinning.

While they functioned smoothly for many decades, Freddie and Fannie ran into trouble during the real estate bubble of the early 2000s, lowering their credit standards and emulating the fast-and-loose lending tactics of Wall Street competitors. That helps explain why the companies became unpopular with many Americans — and have been blamed by Republican leaders and some Democrats for helping create the financial crisis.

In 2008, the U.S. Treasury Department seized the under-capitalized companies. Banks weren't lending and officials feared if Fannie and Freddie failed, the nation's entire housing market would collapse.

$187.5 billion Bailout Freddie and Fannie received from Treasury

Like hundreds of financial institutions — including Citibank and American Express — and major car companies, Fannie and Freddie received taxpayer bailouts. In exchange for $187.5 billion, the government received special preferred stock in the two companies. The government also placed Freddie and Fannie in conservatorship while officials figured out what to do with them.

But political gridlock in Washington killed reform. For now, the companies remain in a zombie-like limbo, unlike General Motors and insurance giant AIG, which were set loose once they had recovered.

It's worth noting that the loans Freddie and Fannie backed during the bubble proved far healthier than private mortgages handed out with far lower qualifications. Between 2001 and 2008, the GSEs had 90-day delinquency rates of 6 percent, compared to 27 percent for private loans, according to government statistics. And Fannie and Freddie have since recovered, generating net income of $17.4 billion in 2015 alone and helping the housing market return to stability.

Just before the companies became profitable again in 2012, Treasury announced changes to the bailout agreement. Instead, of paying a 10 percent quarterly dividend, as had been originally stated, Freddie and Fannie would now be forced to pay all their profits to the government. The move became known as the "net worth sweep."

Liberal Democrats have been critical of the move.

"Right now Fannie and Freddie are basically being used as a piggy bank for the United States Treasury, and I believe at some point they will lose the lawsuit that's been brought by investors and they will owe somebody an awful lot of money because there's no justification for us taking it at this point in time," Congressman Michael Capuano, D-Mass., said in comments carried by Politico.

The cost to buyers

What's really at risk, say some experts, is American home ownership.

Fixed-rate 30-year mortgages are by far the most popular loan product available to consumers. Roughly four-in-five owner-occupied homes — about 80 percent — are financed with fixed-rate 30-year mortgages, according to the Urban Institute. Fixed-rate 15-year mortgages and adjustable-rate mortgages make up most of the rest of the market.

While the Obama administration wants private firms to step into the secondary mortgage market and create more mortgage-backed securities, they currently do a fraction of the business of Freddie and Fannie. Fannie and Freddie mortgage-backed securities are worth about $5.7 trillion, dwarfing the private-label security market of $500 billion, the Urban Institute found.

"Despite all the criticism, I don't think anybody would say Freddie and Fannie are doing a bad job now," Cecala said. "In fact, most people would say they're doing a great job."

80 percent Share of mortgages that are 30-year, fixed-rate loans

Local homeowners, developers and Realtors say the 30-year mortgage is key to the real estate industry — and they're worried changes to the system could make it less available. Fixed-rate 30-year mortgages are less profitable for banks than short-term loans, said Phil Stein, an attorney at Bilzin Sumberg who represents financial services companies.

Before the Great Depression, those shorter-term loans were all that a home buyer could get. Accordingly, many American homeowners lost their properties because their loans came due during the turmoil and lenders wouldn't refinance. But Freddie and Fannie create a safety net for lenders. Most countries don't have Freddie and Fannie-type institutions subsidizing mortgages, making the U.S.'s housing financing system a rarity.

Oswaldo Gutierrez and his parents are one family who thank a 30-year mortgage for their home.

They paid $70,500 for a townhouse between Doral and Sweetwater in 1987, six years after Gutierrez came to Miami from his native Nicaragua.

The three-bedroom, two-and-a-half bathroom home is his piece of the American dream. But he said his family couldn't have afforded it without the 10 percent down payment and low monthly mortgage rates provided by a 30-year mortgage.

"It would have been too much money up front and the mortgage payments would have been much higher than what we could have made back then," said Gutierrez, who works in the hotel industry.

> "
> **SPACE IS TIGHT BUT IT'S OURS.**
> Oswaldo Gutierrez, homeowner

Before his family bought, he said, "we were renting and moving every year because the rent kept going up up."

Now Gutierrez lives in the home with his parents, his wife and their three children.

"Space is tight but it's ours," he said. The family refinanced around 2000 and last December made their final mortgage payment. "You feel proud," he said. "It's an accomplishment after 30 years of paying. You always say it's your home, but the banks owns it. It's not yours yet."

Higher consumer costs?

Buyers like Gutierrez could be in trouble if 30-year mortgages become the exception rather than the rule. John Harris, chief wealth adviser for Coral Gables Trust, said investors believe mortgage rates could go up around 3 percent in a privatized market.

“That cost would be passed to the consumer,” Harris said.

Property values would suffer too if buyers’ purchasing power diminished, said Silvano Gonzalez, a Miami-Dade Realtor.

“It would be almost impossible for [buyers] to afford prices today” without a 30-year mortgage, Gonzalez said. “Most people are trying to buy the maximum they can afford.”

“IT WOULD BE ALMOST IMPOSSIBLE FOR [BUYERS] TO AFFORD PRICES TODAY.

Silvano Gonzalez, Realtor

If buyers dry up, residential prices could fall across the board, crippling the finances of people who’ve sunk their equity into homes.

While mortgages are much more easily available for single-family houses and town homes, some South Florida condo developers have used loan programs to sell units.

At Le Parc, a 128-unit tower in Brickell completed last year, developers won Fannie Mae approval for their project. That meant private lenders could issue mortgages to Le Parc buyers knowing that Fannie Mae would then buy the loans. Primary residents are eligible for 3 percent down loans, second-home buyers for 10 percent down loans and investors for 15 percent down loans.

Raimundo Onetto of Alta Developers said the approval is making it easier for buyers to close and for brokers to market unsold units.

“It helped close out the project,” Onetto said.