

The Last Trillion-Dollar Commitment: *The Destruction of Fannie Mae and Freddie Mac*

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The government takeover of Fannie Mae and Freddie Mac was necessary because of their massive losses on more than \$1 trillion of subprime and Alt-A investments, almost all of which were added to their single-family book of business between 2005 and 2007. The most plausible explanation for the sudden adoption of this disastrous course—disastrous for them and for the U.S. financial markets—is their desire to continue to retain the support of Congress after their accounting scandals in 2003 and 2004 and the challenges to their business model that ensued. Although the strategy worked—Congress did not adopt strong government-sponsored enterprise (GSE) reform legislation until the Republicans demanded it as the price for Senate passage of a housing bill in July 2008—it led inevitably to the government takeover and the enormous junk loan losses still to come.

Now that the federal government has been required to take effective control of Fannie and Freddie and to decide their fate, it is important to understand the reasons for their financial collapse—what went wrong and why. In his statement on September 7, 2008 announcing the appointment of a conservator for the two enterprises, then-Treasury Secretary Henry M. Paulson pointed to their failed business models as the reason for their collapse. But while this was certainly a contributing element, it was not the direct

cause. The central problem was their dependence on Congress for continued political support in the wake of their accounting scandals in 2003 and 2004. To curry favor with Congress, they sought substantial increases in their support of affordable housing, primarily by investing in risky and substandard mortgages between 2005 and 2007.

As GSEs, Fannie and Freddie had both a government mission and an obligation to add value for their shareholders. The two were in irreconcilable conflict. The government mission required them to keep mortgage interest rates low and to increase their support for affordable housing. Their shareholder ownership, however, required them to exploit their government subsidy to maximize profit and fight increases in capital requirements and regulation that would raise their costs and reduce their risk-taking. But there were two other parties—Congress and the taxpayers—that also had a stake in the choices that Fannie and Freddie made. Congress got some benefits in the form of political support from the GSEs' ability to hold down mortgage rates, but it garnered even more political benefits from GSE support for affordable housing. The taxpayers got highly attenuated benefits from both affordable housing and lower mortgage rates but ultimately faced enormous liabilities associated with GSE risk-taking. This article tells the disheartening story of how the GSEs sold out the taxpayers by taking huge risks on

substandard mortgages, primarily to retain congressional support for the weak regulation and profit-maximizing special benefits. As if that were not enough, in the process, the GSEs' operations promoted a risky subprime mortgage binge in the United States that has caused a worldwide financial crisis.

The peculiar structure of the GSEs—shareholder-owned companies with a public mission—reflected a serious confusion of purpose on the part of the Lyndon Johnson administration and the members of Congress who created this flawed structure in 1968. In seeking to reduce the budget deficits associated with the Vietnam War and Great Society programs, the administration hit upon the idea of “privatizing” Fannie Mae by allowing the company to sell shares to the public. This, according to the budget theories of the time, would take Fannie's expenditures off-budget, while allowing it to continue its activities with funds borrowed in the public credit markets. But turning Fannie into a wholly private company was not acceptable either. Various special provisions were placed in Fannie's congressional charter that intentionally blurred the line between a public instrumentality and a private corporation. Among these provisions: Fannie was given a line of credit at the Treasury; the president could appoint five members of its board of directors; and its debt could be used, like Treasury debt, to collateralize government deposits in private banks.

Fannie's congressional charter and its unusual ties to the government ensured that the market would recognize its status as a government instrumentality: that despite its private ownership, the company was performing a government mission. Because it was highly unlikely that the U.S. government would allow one of its instrumentalities to default on its obligations, Fannie was perceived in the capital markets to have at least an implicit government backing and was thus able to borrow funds at rates that were only slightly higher than those paid by the U.S. Treasury on its own debt. In 1970, the Federal Home Loan Bank Board created Freddie Mac to assist federal savings and loan associations in marketing their mortgages; Freddie was also allowed to sell shares to the public in 1989 and became a competitor of Fannie Mae under a congressional charter that established an identical special relationship with the government.

The special relationship, codified by their unique charters, pitted their shareholders against the taxpayers. To the extent that their government backing allowed

the GSEs to take excessive financial risks, it was the taxpayers and not the shareholders who would ultimately bear the costs. The result was the privatization of profit and the socialization of risk. U.S. taxpayers must now fill in the hole that reckless and improvident investment activity, fueled by inexpensive and easily accessible funds, has created in the GSEs' balance sheets. The special relationship was also the GSEs' undoing, because it allowed them to escape the market discipline—the wariness of lenders—that keeps corporate managements from taking unacceptable risks. Normally, when a privately held company is backed by the government (for example, in the case of commercial banks covered by the Federal Deposit Insurance Corporation), regulation is the way that the government protects the taxpayers against the loss of market discipline. When Fannie Mae was privatized in 1968, however, no special regulatory structure was created to limit the taxpayers' exposure. The Johnson Administration officials who structured the privatization may not have realized that they were creating what we recognize today as a huge moral hazard. It was only when Fannie became insolvent in the high-interest-rate environment of the early 1980s that policymakers recognized the potential risk to taxpayers.

Accordingly, in 1991, Congress began the process of developing a regulatory regime for the GSEs. At the time, congressional interest in supporting affordable housing was growing, and Fannie Mae initiated its first foray into affordable housing—a relatively small \$10 billion program, probably intended to show Congress that the GSEs would support affordable housing without a statutory mandate. Nevertheless, Congress added an affordable housing “mission” to the GSE charters when it created their first full-time regulator, the Office of Federal Housing Enterprise Oversight (OFHEO). The new agency had only limited regulatory authority. It was also housed in the Department of Housing and Urban Development (HUD), which had no regulatory experience, and it was funded by congressional appropriations, allowing the GSEs to control their regulator through the key lawmakers who held OFHEO's purse strings.

The new affordable housing mission further increased the congressional policy stake in the GSEs, but it also initiated a destructive mutual dependency: Congress began to rely on Fannie and Freddie for political and financial support, and the two GSEs relied on Congress to protect

their profitable special privileges. In later years, attention to the political interests of Congress became known at the GSEs as “management of political risk.” In a speech to an investor conference in 1999, Franklin Raines, then Fannie’s chairman, assured them that “[w]e manage our political risk with the same intensity that we manage our credit and interest rate risks.”¹

BENEFITS TO CONGRESS

Managing their political risk required the GSEs to offer Congress a generous benefits package. Campaign contributions were certainly one element. Between the 2000 and 2008 election cycles, the GSEs and their employees contributed more than \$14.6 million to the campaign funds of dozens of senators and representatives, most of them on committees that were important to preserving the GSEs’ privileges.² And Fannie knew how to “leverage” its giving, not just its assets; often it enlisted other groups that profited from the GSEs’ activities—the securities industry, homebuilders, and realtors—to sponsor their own fundraising events for the GSEs’ key congressional friends. In addition to campaign funds, the GSEs, Fannie Mae in particular, enhanced their power in Congress by setting up “partnership offices” in the districts and states of important lawmakers, often hiring the relatives of these lawmakers to staff the local offices. Their lobbying activities were legendary. Between 1998 and 2008, Fannie spent \$79.5 million and Freddie spent \$94.9 million on lobbying Congress, making them the 20th and 13th biggest spenders, respectively, on lobbying fees during that period.³ Not all of these expenditures were necessary to contact members of Congress; the GSEs routinely hired lobbyists simply to deprive their opponents of lobbying help. Since lobbyists are frequently part of lawmakers’ networks—and are often former staffers for the same lawmakers—these lobbying expenditures also encouraged members of Congress to support Fannie and Freddie as a means of supplementing the income of their friends.

In the same vein, Fannie and Freddie hired dozens of Washington’s movers and shakers—at spectacular levels of compensation—to sit on their boards, lobby Congress, and in general help them to manage their political risk. (An early account of this effort was an article entitled “Crony Capitalism: American Style” that appeared in *The International Economy* in 1999.⁴ A later version of the same point was made in *Investor’s Business*

Daily nine years later.⁵) The GSEs also paid for academic research to assure the public that the GSE mission was worthwhile and that the GSEs posed minimal risks to taxpayers. For example, Nobel laureate Joseph Stiglitz co-authored an article in 2002 purporting to show that the risk of GSE default producing taxpayer loss was “effectively zero.”⁶

One of the most successful efforts to influence lawmakers came through community groups. Both Fannie and Freddie made “charitable” or other gifts to community groups, which could then be called upon to contact the GSEs’ opponents in Congress and protest any proposed restrictions on the activities or privileges of the GSEs. GSE supporters in Congress could also count on these groups to back them in their re-election efforts.

But these activities, as important as they were in managing the GSEs’ political risks, paled when compared to the billions of dollars the GSEs made available for spending on projects in the congressional districts and states of their supporters. Many of these projects involved affordable housing. In 1994, Fannie Mae replaced its initial \$10 billion program with a \$1 trillion affordable housing initiative, and both Fannie and Freddie announced new \$2 trillion initiatives in 2001.⁷ It is not clear to what extent the investments made in support of these commitments were losers—the GSEs’ profitability over many years could cover a multitude of sins—but it is now certain that the enormous losses associated with the risky housing investments appearing on Fannie and Freddie’s balance sheets today reflect major and imprudent investments in support of affordable housing between 2005 and 2007—investments that ultimately brought about the collapse of Fannie and Freddie.

Even if the earlier affordable housing projects were not losers, however, they represented a new and extra-constitutional way for Congress to dispense funds that should otherwise have flowed through the appropriations process. In one sense, the expenditures were a new form of earmark, but this earmarking evaded the constitutional appropriations process entirely. An illustration is provided by a press release from the office of Senator Charles E. Schumer (D-N.Y.), one of the most ardent supporters of the GSEs in Congress. The headline on the release, dated November 20, 2006—right in the middle of the GSEs’ affordable housing spending spree—was “Schumer Announces up to \$100 Million Freddie Mac Commitment to Address Fort Drum and Watertown Housing Crunch.” The subheading

continued: “Schumer Unveils New Freddie Mac Plan with HSBC That Includes Low-Interest Low-Downpayment Loans. In June, Schumer Urged Freddie Mac and Fannie Mae Step Up to the Plate and Deliver Concrete Plans—Today Freddie Mac Is Following Through.”⁸ If this project had been economically profitable for Fannie or Freddie, Schumer would not have had to “urge” them to “step up.” Instead, using his authority as a powerful member of the Senate Banking Committee—and a supporter of Fannie and Freddie—he appears to have induced Freddie Mac to make a financial commitment that was very much in his political interests but for which the taxpayers of the United States would ultimately be responsible.

Of course, Schumer was only one of many members of Congress who used his political leverage to further his own agenda at taxpayer expense and outside the appropriations process. The list of friends of Fannie and Freddie changed over time; while the GSEs enjoyed broad bipartisan support in the 1990s, over the past decade, they have become increasingly aligned with the Democrats. This shift in the political equilibrium was especially clear in the congressional reaction to the GSEs’ accounting scandals of 2003 and 2004.

THE ACCOUNTING SCANDALS

That Fannie and Freddie reaped significant benefits from the careful management of their political risk is illustrated by the congressional reaction to their accounting scandals. In June 2003, in the wake of the failures of Enron and WorldCom, Freddie’s board of directors suddenly dismissed its three top officers and announced that the company’s accountants had found serious problems in Freddie’s financial reports. In 2004, after a forensic audit by OFHEO, even more serious accounting manipulation was found at Fannie, and Raines, its chairman, and Timothy Howard, its chief financial officer, were compelled to resign.

It is eloquent testimony to the power of Fannie and Freddie in Congress that even after these extraordinary events there was no significant effort to improve or enhance the powers of their regulator. The House Financial Services Committee developed a bill that was so badly weakened by GSE lobbying that the Bush Administration refused to support it. The Senate Banking Committee, then under Republican control, adopted much stronger legislation in 2005, but unanimous Democratic

opposition to the bill in the committee doomed it when it reached the floor. Without any significant Democratic support, debate could not be ended in the Senate, and the bill was never brought up for a vote. This was a crucial missed opportunity. The bill prohibited the GSEs from holding portfolios of mortgages and mortgage-backed securities (MBS); that measure alone would have prevented the disastrous investment activities of the GSEs in the years that followed. GSE immunity to punishment for their accounting scandals is especially remarkable when it is recalled that after accounting fraud was found at Enron (and later at WorldCom), Congress adopted the punitive Sarbanes-Oxley Act, which imposed substantial costs on every public company in the United States. The GSEs’ investment in controlling their political risk—at least among the Democrats—was apparently money well spent.

Nevertheless, the GSEs’ problems were mounting quickly. The accounting scandal, although contained well below the level of the Enron story, gave ammunition to GSE critics inside and outside of Congress. Alan Greenspan, who in his earlier years as Federal Reserve chairman had avoided direct criticism of the GSEs, began to cite the risks associated with their activities in his congressional testimony. In a hearing before the Senate Banking Committee in February 2004, Greenspan noted for the first time that they could have serious adverse consequences for the economy. Referring to the management of interest rate risk—a key risk associated with the GSEs’ holding of portfolios of mortgages or mortgage-backed securities (MBS)—he said:

To manage this risk with little capital requires a conceptually sophisticated hedging framework. In essence, the current system depends on the risk managers at Fannie and Freddie to do everything just right, rather than depending on a market-based system supported by the risk assessments and management capabilities of many participants with different views and different strategies for hedging risks.⁹

Then, and again for the first time, Greenspan proposed placing some limit on the size of the GSEs’ portfolios. Greenspan’s initial idea, later followed by more explicit proposals for numerical limits, was to restrict the GSEs’ issuance of debt. Although he did not call for an outright reduction in the size of the portfolios, limiting

the issuance of debt amounts to the same thing. If the GSEs could not issue debt beyond a certain amount, they also could not accumulate portfolios. Greenspan observed:

Most of the concerns associated with systemic risks flow from the size of the balance sheets that these GSEs maintain. One way Congress could constrain the size of these balance sheets is to alter the composition of Fannie and Freddie's mortgage financing by limiting the dollar amount of their debt relative to the dollar amount of mortgages securitized and held by other investors.... [T]his approach would continue to expand the depth and liquidity of mortgage markets through mortgage securitization but would remove most of the potential systemic risks associated with these GSEs.¹⁰

This statement must have caused considerable concern to Fannie and Freddie. Most of their profits came from issuing debt at low rates of interest and holding portfolios of mortgages and MBS with high yields. This was a highly lucrative arrangement; limiting their debt issuance would have had a significant adverse effect on their profitability.

In addition, in January 2005, only a few months after the adverse OFHEO report on Fannie's accounting manipulation, three Federal Reserve economists published a study that cast doubt on whether the GSEs' activities had any significant effect on mortgage interest rates and concluded further that holding portfolios—a far riskier activity than issuing MBS—did not have any greater effect on interest rates than securitization: "We find that both portfolio purchases and MBS issuance have negligible effects on mortgage rate spreads and that purchases are not any more effective than securitization at reducing mortgage interest rate spreads."¹¹ Thus, the taxpayer risks cited by Greenspan could not be justified by citing lower mortgage rates, and, worse, there was a strong case for limiting the GSEs to securitization activities alone—a much less profitable activity than holding MBS.

The events in 2003 and 2004 had undermined the legitimacy of the GSEs. They could no longer claim to be competently—or even honestly—managed. An important and respected figure, Alan Greenspan, was raising questions about whether they might be creating excessive risk for taxpayers and systemic risk

for the economy as a whole. Greenspan had suggested that their most profitable activity—holding portfolios of mortgages and MBS—was the activity that created the greatest risk, and three Federal Reserve economists had concluded that the GSEs' activities did not actually reduce mortgage interest rates. It was easy to see at this point that their political risk was rising quickly. The case for continuing their privileged status had been severely weakened. The only element of their activities that had not come under criticism was their affordable housing mission, and it appears that the GSEs determined at this point to play that card as a way of shoring up their political support in Congress.

From the perspective of their 2008 collapse, this may seem to have been unwise, but in the context of the time, it was a shrewd decision. It provided the GSEs with the potential for continuing their growth and delivered enormous short-term profits. Those profits were transferred to stockholders in huge dividend payments from 2005 through 2007 (Fannie and Freddie paid a combined \$4.1 billion in dividends in 2007 alone) and to managers in lucrative salaries and bonuses. Indeed, if it had not been for the Democrats' desire to adopt a housing relief bill before leaving for the 2008 August recess, no new regulatory regime for the GSEs would have been adopted at all. Only the Senate Republicans' position—that there would be no housing bill without GSE reform—overcame the opposition of senators Christopher Dodd (D-Conn.), the banking committee chairman, and Schumer.

The GSEs' confidence in the affordable housing idea was bolstered by what appears to be a tacit understanding. Occasionally, this understanding found direct expression. For example, in his opening statement at a hearing in 2003, Representative Barney Frank (D-Mass.), now the chairman of the House Financial Services Committee, referred to an "arrangement" between Congress and the GSEs that tracks rather explicitly what actually happened: "Fannie and Freddie have played a very useful role in helping to make housing more affordable, both in general through leveraging the mortgage market, and in particular, they have a mission that this Congress has given them in return for some of the arrangements which are of some benefit to them to focus on affordable housing."¹² So here the arrangement is laid out: if the GSEs focus on affordable housing, their position is secure.

INCREASED SUPPORT FOR AFFORDABLE HOUSING

Affordable housing loans and subprime loans are not synonymous. Affordable housing loans can be traditional prime loans with adequate down payments, fixed rates, and an established and adequate borrower credit history. In trying to increase their commitment to affordable housing, however, the GSEs abandoned these standards. In 1995, HUD, the cabinet-level agency responsible for issuing regulations on the GSEs' affordable housing obligations, had ruled that the GSEs could get affordable housing credit for purchasing subprime loans. Unfortunately, the agency failed to require that these loans conform to good lending practices, and OFHEO did not have the staff or the authority to monitor their purchases. The assistant HUD secretary at the time, William Apgar, later told the *Washington Post* that "[i]t was a mistake. In hindsight, I would have done it differently." Allen Fishbein, his adviser, noted that Fannie and Freddie "chose not to put the brakes on this dangerous lending when they should have."¹³ Far from it. In 1998, Fannie Mae announced a 97% loan-to-value mortgage, and, in 2001, it offered a program that involved mortgages with no down payment at all. As a result, in 2004, when Fannie and Freddie began to increase significantly their commitment to affordable housing loans, they found it easy to stimulate production in the private sector by letting it be known in the market that they would gladly accept loans that would otherwise be considered subprime.

Although Fannie and Freddie were building huge exposures to subprime mortgages from 2005 to 2007, they adopted accounting practices that made it difficult to detect the size of those exposures. Even an economist as seemingly sophisticated as Paul Krugman was misled. He wrote in his July 14, 2008, *New York Times* column that

Fannie and Freddie had nothing to do with the explosion of high-risk lending.... In fact, Fannie and Freddie, after growing rapidly in the 1990s, largely faded from the scene during the height of the housing bubble... Partly that's because regulators, responding to accounting scandals at the companies, placed temporary restraints on both Fannie and Freddie that curtailed their lending just as housing prices were really taking off. Also,

they didn't do any subprime lending, because they can't ... by law.... So whatever bad incentives the implicit federal guarantee creates have been offset by the fact that Fannie and Freddie were and are tightly regulated with regard to the risks they can take. You could say that the Fannie-Freddie experience shows that regulation works.¹⁴

Here Krugman demonstrates confusion about the law (which did not prohibit subprime lending by the GSEs), misunderstands the regulatory regime under which they operated (which did not have the capacity to control their risk-taking), and mismeasures their actual subprime exposures (which he wrongly states were zero). There is probably more to this than lazy reporting by Krugman; the GSE propaganda machine purposefully misled people into believing that it was keeping risk low and operating under an adequate prudential regulatory regime.

One of the sources of Krugman's confusion may have been Fannie and Freddie's strange accounting conventions relating to subprime loans. There are many definitions of a subprime loan, but the definition used by U.S. bank regulators is any loan to a borrower with damaged credit, including such objective criteria as a FICO credit score lower than 660.¹⁵ In their public reports, the GSEs used their own definitions, which purposely and significantly understate their commitment to subprime loans—the mortgages with the most political freight. For example, they disclose the principal amount of loans with FICO scores of less than 620, leaving the reader to guess how many loans fall into the category of subprime because they have FICO scores of less than 660. In these reports, too, Alt-A loans—which include loans with little or no income or other documentation and other deficiencies—are differentiated from subprime loans, again reducing the size of the apparent GSE commitment to the subprime category. These distinctions, however, are not very important from the perspective of realized losses in the subprime and Alt-A categories; loss rates are quite similar for both, even though they are labeled differently. In its June 30, 2008, Investor Summary report, Fannie notes that credit losses on its Alt-A portfolio were 49.6% of all the credit losses on its \$2.7 trillion single-family loan book of business.¹⁶ Fannie's disclosures indicate that when all subprime loans (including Alt-A) are aggregated, at least 85% of its losses are related to its holdings of both subprime and

Alt-A loans. Indeed, they are all properly characterized as “junk loans.”

Beginning in 2004, after the GSEs’ accounting scandals, the junk loan share of all mortgages in the United States began to rise, going from 8% in 2003 to about 18% in 2004 and peaking at about 22% in the third quarter of 2006. It is likely that this huge increase in commitments to junk lending was largely the result of signals from Fannie and Freddie that they were ready to buy these loans in bulk. For example, in speeches to the Mortgage Bankers Association in 2004, both Raines and Richard Syron—the chairmen, respectively, of Fannie and Freddie—“made no bones about their interest in buying loans made to borrowers formerly considered the province of nonprime and other niche lenders.”¹⁷ Raines is quoted as saying, “We have to push products and opportunities to people who have lesser credit quality.”

There are few data available publicly on the dollar amount of junk loans held by the GSEs in 2004, but according to their own reports, GSE purchases of these mortgages and MBS increased substantially between 2005 and 2007. Subprime and Alt-A purchases during this period were a higher share of total purchases than in previous years. For example, Fannie reported that mortgages and MBS of all types originated in 2005–2007 comprised 49.8% of its overall book of single-family mortgages, which includes both mortgages and MBS retained in their portfolio as well as mortgages they securitized and guaranteed. But the percentage of mortgages with subprime characteristics purchased during this period consistently exceeded 49.8%, demonstrating that Fannie was substantially increasing its reliance on junk loans between 2005 and 2007. For example, in its 10-Q Investor Summary report for the quarter ended June 30, 2008, Fannie reported that mortgages with subprime characteristics comprised substantial percentages of all 2005–2007 mortgages the company acquired, as shown in Exhibit 1. Based on these figures, it is likely that as much as 40% of the mortgages that Fannie Mae added to its single-family book of business during 2005–2007 were junk loans.

If we add up all these categories and eliminate double counting, it appears that on June 30, 2008, Fannie held or had guaranteed subprime and Alt-A loans with an unpaid principal balance of at least \$553 billion. In addition, according to the same Fannie report, the company also held \$29.5 billion of Alt-A loans and \$36.3 billion of subprime loans that it had purchased as private

EXHIBIT 1

Subprime Characteristics of Mortgages Acquired by Fannie Mae, 2005–2007

Subprime Characteristic	Percentage
Negative amortization (option ARMs)	62.2
Interest-only	83.8
FICO scores less than 620	57.5
Loan-to-value ratios greater than 90	62.0
Alt-A	73.0

Source: Fannie Mae, “2008 Q2 10-Q Investor Summary,” August 8, 2008, available at www.fanniemae.com/media/pdf/newsreleases/2008_Q2_10Q_Investor_Summary.pdf (accessed September 29, 2008).

label securities (non-GSE or Ginnie Mae securities).¹⁸ These figures amount to a grand total of \$619 billion—approximately 23% of Fannie’s book of single-family business on June 30, 2008—and reflect a huge commitment to the purchase of mortgages of questionable quality between 2005 and 2007.

Freddie Mac also published a report on its subprime and Alt-A mortgage exposures as of August 2008. Freddie’s numbers were not as detailed as Fannie’s, but the company reported that 52% of its entire single-family credit guarantee portfolio was from book years 2005–2007 (slightly more than Fannie) and that these mortgages had subprime characteristics, as shown in Exhibit 2. Based on these figures, it appears that as much as 40% of the loans that Freddie Mac added to its book of single-family mortgage business during 2005–2007 also consisted of junk loans.

Freddie’s disclosures did not contain enough detail to eliminate all of the double counting, so it is

EXHIBIT 2

Subprime Characteristics of Mortgages Acquired by Freddie Mac, 2005–2007

Subprime Characteristic	Percentage
Negative amortization (option ARMs)	72
Interest-only	90
FICO scores less than 620	61
Loan-to-value ratios greater than 90	58
Alt-A	78

Source: Freddie Mac, “Freddie Mac Update,” August 2008, p. 30, available at www.freddiemac.com/investors/pdf/files/investor.presentation.pdf (accessed September 29, 2008).

not possible at this point to estimate the total amount of its subprime loans from the information it reported. Nevertheless, we can calculate the minimum amount of Freddie's exposure. In the same report, Freddie disclosed that \$190 billion of its loans were categorized as Alt-A and \$68 billion had FICO credit scores of less than 620, so that they would clearly be categorized as subprime. Based on the limited information Freddie supplied, double counting of \$7.6 billion can be eliminated, so that as of August 2008, Freddie held or had guaranteed at least \$258 billion of junk loans. To this must be added \$134 billion of subprime and Alt-A loans that Freddie purchased from private label issuers,¹⁹ for a grand total of \$392 billion—20% of Freddie's single-family portfolio of \$1.8 trillion.

A NEW TRILLION-DOLLAR COMMITMENT

Between 2005 and 2007, accordingly, Fannie and Freddie acquired at least \$1.011 trillion in subprime and Alt-A loans.²⁰ The losses already recognized on these exposures were responsible for the collapse of Fannie and Freddie and their takeover by the federal government, and there are undoubtedly many more losses to come. In congressional testimony on September 23, James Lockhart, the director of their new regulator, the Federal Housing Finance Agency, cited these loans as the source of the GSEs' ultimate collapse, as reported in the *Washington Post*:

Fannie Mae and Freddie Mac purchased and guaranteed "many more low-documentation, low-verification and non-standard" mortgages in 2006 and 2007 "than they had in the past." He said the companies increased their exposure to risks in 2006 and 2007 despite the regulator's warnings.

Roughly 33% of the companies' business involved buying or guaranteeing these risky mortgages, compared with 14% in 2005. Those bad debts on mortgages led to billions of dollars in losses at the firms. "The capacity to raise capital to absorb further losses without Treasury Department support vanished," Lockhart said.²¹

Although a large share of the subprime loans now causing a crisis in the international financial markets are so-called private label securities—issued by banks

and securitizers other than Fannie Mae and Freddie Mac—the two GSEs became the biggest buyers of the AAA tranches of these subprime pools in 2005–07.²² Without their commitment to purchase the AAA tranches of these securitizations, it is unlikely that the pools could have been formed and marketed around the world. Accordingly, not only did the GSEs destroy their own financial condition with their excessive purchases of subprime loans in the three-year period from 2005 to 2007, but they also played a major role in weakening or destroying the solvency and stability of other financial institutions and investors in the United States and abroad.

WHY DID THEY DO IT?

Why did the GSEs follow this disastrous course? One explanation—advanced by Lockhart—is that Fannie and Freddie were competing for market share with the private label securitizers and had to purchase substantial amounts of subprime mortgages in order to retain their position in a growing market. Fannie and Freddie's explanation is that they were the victims of excessively stringent HUD affordable housing goals. Neither of these explanations is plausible. For many years before 2004, Fannie and Freddie had followed relatively prudent investment strategies. They had acquired subprime and Alt-A loans, to be sure, during those years, but they sharply accelerated their purchases in 2005 and subsequent years. Freddie Mac's report, for example, shows that the percentage of mortgages in its portfolio with subprime characteristics rose rapidly after 2004. Exhibits 1 and 2 show that, for each category of mortgages with subprime characteristics, most of the portfolio of loans with those characteristics were acquired from 2005 to 2007. For example, 83.8% of Fannie's and 90% of Freddie's interest-only loans as of June 2008 were acquired from 2005 to 2007, and 57.5% of Fannie's and 61% of Freddie's loans with FICO scores of less than 620 as of June 2008 were acquired from 2005 to 2007. It seems unlikely that competing for market share or complying with HUD regulations—which contained no enforcement mechanism other than disclosure and delay in approving requests for mission expansions—could be the reason for such an obviously destructive course.

Instead, it seems likely that the event responsible for the GSEs' change in direction and culture was the accounting scandal that each of them encountered in

2003 and 2004. In both cases, they lost their reputation as well-managed companies and began to encounter questions about their contribution to reducing mortgage rates and their safety and soundness. Serious observers questioned whether they should be allowed to continue to hold mortgages and MBS in their portfolios—by far their most profitable activity—and Senate Republicans moved a bill out of committee that would have prohibited this activity.

Under these circumstances, the need to manage their political risk became paramount, and this required them to prove to their supporters in Congress that they still served a useful purpose. In 2003, as noted above, Representative Frank had cited an arrangement in which the GSEs' congressional benefits were linked to their investments in affordable housing. In this context, substantially increasing their support for affordable housing—through the purchase of the subprime loans permitted by HUD—seems a logical and even necessary tactic.

Unfortunately, the sad saga of Fannie and Freddie is not over. Some of their supporters in Congress prefer to blame the Fannie and Freddie mess on deregulation or private market failure, perhaps hoping to use such false diagnoses to lay the groundwork for reviving the GSEs for extra constitutional expenditure and political benefit in the future. As the future of the GSEs is debated over the coming months and years, it will be important to remember how and why Fannie and Freddie failed. The primary policy objective should be to prevent a repeat of this disaster by preventing the restoration of the GSE model.

ENDNOTES

The authors wish to thank Edward Pinto, a former chief credit officer of Fannie Mae, for his assistance in deciphering the GSEs' descriptions of their mortgage exposures. AEI research assistant Karen Dubas worked with the authors to produce this article.

¹Quoted in Niles Steven Campbell, "Fannie Mae Officials Try to Assuage Worried Investors," *Real Estate Finance Today*, May 10, 1999. See also Binyamin Appelbaum, Carol D. Leonnig, and David S. Hilzenrath, "How Washington Failed to Rein In Fannie, Freddie," *Washington Post*, September 14, 2008.

²Common Cause, "Ask Yourself Why ... They Didn't See This Coming," September 24, 2008, available at www.commoncause.org/site/pp.asp?c=dkLNK1MQIwG&b=4542875 (accessed September 29, 2008).

³Center for Responsive Politics, "Lobbying: Top Spenders," 2008, available at www.opensecrets.org/lobby/top.php?indexType=s (accessed September 26, 2008).

⁴Owen Ullmann, "Crony Capitalism: American Style," *The International Economy* (July/August 1999), p. 6.

⁵Terry Jones, "'Crony' Capitalism Is Root Cause of Fannie and Freddie Troubles," *Investor's Business Daily*, September 22, 2008.

⁶Joseph E. Stiglitz, Jonathan M. Orszag, and Peter R. Orszag, "Implications of the New Fannie Mae and Freddie Mac Risk-Based Capital Standard," *Fannie Mae Papers*, Vol. 1, No. 2 (March 2002), available at www.sbgo.com/Papers/fmp-v1i2.pdf (accessed September 29, 2008). Interestingly, Stiglitz today is an outspoken critic of GSE risk-taking. According to Stiglitz, GSE risk-taking was a predictable consequence of the structure of the GSEs and their financial structure and compensation schedules. "We should not be worried about [GSE] shareholders losing their investments. In earlier years, they were amply rewarded. The management remuneration packages that they approved were designed to encourage excessive risk-taking. They got what they asked for. Nor should we be worried about creditors losing their money. Their lack of supervision fuelled the housing bubble and we are now all paying the price." (Joseph Stiglitz, "Fannie's and Freddie's Free Lunch," *Financial Times*, July 24, 2008.)

⁷Funding Universe, "Fannie Mae—Company History," available at www.fundinguniverse.com/company-histories/Fannie-Mac-Company-History.html (accessed September 29, 2008); Funding Universe, "Freddie Mac—Company History," available at www.fundinguniverse.com/company-histories/Freddie-Mac-Company-History.html (accessed September 29, 2008); and Business Wire, "Fannie Mae's \$2 Trillion 'American Dream Commitment' on Course with Over \$190 Billion in Targeted Lending," news release, March 14, 2001, available at http://findarticles.com/p/articles/mi_m0EIN/is_2001_March_14/ai_71707186/ (accessed September 29, 2008).

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¹⁰*Ibid.*

¹¹Andreas Lehnert, Wayne Passmore, and Shane M. Sherlund, "GSEs, Mortgage Rates and Secondary

Market Activities” (Finance and Economic Discussion Series 2005–07, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, DC, January 12, 2005), 1, available at www.federalreserve.gov/Pubs/feds/2005/200507/200507pap.pdf (accessed September 29, 2008).

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¹³Carol D. Leonnig, “How HUD Mortgage Policy Fed the Crisis,” *Washington Post*, June 10, 2008.

¹⁴Paul Krugman, “Fannie, Freddie and You,” *New York Times*, July 14, 2008.

¹⁵Office of the Comptroller of the Currency, Federal Reserve Board, Federal Deposit Insurance Corporation, Office of Thrift Supervision, “Expanded Guidance for Subprime Lending Programs,” 2001, available at www.federalreserve.gov/Boarddocs/SRletters/2001/sr0104a1.pdf (accessed September 29, 2008).

¹⁶Fannie Mae, “2008 Q2 10-Q Investor Summary,” August 8, 2008, available at www.fanniemae.com/media/pdf/newsreleases/2008_Q2_10Q_Investor_Summary.pdf (accessed September 29, 2008).

¹⁷Neil Morse, “Looking for New Customers,” *Mortgage Banking*, December 1, 2004.

¹⁸Fannie Mae, “2008 Q2 10-Q Investor Summary,” p. 20.

¹⁹Freddie Mac, “Freddie Mac Update,” August 2008, p. 30, available at www.freddiemac.com/investors/pdffiles/investor-presentation.pdf (accessed September 29, 2008).

²⁰This article was written in September 2008. In December 2008, mortgage expert Edward Pinto testified to the House Oversight Committee that Fannie and Freddie held or had guaranteed subprime and Alt-A mortgage loans with unpaid principal balance of \$1.6 trillion in August 2008.

²¹Zachary A. Goldfarb, “Affordable-Housing Goals Scaled Back,” *Washington Post*, September 24, 2008.

²²James Lockhart, “Reforming the Regulation of the Government Sponsored Enterprises” (testimony, Committee on Banking, Housing and Urban Affairs, U.S. Senate, 110th Cong., 2nd sess., February 7, 2008), p. 6, available at www.ofheo.gov/media/testimony/2708LockharttestimonyWeb.pdf (accessed September 29, 2008).

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