“The old political reality was that we always won, we took no prisoners…We used to, by virtue of our peculiarity, be able to write, or have written, rules that worked for us.”

—Fannie Mae Chief Operating Officer Daniel Mudd e-mail to Fannie Mae CEO Franklin Raines (2004)

V. Lax Regulation Led to the Downfall of Fannie Mae and Freddie Mac

Taylor Lincoln[1]

Those seeking to shift responsibility for the financial crisis from the deregulatory policies of the George W. Bush-era often blame Fannie Mae and Freddie Mac, the bailed-out government-sponsored enterprises, or GSEs, that are tasked with providing liquidity to the mortgage market. Speaker of the House John Boehner (R-Ohio), for instance, referred to Fannie Mae and Freddie Mac as “the government mortgage companies that triggered the whole meltdown.”[2]

The weight of evidence happens to suggest that the GSEs were not major drivers of the housing bubble or the resulting near-meltdown of the financial system.

But determining whether the GSEs were culpable for the crisis is not the purpose of this chapter. Instead, this chapter will show that the GSEs’ failures, which have so far cost the taxpayers about $185 billion, resulted from privatization and lax regulation.[3] Contrary to Boehner’s suggestion, the GSEs’ demise resulted from too little government, not too much.

> The GSEs "are not only too big to be allowed to fail but perhaps too politically connected to be regulated or shaped effectively in the public interest."
>
> —*Consumer advocate Ralph Nader (1999)*

Moving Fannie Mae to the Private Sector Set the GSEs on a Deregulatory Course

The Federal National Mortgage Association, or FNMA, was created in 1938 to provide lenders with capital to help revive a moribund housing sector.[4] While operating as a government agency, FNMA used the government's credit rating to borrow money at low rates, then used that money to purchase mortgages that paid a higher rate, profiting on the difference. For decades, FNMA operated without particular drama. It helped provide predictability for borrowers, was instrumental in creating the 30-year, self-amortizing mortgage and is credited with aiding in a dramatic increase in home ownership.[5]

But FNMA's debt hurt the federal government's balance sheet. To offload this debt, President Johnson in 1968 converted FNMA into a privately held company that would serve a government-mandated purpose.[6] The company came to be known as Fannie Mae. Two years later, Congress created the Federal Home Loan Mortgage Corp., nicknamed Freddie Mac, to compete with Fannie Mae.[7]

The new organizations were known as government-sponsored enterprises, or GSEs. The companies had dual missions of serving a public purpose of facilitating mortgage lending and a private purpose of maximizing profits for their shareholders.

The companies were given privileges that other private-sector companies did not enjoy. They could borrow money at interest rates nearly as low as the federal government could obtain; they were given a $2.25 billion government credit line; and they were exempted from requirements to register their stock and debt offerings with the Securities and Exchange Commission.[8] They also enjoyed an implicit guarantee that the government would make good on their investments if they failed.

> "Fan and Fred's current regulatory setup has allowed them to indulge in all sorts of risky practices and the taxpayers are on the hook for risks that go sour."
>
> —*The Wall Street Journal, editorial (2003)*

Warning Signs Bubbled up Throughout the GSEs' Existence

Fannie Mae and Freddie Mac have long been attacked by critics who charged that they enjoy unjust privileges and pose a risk to society as a whole.

The first suggestions of the GSEs' fallibility came in the late-1970s, as soaring interest rates caused the GSEs to post losses. This caused concern that the taxpayers could be left on the hook for enormous liabilities if the GSEs failed. During the 1980s, Reagan administration conservatives suggested fully privatizing the GSEs or, at least, strengthening their regulatory oversight to reduce the threat that they posed to the taxpayers.[9]

In 1992, the Federal Housing Enterprises Financial Safety and Soundness Act was passed with the intent of reducing the risk that the GSEs posed to the taxpayers.[10] But, by then, the GSEs had built a powerful lobbying machine. They were able to weaken the bill so much that it would not prove effective.

The law created an oversight agency, the Office of Federal Housing Enterprise Oversight, or OFHEO, to oversee the GSEs' safety and soundness. But OFHEO was weakened because its funding was subject to annual appropriations by Congress, an unprecedented imposition on an oversight agency charged with ensuring the safety and soundness of financial institutions.[11]

The law also set the GSEs' capital requirements at 2.5 percent (just a quarter of that required of other lending institutions at the time) and prohibited OFHEO from altering the requirements without congressional approval.[12] The low capital requirements permitted the GSEs to reduce their margin for error in their pursuit of profits.

The law also created a mandate for the GSEs to ensure that 30 percent of the loans they financed went to low- and moderate-income families. The GSEs in the coming years would use this mandate as a bargaining chip to ward off regulatory proposals.[13]

"There is a general recognition that the supervisory system for housing-related government-sponsored enterprises neither has the tools, nor the stature, to deal effectively with the current size, complexity and importance of these enterprises."

—*Treasury Secretary John Snow (2003)*

Eventually, the GSEs' became highly profitable. Fannie Mae would report average earnings of $5.2 billion a year from 1999 to 2006.[14] Freddie Mac averaged $5.3 billion in reported profits in this time period.[15]

Despite their profitability—or perhaps because of it—the GSEs were lightning rods for criticism from across the political spectrum. The GSEs "are not only too big to be allowed to fail but perhaps too politically connected to be regulated or shaped effectively in the public interest," consumer advocate Ralph Nader wrote in 1999.[16]

The *Wall Street Journal* published a series of editorials in the early-2000s that chided the companies for excessive risk taking and lack of transparency. "Fan and Fred's current regulatory setup has allowed them to indulge in all sorts of risky practices and the taxpayers are on the hook for risks that go sour," the *Journal* wrote in 2003.[17]

"There are two ultimate remedies for this problem. Either privatize or nationalize," the 2003 editorial continued, adding that the *Journal* preferred full privatization.[18]

In 2000, Representative Richard Baker (R-La.) introduced legislation that would have eliminated the GSEs' federal credit line, restricted the companies' freedom to enter into new lines of business and imposed more stringent regulation in general. At least 10 other bills aiming to constrain the GSEs were introduced between 2001 and 2006, but none was approved.[19]

"The whole army of lobbyists that continually paraded in a bipartisan fashion through my offices…It's pretty amazing the number of people that were in their employ."

—Former HUD Secretary Mel Martinez

In 2003, the Bush administration sent Congress a plan to create a new oversight agency within the Treasury Department to oversee the GSEs. The plan called for giving the new agency the authority to alter the GSEs' capital-reserve requirements and to veto their entrance into new business ventures.[20]

"There is a general recognition that the supervisory system for housing-related government-sponsored enterprises neither has the tools, nor the stature, to deal effectively with the current size, complexity and importance of these enterprises," Treasury Secretary John Snow said in House testimony.[21]

But despite the fact that President Bush's Republican Party controlled both houses of Congress, the proposal languished until the GSEs were on the brink of collapse in the summer of 2008.[22]

By the end of 2007, Fannie Mae and Freddie Mac held $5.3 trillion of mortgage-related assets and only $70.7 billion of capital, a ratio of 75-to-1, according to the Financial Crisis Inquiry Commission, or FCIC, which Congress commissioned to investigate the causes of the 2008 financial crisis.[23]

In July 2008, Congress passed the Housing and Economic Recovery Act, which established a new independent agency, the Federal Housing Finance Agency, or FHFA, to oversee the GSEs. The law granted the government authority to provide money to stabilize the GSEs and to place them into conservatorship. But, by then, it was too late.

Circumstances required the FHFA to use its authority almost immediately. In September 2008, the federal government determined that the GSEs were insolvent. It seized the companies, and took on their liabilities.[24]

The GSEs Used a Massive Influence-Peddling Campaign to Block Regulation

The GSEs consistently beat back regulatory proposals by prosecuting one of the most relentless and multi-faceted influence-peddling campaigns Washington has ever known. Between 1999 and 2008, Fannie Mae and Freddie Mac employed at least 622 lobbyists, and spent $158 million on lobbying.[25]

"The whole army of lobbyists that continually paraded in a bipartisan fashion through my offices…It's pretty amazing the number of people that were in their employ," Bush administration HUD secretary Mel Martinez told the FCIC. [26]

Andrew Cuomo, who served as HUD secretary in the Clinton administration, offered a similar account. "You did not question Fannie Mae," he said. "Fannie did as Fannie wanted."[27]

The GSEs hired numerous executives with roots in Washington's power structure. For example, Fannie Mae CEO James Johnson came to Fannie Mae after serving as a top aide to Senator Walter Mondale (D-Minn.), the Democratic nominee for president in 1984.

Johnson's successor, Franklin Raines, served as manager of the Office of Management and Budget under President Clinton. Robert Zoellick became an executive vice president at Fannie Mae after serving as a high official in the State and Treasury Departments, and as deputy chief of staff in the George H.W. Bush administration.[28]

The GSEs also employed influential consultants from government leadership positions. Freddie Mac, for instance, hired former Speaker of the House Newt Gingrich (R-Ga.) shortly after Gingrich left Congress in 1999. Gingrich received at least $1.6 million from Freddie Mac over the next decade.[29]

"Gingrich was asked to build bridges to Capitol Hill Republicans and develop an argument on behalf of the company's public-private structure that would resonate with conservatives seeking to dismantle it," Freddie Mac employees told *Bloomberg News*.[30]

The GSEs used their connections to influence the executive branch, as well. In 2003, Armando Falcon, the director of the agency that supervised Fannie Mae, refused a demand by Fannie Mae CEO Franklin Raines to shelve a report on systemic risks posed by the GSEs. Raines "threatened to bring down me and the agency," Falcon recalled.[31]

Falcon went forward with plans to release the report. The day the report was scheduled for publication, Falcon received a call from the White House informing him that he was being replaced as OFHEO director. Falcon was ordered to submit a resignation letter immediately, which he did. The resignation demand was later withdrawn, and Falcon kept his job.[32]

The GSEs also relied on campaign contributions to grease their relations with Capitol Hill. From 2000 through 2008, their political action committees made $24.4 million in political contributions.[33] In 2006, Freddie Mac paid a record $3.8 million fine to settle charges of making illegal campaign contributions.[34]

To buttress their connections within the government, the GSEs also invested in initiatives to compel the public to bid for them. Fannie Mae maintained a foundation that disbursed $1 billion in grants to nonprofit groups from 1979 to 2006. As part of the application process, nonprofits were asked to list "affinity contacts," such as a lawmaker's barber or pastor. The affinity list eventually grew to about 4,000 people with a direct connection to a member of Congress.[35]

The foundation also financed "Partnership Offices," which Fannie Mae was accused of using to curry favor with lawmakers. "The activities of the Partnership Offices were not confined to affordable housing initiatives," the Department of Housing and Urban Development wrote in 2005. "Rather, a central purpose of the Partnership Offices was to engage in activities that were primarily designed to obtain access to or influence members of Congress."[36]

Fannie Mae's foundation also financed enormous amounts of advertising to fight regulatory legislation. For example, it paid $87 million for ads targeted to the Washington, D.C., market in 2003 and 2004, as Congress was debating reform legislation.[37]

"By now every one of you must have 6.46 branded in your brains…you must live, breathe and dream 6.46, you must be obsessed on 6.46."

—Fannie Mae's risk manager Sampath Rajappa, beseeching auditors to help raise earnings to $6.46 per share (circa 1999)

Fannie Mae's message was simple: regulating the company would reduce its ability to help the public realize the American dream. For example, one advertisement included this dialogue:

Husband: Uh-oh.
Wife: What?
Husband: It looks like Congress is talking about new regulations for Fannie Mae.
Wife: Will that keep us from getting that lower mortgage rate?
Husband: Some economists say rates may go up.
Wife: But that could mean we won't be able to afford the new house.
Husband: I know.[38]

Fannie Mae also used front groups to create the illusion of grass roots support. Fannie Mae in 2000 coordinated a campaign by the "Coalition for Home Ownership," in which members of Congress received letters that appeared to be from their constituents which expressed fears that a regulatory bill "would increase the cost of homeownership." The individuals' whose names were included on the letters later said they were misled.[39]

"The old political reality was that we always won, we took no prisoners," Fannie Mae Chief Operating Officer (and future CEO) Daniel Mudd wrote to CEO Raines in 2004. "We used to, by virtue of our peculiarity, be able to write, or have written, rules that worked for us."

> "While all of this political power satisfied the egos of Fannie and Freddie executives, it ultimately served one primary purpose: The speedy accumulation of personal wealth by any means."
>
> *—Former OFHEO Director Armando Falcon*

The GSEs Were Motivated to Engage in Undue Risk By Their Executives' Greed

The GSEs would likely have stayed out of trouble if not for a peculiarity that permitted their executives to reap astronomical levels of compensation for performing their government-chartered function.

In 1992, Fannie Mae's board altered the firm's compensation policy to deem earnings-per-share and adherence to government-imposed affordable housing goals as the only factors to determine incentive-based pay for the firm's employees.[40] CEO James Johnson would receive $100 million during his 1991 to 1999 tenure.[41]

Fannie Mae's leaders went to extraordinary lengths to maximize bonuses. In 1999, CEO Franklin Raines announced a goal of doubling earnings over five years, from $3.23 a share to $6.46 a share.[42]

In response, the head of Fannie Mae's auditing department said in a speech: "By now every one of you must have 6.46 branded in your brains. You must be able to say it in your sleep, you must be able to recite it forwards and backwards, you must have a raging fire in your belly that burns away all doubts, you must live, breathe and dream 6.46, you must be obsessed on 6.46."[43]

Fannie Mae's reported earnings from 1999 to 2004 ended up matching those needed to maximize bonuses almost to the penny, a preposterous result if proper bookkeeping were used.

In 2002, alone, 20 Fannie Mae executives earned at least $1 million.[44] From 1998 to 2003, Raines was paid $90.1 million, $52 million of which was for meeting earnings goals.[45] In 2006, Fannie Mae was forced to reduce its stated earnings from 2001 to 2004 by $6.3 billion.[46]

"While all of this political power satisfied the egos of Fannie and Freddie executives, it ultimately served one primary purpose," Falcon told the FCIC. "The speedy accumulation of personal wealth by any means."

Affordable Housing Goals Did Not Cause the GSEs' Failure

Some have claimed that the GSEs' increased risk-taking was intended to meet affordable-housing goals, but the evidence suggests that profits were the real motivator. The GSEs increased their purchases of subprime loans and other risky mortgages during the housing bubble, but not fast enough to maintain their market share.

The FCIC interviewed dozens of current and former employees and regulators of the GSEs and reported that "all but two" said the affordable housing goals were "not the primary driver of the GSEs' purchases of riskier mortgages."[47]

Many of the high-risk loans that the GSEs purchased during the bubble were not subprime loans, but Alt-A loans (meaning alternative to "A," the letter used to describe prime loans), which were generally issued to borrowers who made larger down payments but did not provide complete documentation.[48]

These loans did not generally count toward meeting the GSEs' goals to serve low- and moderate-income buyers. Instead, the FCIC concluded, the GSEs' purchase of Alt-A loans required them to purchase even more loans involving low- and moderate-income home buyers to keep their ratios in line with the goals.[49]

Robert Levin, the former chief business officer of Fannie Mae, told the FCIC that buying high-risk mortgages was intended to "meet the market" and regain market share.[50] "There was no trade-off," Levin said. It amounted to "win-win-win: money, goals, and share."[51]

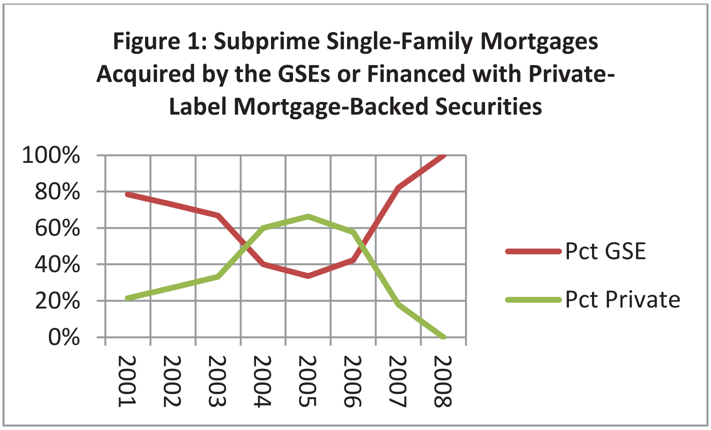
Only about 4 percent of all loans purchased by Freddie Mac between 2005 and 2008 were bought "specifically because they contribute to the goals," the FCIC reported.[52]

The GSEs Were Not Primarily to Blame for the Housing Bubble or Financial Meltdown

The theory that the GSEs caused the housing bubble generally holds that they enabled reckless lending by providing an easy means for lenders to unload risky mortgages, thereby reducing lenders' concern over borrowers' credit worthiness.

Although it is not the purpose of this chapter to settle the question of the GSEs' culpability for the crisis, the data do not suggest that the GSEs were the driver of the lending frenzy that led to the housing bubble and crash. For instance, the GSEs' share of the overall secondary market and of the subprime segment declined considerably in the years 2003 to 2007, when the mortgage boom peaked.[53] [See Figure 1] If the GSEs were drivers of the subprime lending boom, one would have expected their share to rise.

Moreover, the subprime mortgages that the GSEs purchased fared better than those purchased by others.[54] Thus, mortgages facilitated by the GSEs were less likely to cause cascading failures in the financial system than those issued by others.



Source: Federal Housing Finance Agency. Subprime refers here to loans issued to borrowers with FICO scores below 660.

Maintaining Greater Capital Levels Would Have Reduced or Eliminated the Need for the GSEs' Bailout

Even if the GSEs had nothing to do with causing the bubble, that would not reduce the toll the firms exacted on taxpayers. In

September 2008, the GSEs were taken into conservatorship by the government. James Lockhart testified to the FCIC that the GSEs' ratio of debt to equity "was impossible to overcome."[55] The taxpayers have since provided about $185 billion to keep the GSEs afloat.[56]

If the GSEs had maintained greater capital levels, as sensible regulation would have required, they may not have needed a bailout at all. When the GSEs were seized by the government, they had about $78 billion on hand, which represented only about 1.3 percent of their outstanding investments.[57]

If the GSEs had maintained capital levels of just 5 percent, they would have had about $292.5 billion on hand, enough to cover their losses. At worst, any bailout of the GSEs would have been far smaller if they had retained sensible capital levels.

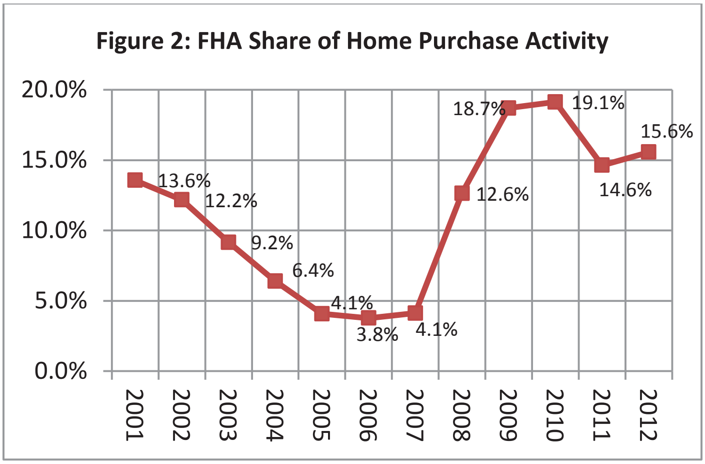
"There were two major problems for the GSEs: they did not have the capital to survive the decline in property values beginning around 2006, and they ramped up their risk-taking when their market share fell and the franchise was in danger," Jason Thomas and Robert Van Order concluded in a comprehensive 2011 review of the GSEs' demise.[58]

The GSEs' Downfall Would Likely Have Been Avoided if They Had Remained Within the Government

If the federal government had kept the GSEs' function as in-house agency, that agency almost certainly would not have collapsed like the GSEs did. We know this because the government retains such an agency.

The Federal Housing Administration, or FHA, performs a similar function to the GSEs. The FHA explicitly serves low- and moderate-income buyers, for whom it guarantees mortgages with down payments of as little as 3.5 percent.[59]

But the FHA did not crash and burn like the GSEs. The reason, in broad terms, is that the FHA was not seeking to meet profit goals and, hence, was not compelled to lower its standards to maintain market share. Consequently, it did not offer exotic mortgages, such as adjustable-rate, low-documentation and interest-only loans. The FHA's market share bottomed out during the boom years of 2003 to 2007. [See Figure 2]



Source: Federal Housing Administration

The FHA's delinquency rates soared after the housing market crash. But, even here, the negative result was not caused by reckless behavior so much as a decision to fill a void after the rest of the mortgage market dried up.

Economist Mark Zandi, who advised Senator John McCain (R-Ariz.) during McCain's 2008 presidential campaign, has estimated that housing prices would have fallen an additional 25 percent if not for the FHA's efforts to prop up the market.[60]

President Obama "empowered the Federal Housing Administration to ensure that households could find mortgages at low interest rates even during the worst phase of the financial panic," Zandi wrote in an op-ed. "Without such credit, the housing market would have completely shut down, taking the economy with it."[61]

The FHA's solvency has come into question in recent years and it may require some extra funding from the federal government. But if such an infusion becomes necessary, it will likely represent only a fraction of its portfolio and the FHA likely will be able to pay back the money.[62]

Conclusion

The GSEs caused their own downfall, although not the broader housing bubble or financial crisis. Their failure can be traced to a bad government decision to privatize their function and, later, to insufficient regulation. The best solution would have been to leave the GSEs' function in the hands of the entity designed to perform public functions: the government.

The GSE disaster also should serve as a lasting lesson of the pernicious harms that unchecked lobbying and influence-peddling campaigns can wreak on society's regulatory framework. If not for the effects of their influence-peddling campaign, the GSEs likely would have been forced to act responsibly, regardless of their desires.