

Worse Than You Think: What Went Wrong at Fannie and Freddie -- And What Still Might

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The government's takeover of Fannie Mae and Freddie Mac in the middle of a presidential race -- coupled with the fact that their activities contributed significantly to the current financial crisis -- has brought these "government-sponsored enterprises" (GSEs) into unusual prominence. One of the principal elements of the story is its similarity to the savings-and-loan (S&L) collapse of only 20 years ago, and the failure of Congress to understand and apply the lessons of that debacle.

Fannie began life as a government agency, commissioned to add liquidity to the housing-finance system. To perform this function, it borrowed funds in the capital markets and used them to buy mortgages from lenders. For many years it toiled quietly in this routine business.

In 1968, as a budgetary measure, the Johnson administration privatized Fannie by allowing it to sell shares to the public. But the shareholder-owned company retained many of its ties to government, and was given a congressional charter. So despite its private ownership, investors and other creditors continued to believe the government backed it -- that taxpayers would come to the rescue if things went wrong.

By the late 1980s, the U.S. financial world was in turmoil. Fed chairman Paul Volcker's effort to curb inflation had resulted in high market interest rates, which in turn had devastated the S&L industry. Unlike commercial banks, S&Ls had a narrow range of permissible activities, focused primarily on housing. Their assets -- principally home mortgages -- were not diverse enough to keep them alive when the housing market went into one of its frequent tailspins. In a high-interest-rate environment, S&Ls had to pay more to attract and hold deposits than they were receiving in revenue from mortgages. The mismatch -- high short-term liabilities, low-yielding long-term assets -- was driving the industry toward insolvency.

Deposits in S&Ls, like those in commercial banks, were federally insured, and this enabled them to raise funds despite their weak financial condition. Congress broadened their investment powers, allowing the industry to invest in new and risky ventures as it "gambled for resurrection." This gamble did not pay off, and the losses continued to mount.

In 1989, the first Bush administration recognized that it had to intervene. New legislation established the Resolution Trust Corporation to acquire and sell the assets of failed S&Ls, a process that eventually cost the taxpayers \$150 billion. The same legislation also "privatized" Freddie Mac -- then a subsidiary agency of the Federal Home Loan Bank Board -- under a charter virtually identical to Fannie's.

The prospect of huge losses for taxpayers engendered a bitter debate about causes and blame. On one side were those who argued that greed, fraud, and incompetence among S&L owners and managers were responsible. On the other were those who blamed the government for allowing an

industry that was inherently vulnerable to take enormous risks with insured deposits. Both sides were partially right, but only the former explanation seemed to sink in with a Congress eager to deny its culpability.

The Super-S&L

By 1991, James A. Johnson, a politically connected former top aide to Walter Mondale, had become Fannie's chairman and CEO. He stepped into this barren landscape with an idea that would have been rejected out of hand if Congress had correctly diagnosed the S&L problem. Johnson's view was that Fannie could prosper as a super-S&L by using its low-cost, government-backed funds to buy and hold a portfolio of high-yielding mortgages. Fannie and Freddie's activities, as in the case of the S&Ls, were restricted to housing. This business model was different from the S&Ls' in but one important way: This new S&L wouldn't have to limit itself to \$100,000 deposits to get government insurance; all of Fannie's debt had the implicit backing of the taxpayers.

Fortunately, some in Congress saw that allowing a privately owned company to borrow money with government backing required at least some form of regulation, and in 1991 Congress finally got around to considering revisions to the GSEs' charters and the creation of a regulatory agency to oversee their activities.

At about this time, Fannie, under Johnson's control, committed to loan \$10 billion over two years to promote affordable housing. This initiative helped Fannie resist effective regulation in several ways. First, it showed that Fannie would share some of its gains with taxpayers -- and thereby created goodwill with lawmakers. Second, members of Congress saw that they could use affordable-housing lending much the way they use earmarks: They could select projects in their states and districts, and politely request that Fannie loan money to them. Unlike the countless banks scattered across the country, Fannie was conveniently centralized in D.C., and talks with it did not require (or receive) much public scrutiny.

In the end, Johnson got a good deal: The regulatory structure that Congress adopted -- which, in passing, added an affordable-housing "mission" to Fannie's charter -- was seriously deficient. Not two years after the demise of the S&Ls had shown beyond question that government backing (in the form of FDIC insurance) without adequate risk controls was a prescription for disaster and taxpayer loss, Congress repeated its mistake.

The new regulator -- the Office of Federal Housing Enterprise Oversight (OFHEO) -- had none of the strong authorities routinely given to bank regulators; it was also subject to congressional appropriations, which made it possible for the GSEs to control their own regulator through their congressional supporters. This was an aberration from other congressional activity: The year before, the same Congress had adopted the Federal Deposit Insurance Corporation Improvement Act, which significantly toughened the regulation of banks and gave their regulators more independence.

Jim Johnson lost no time in using the affordable-housing initiatives to cement congressional support into place. The principal element of this bargain was that Congress would allow the

GSEs to retain federal backing, and the absence of a strong regulator would permit Fannie and Freddie to grow without serious restriction. The lack of regulation would also make it possible for the GSEs to meet the demands of Congress on the allocation of affordable-housing funds.

In 1994, Johnson announced another affordable-housing initiative, this time with a goal of \$1 trillion in loans -- intended to enable 10 million families to buy homes by the end of 2000. At the same time, he created local partnership offices (eventually totaling 51) in urban areas across the country. These offices were overtly political, and performed a grassroots lobbying function, assuring congressional backers of Fannie and Freddie that they could tap into supportive local groups when it came time for reelection -- or to beat back initiatives that might clip the GSEs' wings.

In 2000, after succeeding Jim Johnson as chairman and CEO of Fannie Mae, Franklin Raines, head of the Office of Management and Budget in the Clinton administration, announced Fannie's "American Dream Commitment," a ten-year, \$2 trillion pledge to support affordable housing. It made another huge, taxpayer-backed program available for manipulation and political patronage.

In 2003 and 2004, when Fannie and Freddie were found to have been practicing Enron-style accounting, their friends in Congress rushed to their defense, citing affordable housing. At a House Financial Services Committee meeting in September 2003, Massachusetts Democrat Barney Frank -- then ranking minority member and now chairman -- observed: "I do think I do not want the same kind of focus on safety and soundness. . . . I want to roll the dice a little bit more in this situation towards subsidized housing." Charles Schumer of New York, then a powerful member of the Senate Banking Committee, stated the next month: "My worry is that we're using the recent safety and soundness concerns, particularly with Freddie, and with a poor regulator, as a straw man to curtail Fannie and Freddie's [affordable-housing] mission."

An Attempt To Regulate

By the end of 2004, things had gotten a great deal bleaker for the GSEs. Their accounting frauds had prompted bad publicity and some serious challenges from within the government. The Bush administration sought the stronger, bank-like regulatory regime that Congress had failed to adopt in the early '90s. Alan Greenspan -- then at the height of his authority as Federal Reserve chairman -- called for controls on the growth of the GSEs' hugely profitable mortgage portfolios. Fed economists had determined that the GSEs did not, as they'd claimed for years, reduce interest rates for middle-class homebuyers. Franklin Raines had resigned under fire for his participation in Fannie's false accounting. Republicans had introduced stronger regulatory legislation in both the House and the Senate. Drastic steps were needed to rebuild the bond with Congress and prevent the adoption of tough new regulations.

The GSEs made it clear that such regulations would make it harder to get affordable-housing pork to Congress's constituents. A strong regulator could make the GSEs' portfolios less profitable -- and without these profits, it would not be possible for Fannie and Freddie to continue to subsidize affordable housing. Worse, a strong regulator might scrutinize their affordable-housing investments, including ones members of Congress had requested.

Beginning in 2005, Fannie and Freddie put more than \$1 trillion in junk loans on their books. The unprecedented rate of defaults on this \$1 trillion is what precipitated the takeover of Fannie and Freddie by the federal government in September, and will burden taxpayers with tremendous costs. But it worked politically. The GSEs' supporters (and beneficiaries) in Congress held off on any new regulation. The Senate Banking Committee adopted a strong regulatory bill in 2005 -- with the unanimous support of committee Republicans and over the unanimous opposition of committee Democrats -- but it could not be brought to a vote on the Senate floor. Not a single Democrat, including Barack Obama, supported it. The benefits that Fannie and Freddie offered to Congress continued to flow. In 2006, Chuck Schumer's office issued a press release headlined "Schumer Announces up to \$100 Million Freddie Mac Commitment to Address Fort Drum and Watertown Housing Crunch." The release boasted that the senator had "urged" the company to "step up" and make this commitment.

Congress thus repeated with Fannie and Freddie the error that had produced the collapse of the S&L industry in the late 1980s. It gave government backing to inadequately supervised private companies. But the case of Fannie Mae and Freddie Mac is far worse than the S&L debacle. First, taxpayers' losses this time will be enormously larger. Second, in the case of the S&Ls, the missteps of Congress can be understood and to some extent excused: It had never encountered anything quite like the S&L collapse, and the banking failures of the Depression were 50 years in the past. Third, while individual lawmakers received favors from the S&L industry, these were the petty graft that tends to go along with political power -- not to be condoned, of course, but nothing new. But Congress's failure to create a strong regulatory regime for Fannie Mae and Freddie Mac was something new. Coming as it did on the heels of the passage of tough new banking regulation, it had to be a conscious choice by the GSEs' supporters in Congress -- most of them liberal Democrats -- to continue using the GSEs' financial resources for political purposes.

Perhaps worst of all, the takeover of Fannie and Freddie by a government conservator does not end the problem. In fact, it might open a new and more costly era. In a statement to the House Financial Services Committee on September 25, James B. Lockhart III, director of the agency that serves as both regulator and conservator of Fannie and Freddie, insisted on meeting the affordable-housing goals required by HUD regulations: "The market turmoil of this year resulted in a tightening of underwriting criteria . . . thereby reducing the availability of traditionally goal-rich, high loan-to-value home-purchase loans. . . . I will expect each enterprise to develop and implement ambitious plans to support the borrowers and markets targeted by the goals."

If this is what a Republican administration says about the use to which Fannie and Freddie will be put in conservatorship, one can only imagine what a Democratic administration might do.

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