The Strange Saga of the U.S. Mortgage Giants

SEASON 2
episode thirteen

Nick Lemann

Hello, welcome to Underreported, a podcast from Columbia Global Reports. Since the fall of 2015, we have commissioned authors to do original onsite reporting around the world, with an aim to combine the immediacy and narrative power of journalism with the intellectual ambition and acuity of scholarship. Our short books are on a wide range of political, financial, scientific, and cultural topics. They're stories and ideas that matter.

Our first project back in September 2015 was a book called Shaky Ground: The Strange Saga of the U.S. Mortgage Giants. It chronicles the story of Fannie Mae and Freddie Mac, little known but enormous government agencies, and tells us why homeownership finance is now one of the biggest unsolved issues in today's global economy.

Based on comprehensive reporting and dozens of interviews by its author, Bethany McLean, it was an exciting launch for a small imprint at Columbia University. And the book, Shaky Ground, was included on a 2015 list of notable nonfiction by the Washington Post. In 2018, we went on to publish another book with Bethany, Saudi America: The Truth About Fracking and How It's Changing the World.

Bethany McLean is, of course, the coauthor of the bestseller The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron, with Peter Elkind. Her second book, which she coauthored with Joe Nocera, is All The Devils Are Here: The Hidden History of the Financial Crisis. She lives in Chicago and is a contributing editor to Vanity Fair and hosts a podcast called Making a Killing. Bethany, thanks for being here with us. How are you doing today?

Bethany McLean

I'm doing great. Thanks for having me.

Nick Lemann

I want to start, well, let's start now, and go back. So Fannie Mae and Freddie Mac are called GSEs, government-sponsored entities, I believe. Correct me if I'm wrong. You know, they're the largest banking organizations in the world, if you want to call them a bank, and they're about, you know, the home mortgage system, we'll get all that in a minute.

It’s sort of unfair to start with the present, but I’m going to start with the present. So I assume, given this, you know, incredibly distressing world we live in, you’re in this kind of situation: there’s a tremendous amount of financial distress out there because of this shutdown of the country, because of the pandemic. And among the things that are shut down are home foreclosure proceedings. But they’re going to reopen. So do you think we’ll see as everything reopens into the fall, a massive wave of mortgage foreclosures?

Bethany McLean

I think if, if we were just living in an economy as normal with the economic devastation that we’ve seen, then yes, there would be a rash of foreclosures because there’s no question people are going to have trouble paying their mortgages going forward.

But two things that I think might change that are the government has shown a real willingness and ability to intervene in the markets. And this time around, unlike after the financial crisis, to actually help real Americans, not just to help the financial system.

So what we’ve seen may not be the end of it. And it shouldn’t be the end of it, not only for the moral reason, but for the practical financial reason. What happens if there are foreclosures on these properties? We’ve already seen that neither Fannie Mae nor Freddie Mac, as you referenced, nor the big banks, are good owners of abandoned houses. Right?

And what good do you get out of foreclosing on people’s homes and kicking them out onto the street, only to have all these properties that are decaying in value on the books of banks. So I think and hope we will see some kind of public policy around mortgage foreclosures that will mean what you might expect economically to happen doesn’t actually happen.

Nick Lemann

That would be good. So let’s go back now to the beginning. There may be a few viewers who don’t know what Fannie Mae and Freddie Mac are. So let’s just start there. What are these things?

Bethany McLean

Sure. Well, let me just say, I’ve thought numerous times during this pandemic that when I am being optimistic, we know the end of the world is nigh because I'm never optimistic. So for me to begin our podcast with a bit of optimism is perhaps the scariest thing of all.

But anyway. Okay, back to Fannie and Freddie. So they are, as you said, the government-sponsored enterprises. And they're really odd companies because most Americans may only vaguely know that they exist. A lot of times when people hear Fannie Mae, they think of the chocolate making company, Fannie May, and yet these two companies are together collectively the largest financial institution in the world. They control some $5 trillion worth of mortgage debt. Without them, the mortgage machine in this country would literally shut down.

So they're what enables liquidity in the mortgage market. And the reason for that, it goes back actually to the aftermath of the Great Depression, the time not unlike what we're in today, where President Roosevelt was trying to figure out how did you get mortgage credit to people? Because our nation depends on mobility, people being able to move. If you can't buy and sell a house, you can't move. Right?

So, so much of the structure of our nation is bound up not just in the concept of home ownership, but also in mobility. So the idea was that banks, local institutions, could extend mortgages to people, but the flow of credit was dependent on the region where the institution was, and whether it could afford to make any more mortgages.

So if you created this national institution called Fannie Mae, it could then buy the mortgages from the local financial institution and have them on its books, so thereby freeing up the local institution to go and make more mortgages.

And that's essentially the way the system works today. Over time, it's become — there are a lot more nuances to it. Freddie Mac came into existence as well, and Fannie and Freddie essentially now take the securities on their books and package them up into securities, mortgage-backed securities, which they sell to other investors.

So the situation, the setup has all sorts of layers of complexity added onto it. But the basic idea is that it's the government meddling in, what detractors would say is that it's the government meddling in private business. And it is really odd that Mervyn King, the former governor of the Bank of England, said to me once "You Americans are so strange. Most countries have socialized health care and a private market and mortgages. You've socialized mortgages and you have a private market and health care."

And there are lots of wrinkles around that, too. But it is sort of amusing. So these institutions have also long been complicated, long been very controversial because real die-hard advocates of the free market say, "Wait, wait, wait. What is the government doing in mortgage finance? Why do we need the government involved in this?

Nick Lemann

So if we go back to the financial crisis, at least from where I sit, we all sort of knew about things like Bear Stearns and Lehman Brothers going under. Those are sort of what got the headlines. And given the size of Fannie Mae and Freddie Mac, they really didn't get a lot of mainstream attention. So could you just walk us through what happened to them in the financial crisis?

Bethany McLean

Right. So part of the controversy, when I say that Fannie and Freddie were government-sponsored enterprises, in the runup to the financial crisis, they were also publicly traded companies.

So they looked like any other publicly traded company, except they had these special privileges that critics said immensely increase their clout. And one special privilege, there was always this implicit idea that if they got in trouble, the US government would bail them out because they were so critical to the functioning of the mortgage market. And it turned out that that was true.

As the mortgage market, as the financial system got into trouble, the government stepped in in September of 2008 and took over Fannie and Freddie, putting them into a state called conservatorship, where they were essentially wards of the government. Kicked out all of their executives, said they can't lobby anymore, wiped out the equity, and took them over as wards of the government.

And now it is true, Fannie and Freddie did have an implicit guarantee from the US government, and when times get tough, the government did have to save them. I would argue that's no different than the big banks, which turned out to have the same guarantee. Right. But the punishment doled out to Fannie and Freddie was significantly harsher than that doled out to the big banks. Because the big banks were very quickly allowed to go their merry way and return to paying their executives millions of dollars in bonuses.

Fannie and Freddie are still wards of the government now. We've never come up with a plan. Conservatorship was supposed to be temporary, and we've never come up with a plan for getting them out.

Nick Lemann

So let's spend a minute on that. Why is conservatorship for Fannie and Freddie so sticky? You know, when the book came out five years ago, we were kind of saying, "Well, now that we're calling attention to it, it'll come to a close maybe." Or at least, or the government would throw in the towel and say, "No, this is our policy now, we're not calling it conservatorship." And here we are five years later, and they're still in conservatorship. So, why?

Bethany McLean

Yeah, I know, people occasionally ask me for updates on the book and I'm like, there isn't really one. So the answer to that is somewhat complicated, although maybe it's not.

But one reason is that on the surface, it's really appealing ideologically. You think if you're a Republican free market person, you look at the situation, you say, "Oh my God, we shouldn't have the government in the mortgage market. This is easy. Let's just write legislation wiping out these two companies and putting the mortgage market into the hands of the, quote, free market."

And then you start to get into the details of it and it gets inordinately more complicated from that point on, because it turns out that a market without any sort of government support in mortgages doesn't actually work that well.

For one thing, we know in the wake of the financial crisis that when private capital gets spooked, it just runs away and there would be no mortgages available. Secondly, it'd have a real disparate impact on the flow of mortgage credit to different parts of the country.

So it becomes very unappealing ideologically as soon as you get into the weeds of it. So most people in Washington who come to this issue fresh and take an interest in this immediately say, "Well, not only is this really complicated, but it doesn't tick any easy ideological boxes, and I'm not going to make any friends by taking this on."

A second issue is that Fannie and Freddie in their heyday were immensely politically powerful. And the world is far more emotional than most people give it credit for, and memories in Washington, DC are long. And there are still people in DC who remember Fannie and Freddie in their heyday and want to get back at them for the harms that Fannie and Freddie inflicted on those who disagreed with their policies when they had the power to inflict harm on people.

So there's a huge emotional overlay to this too, that overpowers the practical considerations of what one should do with this. And then the third reason is that conservatorship appears to be working pretty well on the surface.

So right now, the Democrats get everything they want, which is a mortgage machine that is effectively a captive of the government. And the Republicans don't have to risk reform that is far more likely to annoy their base than it is to make their base happy.

So the status quo is preferable to figuring out a long-term solution. And because of that, you know, if the status quo appears to be working, how on earth are you going to create any motion?

Nick Lemann

So if you, if it's working, and we go to the present moment, how does — if I heard you right, at the outset of this part of the interview, you were saying the government is going to be much more helpful to ordinary homeowners than it was last time around. If it does so, does that mean that this crisis won't have any effect on Fannie and Freddie, that they'll be fine? Or could they go back into crisis as they did in 2008?

Bethany McLean

That's a really interesting question. Fannie and Freddie do — so the way this is structured, when they sell their mortgages on to investors, the investors take the interest rate risk, the risk that interest rates change. Fannie and Freddie keep the credit risk. So, yes, if there is a widespread wave of defaults that is going to hurt Fannie and Freddie and it is going to end up being taxpayers who bear the burden of that.

And the reason for that, and it's quite possible that we are going to end up paying the price for our sins over the decades since the financial crisis. Because one of the things that happened in the Obama administration was that the Obama administration said these two institutions, these financial institutions that are at the core of the functioning of our mortgage market, we're not going to allow them to keep any more capital, no capital whatsoever, which for a financial institution is insane. It means that there's absolutely zero buffer against any loss that they might suffer.

But that money, the money that Fannie and Freddie earned, was used to plug holes in the budget. So it seemed really appealing, again, from the standpoint of the status quo. What's wrong with having these institutions that are making billions of dollars and being able to take their billions and appropriate them for the US government?

Except now that you've left two institutions with absolutely no capital base, potentially about to face a wave of mortgage defaults, and because they are owned by the US government, that means taxpayers are going to have to pick up the pieces of that. So I think we might be seeing our sins brought, our proverbial sins brought home to roost.

Nick Lemann

But going back to your original optimism. Why would the Trump administration, if you're right, do more for ordinary American mortgage holders than the Obama administration, much more liberal, did?

Bethany McLean

I don't know a good answer to that. It certainly is not what you would expect. But when you look at the way the CARES Act was designed, we can all quibble about pieces of it that weren't well executed, but it certainly tried to get money to mainstream Americans.

It was aware of the potential, the administration was very aware of this, and that was Democrats as well. Right. I shouldn't say the administration, I should say Congress was very aware of the impact this was going to have on citizens across the country and tried to get money to them.

And so if again, if people are smart, they'll realize that a cascading wave of defaults ends nowhere good. It's taxpayer money one way or the other, right? Either we get money to people so that they don't default on their mortgage, or we put in place a system so they don't have to default, or they end up defaulting and there are huge losses at Fannie and Freddie and taxpayers have to cover that anyway. So if people are intelligent, then they will, then we will see a well-designed outcome.

Nick Lemann

I hope you're right.

Bethany McLean

I mean, I hope I'm right too. But hear the big caveat: if people are intelligent. Right?

Nick Lemann

A few minutes on the sort of institutional side about Columbia Global Reports. You were our first book that we published September 15th, 2015. So, why did you decide to agree to write a book for a book publisher that didn't even exist?

Bethany McLean

Well, you came to me and asked if I had any thoughts about the aftermath of the financial crisis. And I have actually always been obsessed with Fannie Mae and Freddie Mac, which is a really strange and completely wonky obsession.

I admitted, actually, when I was reporting the book, I remember going to a Goldman Sachs conference, and the PR guy there said, "What are you doing here?" It was a conference on housing finance. And I said, "Oh, well I'm working on a book on Fannie and Freddie." And he looked at me and his eyes got wide and he said, "Who's going to read that?" And I thought, well, that's quite possibly true.

But I think these, I'm always fascinated by parts of the economy that are almost invisible to most people. These subterranean aspects of the economy that nonetheless have a huge impact on people's lives.

I mean, if Fannie and Freddie didn't exist, the entire structure of our financial system would be different, particularly as it applies to most Americans, right? It would change your ability to get a mortgage, that most basic element of adult American life. The financial instrument with which most of us are the most familiar, a mortgage, would be entirely different if it weren't for Fannie and Freddie.

And they have these global financial reverberations as well, in that a great deal of Fannie and Freddie's debt was, and is, held by overseas financial institutions. So that's also sprinkled throughout global financial institutions.

So I just found them fascinating. They are, because they are a little bit wonky. You could not — and I was incredibly frustrated at that time with the idea that they were still in conservatorship. That they were still wards of the government all these years later, and that there was just the stasis around this refusal to engage with what we were going to do with Fannie and Freddie.

And it actually, even though I had at points of my career been very much a foe of Fannie Mae, it actually struck me as unfair, the disparate treatment of Fannie and Freddie versus the big banks.

And so when you offered me the opportunity to actually be able to write about this in a substantive way, I thought it was an incredibly important topic. And for better or for worse, my choices of what to write about have always been dictated by my own strange interests, rather than any attempt to figure out what people are actually going to want to read.

Nick Lemann

On our side, you know, we're — a lot of people in mainstream media organizations are sort of scared off by this story because it's so wonky, and we're not afraid of that. As long as it's important, we think we can make it interesting if we work with writers like Bethany.

So we were thrilled to be able to work with you as our first author. You know, we had a wonderful, if you remember, launch event for the book where one of the speakers — we basically had two guests: one a man named Franklin Raines, who was the former head of Fannie Mae, and the second is a guy who runs a fund named Bill Ackman.

And I was surprised when we had the event, you know, we had the big space called Low Library at Columbia University, and it was like it was a Bruce Springsteen concert. There were all these people camped out on the steps and so on to get in. And I'm sure many of them were there to hear you, but the big finding was that they were business students who were there to hear Bill Ackman. Right?

Bethany McLean

Yes. 100%.

Nick Lemann

So more so than Frank Raines. So. I just would love to get an update on him, both his investing strategy with regard to Fannie and Freddie, and generally what he's up to and why he was so fascinating to Columbia business students and economics majors.

Bethany McLean

So Bill Ackman is one of the star hedge fund managers of the last decade, 15 years.

He runs a mostly successful, mostly extraordinary successful hedge fund named Pershing Square, and what he says literally moves markets.

And Bill was on that stage because he's one of many hedge fund managers who took a position in Fannie and Freddie securities under the belief that conservatorship was going to have to come to an end, both for legal reasons and for practical reasons. And that securities that had been deemed almost worthless by the advent of conservatorship were going to have to have value again once Fannie and Freddie were revived as publicly traded institutions.

And I actually happen to agree with the hedge fund manager take on this, which was quite surprising to me. But I thought they were right because their essential view was quite pragmatic, which is that Fannie and Freddie are essentially — like with Winston Churchill's definition of democracy: the worst possible system, with the possible exception of everything else that's ever — I'm sorry, I think it was Winston Churchill's definition of capitalism: the worst possible system, with the possible exception of anything else that's ever been proposed?

And that's how I began to feel about Fannie and Freddie. That yes, there were a lot of flaws with this setup of these hybrid government-slash-private institutions. But every time you tried to think about something that would work better, you quickly realized that the old way actually wasn't — with some reforms — wasn't so bad.

And I thought some of the things that happened during conservatorship, like the government deciding to strip Fannie and Freddie of all of their capital, was a huge mistake. So I ended up being somewhat on the hedge fund manager side. And so Bill was a prominent character in this.

I haven't actually kept tabs on how well the investment has worked out for the hedge fund managers. It has come and gone as there have been various iterations through the Trump administration of Fannie and Freddie potentially being released from conservatorship.

Even I have stopped following all of the details because it gets very exciting and then it all goes away as if nothing had ever happened. And so it feels like, to quote another literary, to quote another literary person, the sound and the fury. Right? Just signifying nothing.

And Bill, Bill's investing track record hit a big snag for a reason not to do with Fannie and Freddie, but over a very controversial drug maker called Valeant, which led to a period of really abysmal performance. But he has since come back in a major way and once again proven that he is one of this era's great investors.

Nick Lemann

But he didn't make the killing on Fannie and Freddie that he was expecting to make? If they're still in conservatorship?

Bethany McLean

To be perfectly honest, I don't know, because these securities that a lot of hedge fund managers invested in, the preferred stock and the remainder — a little stub of common equity that is traded on the pink sheets — has actually been extremely volatile.

So it's possible that you could have invested in a low level and sold at a much higher level, even though nothing has actually happened with Fannie and Freddie. You could have made money just on the news flow. The big dramatic payoff that people expected when Fannie and Freddie were taken out of conservatorship, which felt like it was not only right, but inevitable, has not happened.

Nick Lemann

At this point, we're going to bring this part of the interview to a close. So thank you. And next Monday, we'll have part two of our discussion, which is about Bethany's second book for us, called Saudi America. Much more on that then. I'm Nick Lemann and thank you for listening. And be well and stay safe.