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Government Influence and the Failure of Fannie Mae and Freddie Mac

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by

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A Thesis Submitted to the Honors Council

For Honors in Economics

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Abstract

In 2008 two government-sponsored enterprises, Fannie Mae and Freddie Mac, were placed into conservatorship due to insolvency. The financial bailout of the two publically traded corporations came at the expense of the American tax payer. This study investigates the relationship between direct and indirect government influence and the increasing risk taking of Fannie Mae and Freddie Mac from the late 1990's through their conservatorship in 2008. As government-sponsored enterprises Fannie Mae and Freddie Mac have many special advantages that other publically traded companies did not possess. These advantages allowed Fannie Mae and Freddie Mac to increase their profitability. Theoretical literature regarding Congress and the bureaucracy suggests that the actions of bureaucrats can be linked to the preferences of Congressional members because bureaucrats are responsive to potential threats or perceived threats from the legislature. This theory is applicable to Fannie Mae and Freddie Mac, and is used to explain why the government was able to directly and indirectly influence the government-sponsored enterprises. Overall this investigation has determined that the United States government pursued a clear mission that determined to increase the availability of housing to all Americans, specifically to low-income and under-served individuals, through the use of the government-sponsored enterprises. Despite this link there is no conclusive data to show that the pursuit of this housing mission led Fannie Mae and Freddie Mac to operate in riskier business segments. This study has also found that motivation regarding profit-seeking and compensation structure provide a more

plausible explanation for why the government-sponsored enterprises began to engage in riskier business practices that led to their insolvency.

Introduction

The purpose of this study is to investigate the failure of the government-sponsored enterprises Fannie Mae and Freddie Mac during the financial crisis of 2007-2008. As publically traded entities that possessed advantages vested on them by the government, as well as a Federal housing mission, it was generally assumed that Fannie Mae and Freddie Mac were stable corporations that adhered to risk management protocols that were superior to those of most other financial institutions. This assumption was proven false when the United States Treasury was forced to inject billions of dollars in tax-payer money into the firms in September of 2008 to prevent their bankruptcy, placing them into conservatorship. Conservatorship is when an organization in financial distress is subject to the legal control of an entity acting in the public interest.

As government-sponsored enterprises Fannie Mae and Freddie Mac had a different relationship with the United States government than other publically traded corporations. They were subject to special government regulation, forced to pursue government initiated goals, and were a topic of discussion amongst legislatures. This thesis seeks to determine whether the direct and indirect influence of the United States government played a significant role in increasing the risk taking of Fannie Mae and Freddie Mac that inevitably led to the failure of these institutions.

This topic is of special interest because of the historic and complex nature of the financial crisis of 2007-2008. The collapse of the housing bubble, conservatorship of

Fannie Mae and Freddie Mac, and the capital injection into many investment banks and other financial institutions was a defining moment in United States history that called into question regulatory policy, financial innovation and risk taking, and lending standards within the United States. This thesis will investigate a specific component of the crisis to provide more clarity into the failure of two of the largest government-sponsored enterprises, Fannie Mae and Freddie Mac.

Chapter one of this study provides background information regarding the government-sponsored enterprises just prior to conservatorship as well as historical context of the real-estate boom and subprime lending explosion that occurred in the United States just prior to the financial crisis. A theoretical framework regarding Congress and the bureaucracy is introduced in chapter two. This framework will be used to evaluate the relationship between government influence, which is presented in chapters three and four, and the changing risk positions of the GSEs which is detailed in chapter five. Chapter six evaluates the relationship between government influence and financial risk taking within the framework of the theoretical relationship examined in chapter two. Overall this investigation has found that there is no conclusive evidence to link government influence to the increasing risk taking of Fannie Mae and Freddie Mac. Chapter seven of this thesis discusses alternative explanations discovered in course of this study that serve as plausible explanations for the failure of these two financial institutions. This chapter also offers concluding remarks.

This study relies heavily on the use of financial data and the interpretation of Congressional testimony and legislation. Further discussion regarding the methods used to collect legislative testimony is included within chapter four. Much of the desired financial data used to evaluate the riskiness of Fannie Mae and Freddie Mac is unavailable due to poor record keeping by the government-sponsored enterprises and their regulators. Given this several third party studies were utilized to analyze the risk positions of both enterprises. A phone interview with Gregory Parseghian, the former Chief Executive Officer of Freddie Mac, was also used to provide further clarity on the financial practices of Fannie Mae and Freddie Mac.

Throughout this study there are several short-hand terms and acronyms that are used. These terms are defined within the text and also within a glossary of terms that is included in the appendix to this thesis.

Chapter 1

Throughout history politicians, novelists, and filmmakers have championed the idea of the American Dream. America is viewed as a place where regardless of background, education, or income an individual has the opportunity to work hard and reap the benefits of his or her labor by progressing upward through society. Owning a home is symbolically viewed as the manifestation of the American dream. Throughout the 1990’s and early 2000’s, with the explosion of subprime lending and the housing market, this dream became a reality for more Americans than ever before. The eventual collapse of the subprime market and the housing bubble inevitably had repercussions for the financial markets and global markets that are still being felt today. The decline in value of real-estate assets undeniably contributed to the failure of many financial firms including the government-sponsored enterprises (GSE) Fannie Mae and Freddie Mac. This section will provide general background information regarding the GSEs just prior to conservatorship as well as a look into the subprime and real-estate markets preceding the 2007-2008 financial meltdown. This information is important to grasp to develop a clear understanding of the financial risk levels and failures of Fannie Mae and Freddie Mac.

1.1 Government-Sponsored Enterprises

Beginning in the early 1900's the United States government started establishing financial intermediaries to provide capital to various sectors of the economy that the government viewed under-capitalized by the private markets. The financial intermediaries were coined government-sponsored enterprises, or, GSEs. Early GSEs include the Federal Home Loan Bank System and the Farm Credit System. The GSE's Fannie Mae and Freddie Mac were specifically created for the intention of providing capital to the residential mortgage market, under the belief that restrictions on bank lending and a desire to limit portfolio risk constrained the amount of real estate loans that were created by banks. It is important to note that GSEs are privately owned. This distinguishes them from other government agencies. Private ownership of the GSEs allowed them to reap the benefits of the private debt and equity markets. Their relationship with the government subjected them to more regulation then other private companies; however, their close ties with Washington afforded the agencies many implicit and explicit benefits (Owens, 1993).

Fannie Mae and Freddie Mac were able to realize many advantages while operating within the secondary mortgage market because of their status as GSEs. The most notable explicit benefits include a line of credit with the United States Treasury, exemptions from state and local income taxes, security exemption from the Securities and Exchange Commission's (SEC) registration and reporting fees, security exemption from many state and local investor protection laws, and the ability for banks and savings and loans institutions to use their debt as collateral for public deposits, for purchase in open-market operations, and for unlimited investment by commercial banks and savings and loan agencies. The close relationship between Fannie and Freddie and the United States government also created an implicit guarantee amongst investors that debt obligations originated by the secondary-mortgage makers were backed by the full faith of the United States government (White, 2004). This implied guarantee eventually became overt in September 2008 when the GSEs were placed in conservatorship.

The many advantages granted to Fannie and Freddie by the government did not come without cost. The charters of both organizations were created by Congress as opposed to registered within a specific state. The charters of Fannie and Freddie restrict them specifically to residential mortgage finance, prohibit them from mortgage originations, put forth size and risk limits (as determined by mortgage value and loan-to-value ratio) on mortgage purchases, and subject them to federal operational and "mission" oversight. Fannie and Freddie are specifically designed to finance the mortgage market by serving the roles of an insurer and portfolio lender (White, 2004). A brief history of Fannie Mae and Freddie Mac is included in the next section.

1.2 Federal National Mortgage Association and Federal Home Loan Corporation

In 1938 under the guidance of Franklin D. Roosevelt's "New Deal" the Federal National Mortgage Association (FNMA), more commonly known as Fannie Mae was established in an effort to provide local banks with federal money in order to finance home mortgages with the hopes that this capital would reverberate through the real-estate markets and increase the availability of affordable housing. Fannie Mae remained a federally controlled entity until 1968, when it became a publically traded corporation listed on the New York Stock Exchange (White, 2004).

In 1970 the Federal Home Loan Corporation (FDMC) or Freddie Mac was created in an effort to expand the availability of mortgage finance to thrift institutions and serve as competition to Fannie Mae in the secondary mortgage market. A thrift specializes in accepting savings deposits and making mortgage or other loans. Thrifts include mutual savings banks, savings and loan institutions, and credit unions. At its inception Freddie Mac was designed mainly to help facilitate mortgage credit to thrifts, whereas Fannie Mae serviced a broader group of lenders. Freddie Mac was originally wholly owned by twelve banks within the Federal Home Loan Bank system (FHLB). The FHLB consists of

12 federally owned banks throughout the United States that provide stable low-cost funding for American financial institutions for things such as home mortgage loans, small business loans, agricultural loans, and economic development lending. Similar to Fannie Mae, Freddie Mac became a publically traded company in 1989 (White, 2004).

Fannie Mae and Freddie Mac were placed into conservatorship by the United States government on September 6, 2008 as the mortgage giants flirted with bankruptcy due to insolvency. The federal takeover of Fannie and Freddie cost taxpayers billions of dollars and the failure of these institutions placed significant stress on the financial markets. In an effort to fully understand how these two organizations came into financial distress it is important to understand their business model.

1.3 Business Operations

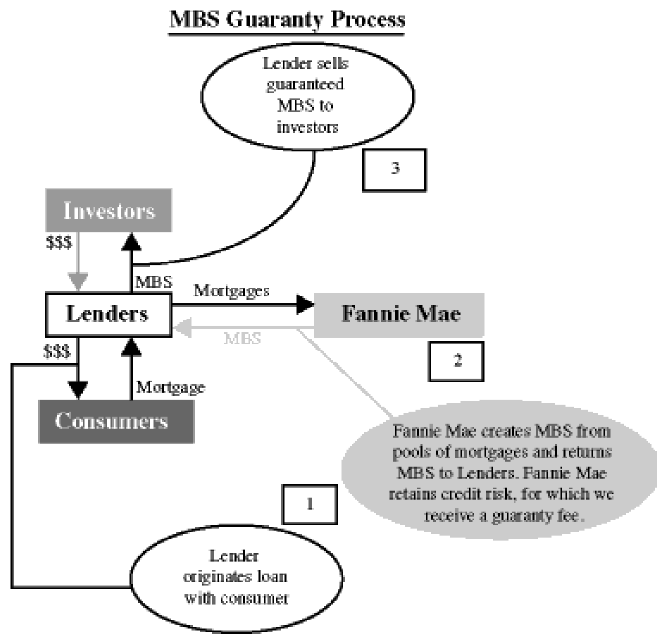
Fannie Mae and Freddie Mac classify their business segments with different titles, but both GSEs function in the same distinct operational segments. Fannie Mae classifies its business segments as the "Single-Family Credit Guaranty Business," which refers to the purchasing and packaging of single-family mortgage loans (properties with four or fewer residential units), the "Housing and Community Development Business," which encompasses multifamily mortgage loans, and the "Capital Market Group," which manages internal investment in mortgage loans, mortgage-related securities, debt financing activity, and other related capital positions. Freddie Mac operates under a similar structure, classifying its business segments as "Single-family Guarantee," "Multi Family" and "Investments" (FNMA and FDMC Annual Report 2008).

Generally speaking both Fannie Mae and Freddie Mac purchase loans, package these loans into mortgage-backed securities (MBS), and re-sell the MBS to lenders, banks, and private investors. Fannie and Freddie guarantee timely payment on its outstanding securities and receive a payment, similar to an insurer, for packaging and guaranteeing mortgages within MBS. The GSEs also hold their own internal investment portfolios composed of their MBS and other privately created MBS

1.4 Mortgage-Backed Securities

Fannie Mae and Freddie Mac are unable to directly offer consumers credit to purchase real-estate. Instead Fannie and Freddie provide liquidity within the mortgage market by purchasing mortgage loans from mortgage banking companies, investment banks, savings and loan associations, savings banks, commercial banks, credit unions, community banks, insurance companies, and state and local housing agencies. After these loans are purchased, Fannie Mae and Freddie Mac package loans into mortgage-backed securities (MBS) and re-sell them to their original customers. This process is called securitization. As Fannie Mae and Freddie Mac purchase more loans and issue more securities they generate higher profits because they receive more guarantee fee-payments on the MBS they guarantee The mortgage guarantee process is depicted in Figure 1 on the following page.

Figure 1 MBS Guaranty Process[1]



In the credit guaranty business, lenders originate mortgages with consumers. They "swap" the loans for MBS with Fannie Mae assuming the credit risk on the loans and guaranteeing the timely payment of scheduled principal and interest on the MBS, for which Fannie Mae receives a guaranty fee. Fannie Mae returns the MBS to the lender, who sells it to investors.

The outstanding MBSs that Fannie and Freddie guarantee and the associated pools of mortgages are held off-balance sheet in a special purpose vehicle (SPV) (Board of Governors of the Federal Reserve System, 2000). For the SPV, mortgages that had been purchased are assets, and MBS are liabilities. The transactions of Fannie and Freddie, whether through the purchasing of mortgages or the sale of securitized products, allow the agencies to provide liquidity to the residential real-estate market. This enables lenders to originate more loans (FNMA Annual Report 2006). Fannie and Freddie further help facilitate the mortgage market by purchasing mortgage-related securities, including their

[1] Fannie Mae 2005 SEC Filing.

own MBS, for their own internal mortgage portfolio. The GSEs could recognize revenue through the investment returns on their internal mortgage portfolio.

Mortgage-backed securities were developed in the 1970's through the combined efforts of Fannie Mae, Freddie Mac, another housing GSE Ginnie Mae, the United States government, and bond traders at Solomon Brothers Investment Bank who hoped to generate profits by trading residential mortgages. Initially investors feared holding mortgage loans in their portfolio because there was no guarantee regarding a steady source of income: the borrower of a mortgage could default or pay the remaining balance of a mortgage at any time, interrupting a consistent flow of payments that one would have if they held a bond or treasury bill (Hayre 1999). This changed with the development of the mortgage-backed security, which is an investment security available for purchase that pools many different mortgages together and returns to investors a monthly payment. This type of mortgage-backed security is referred to as a pass-through security. When an investor or agency purchases a mortgage-backed security they are not given any information regarding the credit history of the individual borrowers of any pooled mortgage-loan, and instead only know the credit-risk related to the entire pooled security, which is generally determined by rating agencies. Fannie Mae and Freddie Mac mainly operated in the pass-through MBS market avoiding more complex mortgage backed securities that varied the stream of cash flows in different ways. In addition to creating MBS Fannie Mae and Freddie Mac often purchased MBS created by non-GSE institutions, which were known as private label MBS, and held them in their own portfolio for investment purposes. By operating in the MBS market Fannie and Freddie played an integral role in creating and facilitating the transfer of both GSE MBS and privately created MBS that helped provide liquidity to the housing market. As the GSEs were able to package, sell, and hold more MBS, more credit was available to mortgage lenders to originate loans. Funds from investors in MBS such as pension funds, credit unions, investment banks, and other private investors also flowed into the mortgage market with the expansion of MBS expanding the availability of home mortgage loans.

1.5 Subprime Lending

The subprime market can be characterized by loans that hold similar qualities and are of riskier nature than a standard loan. Subprime are loans made to borrowers with weak credit histories and viewed as more unlikely to be paid back. Generally speaking, the title subprime is given by the lender that originates the mortgage (Mizin, 2008). Many organizations, including The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision utilize previous record of delinquency, foreclosure, or bankruptcy, a credit score of 580 or below, and a debt-service ratio of 50 percent or greater for borrowers to characterize subprime loans. From a borrower's perspective, subprime mortgages are generally attached to higher up-front fees, higher insurance costs, and a higher rate of default.

Aside from the term "subprime" there are several other titles that could identify loans with similar risk profiles as subprime originations. For the purposes of this study two such loans of note are Alt-A loans (Alternative A-Paper) and EA (Expanded

Approval) loans. Generally Alt-A loans refer to riskier mortgages given to borrowers with clean credit histories. The mortgages are generally riskier because of documentation issues, high loan-to-value ratios, or because the borrower's income is low in comparison to the mortgage value. EA loans are a term used by Fannie Mae to describe loans that are for consumers that couldn't qualify for a normal loan. These loans are generally characterized as higher risk. Freddie Mac also offered similar products.

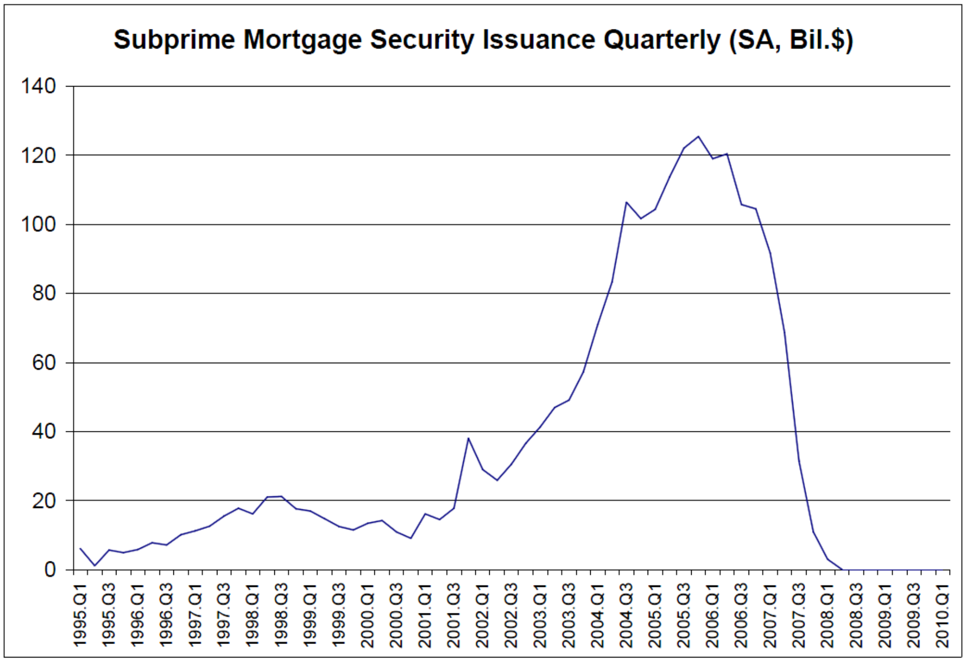
Within the United States there were two general subprime mortgage booms. The first boom occurred in the late 1990's, when the subprime market grew to roughly $150 billion dollars or 13% of all mortgage originations. This boom came to a screeching halt with the burst of the dotcom bubble in 2001; however, a second expansion phase occurred from 2002 to 2006 when subprime mortgage originations rose from $160 billion dollars to $600 billion dollars. The 2006 figure represented roughly 20% of all mortgage originations, which had increased dramatically from less than 9% of all mortgage originations in 2003. (Baker 2008).

The large increase in subprime lending can be attributed to a multitude of reasons. Some scholars have argued that changes in regulation allowed for mortgage lending at high interest rates and fees that provided many tax advantages. Many scholars believe that the Depository Institutions Deregulation and Money Control Act of 1980, which allowed borrowers to obtain loans from states other than the state they lived in, made interest-rate caps at the state level ineffective. The Alternative Mortgage Transaction Parity Act allowed variable-rate mortgages, and the Tax Reform Act ended a tax deduction for interest on forms of borrowing except for mortgages (Chomsisengphet and Pennington-Cross 2006). These changes, scholars argue, largely set the stage for the growth in the subprime market.

In addition to changes within the law, there was a large desire for mortgage originations within the financial markets for securitization purposes because of the yield these investments provided to investors. The principal and interest payments on the debt are paid to the investors regularly, providing them a source of income. Throughout the late 1990's and early 2000's especially interest rates were kept low, which led investors to search for high yields in alternative arenas. The mortgage-backed securities and other more innovative investment products linked to both prime and subprime mortgages provided a vehicle for increased returns in what appeared to be relatively safe investments (Mizen 2008).

As subprime loans grew in availability they began to be packed into MBS securities at a greater rate. These new securities presented even higher yields to investors, but represented increasing risk. Figure 2 on the following page depicts the growth in subprime MBS securities issued from 1995 to 2008. The large increase in subprime MBS originations and the eventual collapse of this market is largely correlated with the subprime boom and real-estate bubble that occurred in the years preceding the housing crisis.

Figure 2 Quarterly Subprime MBS Outstanding[2]



Source: Inside Mortgage Finance 4/15/2010

To further heighten the risks associated with subprime lending, many mortgage originators such as Countrywide Financial Corp, Ameriquest Mortgage Co., and New Century Financial Corp., the three biggest subprime lenders, had low standards when originating mortgages. Many Americans could purchase mortgages with little proof of income levels or credit history. The increase in volume of subprime lending and the poor lending standards of many mortgage originators ultimately served as a catalyst for the meltdown of the financial system when the housing market collapsed (Health 2010).

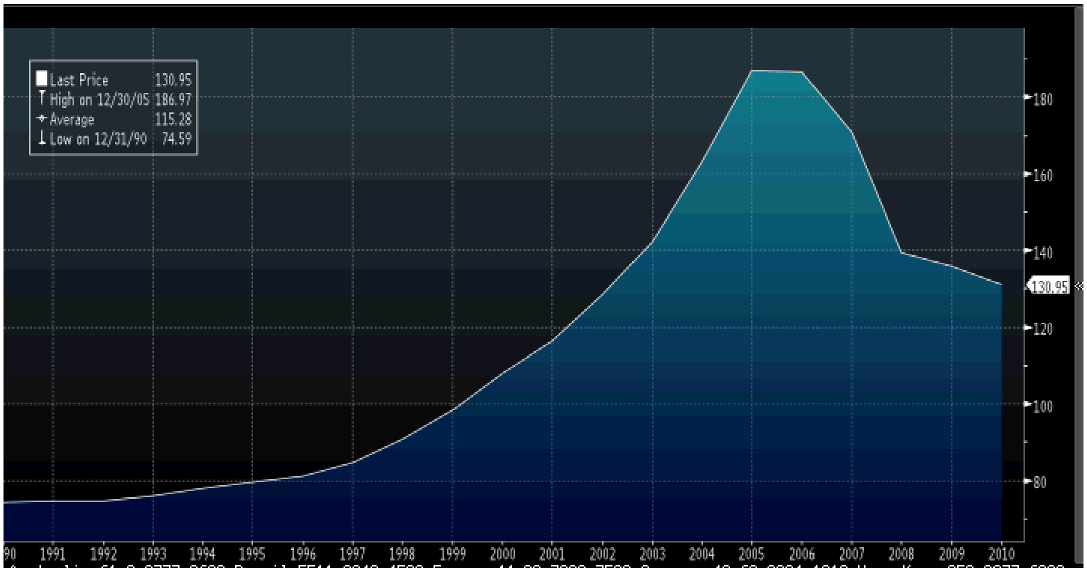
1.6 Real-Estate Bubble

[2] Greenspan, 2010.

As the subprime market exploded in the late 1990's and early 2000's the real-estate market as a whole was thriving. Historic data shows two separate periods that contributed to the housing bubble. The first period preceded the collapse of the stock market in the early 2000's as consumption and consumer spending remained high. After the collapse of the dotcom bubble real estate became an even more attractive investment, especially because of the decline and uncertainty in the equity market. In 2000 the Federal Reserve reduced short-term interest rates from 6.5% to 3.5%, and then ultimately to 1% following the September 11th terrorist attacks (Federal Reserve Website, 2012). The decline in interest rates greatly reduced the costs of funds, which increased credit available for the real-estate market.

As interest rates remained around 1% throughout 2003 and 2004, with real short-term interest rates negative, Americans continued to flock to the housing market. Figure 3 on page 16 depicts real housing prices using the Case Shiller Home Price Index. As the graph shows home prices remained relatively constant through the mid 1990's, after which they began to increase rapidly until 2005. Prices continued to rise at declining rates for at least another year after this. As the demand for mortgages and homes increased, the market value of homes grew by more than 50 percent from 2000 through 2007.

Figure 3 Case-Shiller United States Home Price Index Annual Data 1990-2010[3]



The demand for housing, increase in housing prices, and low interest rate environment fueled a construction boom, and in 2005, housing starts peaked at roughly 2,070,000. This was 50% more than the rate of housing starts preceding the bubble in the mid 1990's. During this same time period consumption increased dramatically with the savings rate falling to less than 1% between 2005 and 2007 (Baker, 2008).

Speculation regarding continual low short-term interest rates and an increase in housing prices fueled the housing boom: as consumers continued to believe housing prices would rise, money continued to flow into real estate. Eventually, as construction peaked, supply began to outpace demand within the housing market. Prices were impacted in line with general microeconomic theory, with excess supply leading to a decline in prices. In the middle of 2007, prices began to drift downward. As housing

[3] Case-Shiller Index taken from Bloomberg Financial Terminal.

prices began to decline and interest rates began to rise, more homeowners began to realize that paying off their mortgages was not economically sensible. In many cases the value of homes became far lower than the value of the outstanding mortgages making it economically beneficial for homeowners to walk away from their mortgages. As this notion became a reality foreclosures began to increase and default rates began to soar. Increasing foreclosures drove lenders to increase down payments by as much as 25% on new mortgages, excluding many potential home buyers from the market which served to increase the supply of houses that were being constructed during a period of minimal demand (Baker, 2008).

By the end of 2007 real housing prices had already fallen by more than 15% from their peak. These problems were even more apparent in the subprime market. Due to the poorer credit standing of borrowers and relaxed lending standards, defaults were even more prevalent. By Q2 of 2008 roughly 18.6% of all subprime mortgages were delinquent and an additional 12% were in the process of foreclosure (Baker, 2008).

The decline in real-estate prices and high default rates generated a large instability in the financial services market. This was largely due to the large amount of securitized assets backed by mortgages. During this time period the value of mortgage-backed securities (MBS) and other financial instruments backed by private mortgages dropped significantly. Fannie and Freddie guaranteed the stream of payments underlying the MBS, and when mortgages began to default at unprecedented rates the GSEs lacked the funds to make payments on the MBS assets they had previously guaranteed. In short, the

GSEs did not have enough capital to guarantee the stream of payments of the mortgages that were underlying the MBS that had defaulted, despite their guarantee to do so.

1.7 Setting the Stage

Fannie Mae and Freddie Mac operate within the home mortgage market, including the subprime market. As a result of rising defaults, they were unable to cover their liabilities, and became insolvent. Given the many advantages enjoyed by the GSEs as well as their relationship with the United States government Fannie and Freddie were subject to many Congressional pressures. This raises the question that drives this investigation: Did Congressional pressure lead to the insolvency of Fannie Mae and Freddie Mac? Existing theory regarding the relationship between bureaucracies and Congress provides a framework within which this question can be answered.

Chapter 2

This chapter will provide the framework with which we will analyze the possible connection between insolvency of Fannie Mae and Freddie Mac and government influence. The theoretical framework regarding the way Congress is able to influence bureaucratic organizations will be used to determine whether the government influence examined in chapters three and four played a role in increasing the risk levels of Fannie Mae and Freddie Mac that is examined within chapter five.

2.1 Congress and the Bureaucracy

Bureaucracy, broadly defined, refers to a system of government in which the implementation of the rules, laws, and functions of an institution are made by non-elected officials. The GSEs serve as bureaucratic organizations because of their ties to the United States government. The 12th edition of *Congress and its Members* summarizes the relationship between Congress and bureaucracies. Theoretically *Congress and its Members* argues that Congress generally allows bureaucratic executives a wide discretion in implementing and running their organizations because legislators lack the time, knowledge, or expertise to address the complexities of each contemporary bureaucratic organization (Davidson, et. al 2010). Despite the relative freedom of bureaucratic leaders, the Constitution implicitly grants Congress an oversight role because of their ability to make laws, raise and appropriate money, and impeach Federal officials (Davidson, et. al 2010). Fannie Mae and Freddie Mac differ slightly from other bureaucracies because their administrative structure is that of a corporation with a Board of Trustees and nonappointed officials who positions are largely dictated by performance since they are publically traded companies. The many advantages the GSE's hold because of their government ties make them subject to the Congressional oversight that exists within traditional bureaucracies because their business would not be as profitable if these ties were removed. As a result of such ties Fannie and Freddie receive a federal subsidy that the Congressional Budget Office (CBO) calculated to be as high as $15.6 billion in 1999 (Congressional Budget Office, 2001). This subsidy makes it financially profitable to adhere to the pressures of Congress.

Oversight of bureaucratic organizations generally occurs for political reasons such as generating favorable publicity for programs, responding to requests from special interests to influence agency decisions, or winning over electoral support from constituents and groups (Davidson, et. all 2010). There are several formal and informal processes and techniques which Congress utilizes to maintain bureaucratic oversight. These techniques include formal legislation, hearings and investigations, mandatory reports, and appropriation of funds (Davidson, et. all 2010). Many oversight mechanisms are ad hoc, and not subject to any measurement or even recognition. As one Congressman noted when he chaired the Energy and Commerce Committee, "Sometimes it's just a letter. We find our letters have a special effect on a lot of people" (Davidson, et. all 2010) This quote recognizes the fact that many types of oversight, and influence, are inherently indirect and can come in the form of simple statements or perceived threats.

R. Douglas Arnold examined the theoretical and practical groundings for Congressional influence within the bureaucracy in his book, *Congress and the Bureaucracy: A Theory of Influence*. Arnold notes that two casual links connect a Congressmen's preference and bureaucrats decisions. Arnold states:

> "The first link is implied by the traditional definition of influence: congressmen A's preferences regarding allocation initially affect his own behavior (e.g., he issues conditional threats or promises) and his behavior in turn affects bureaucrat B's allocation decisions. Second is the link applied by the rule of anticipated reactions: congressmen A's preferences regarding allocation affect bureaucrat B's expectation about how A might react to various alternative allocation decisions, and this expectation in turn affect's B's actual decisions" (Arnold, 1979 p. 76).

Congress has the ability to influence a bureaucracy because bureaucrats react to both the preferences and reactions of Congressional members when making decisions. These reactions may be realized or potential reactions. An integral part of this is the perceived expectation of anticipated actions because it places immense weight on the interpretation of Congressional sentiment by bureaucrats on their decision making process.

2.2 Police Patrols and Fire Alarms

In many instances scholars have commented that Congress does an inadequate job of providing oversight to bureaucratic organizations. Matthew McCubbins and Thomas Schwartz argue that in general, Congress does not neglect its oversight role. The scholars argue that Congress enacts different strategies to enact their goals (McCubbins and Schwartz, 1984). These strategies present evidence that counter the claim that Congress largely neglected regulating the GSE's.

McCubbins and Schwartz detail two types of oversight that are used by the legislature to guide their bureaucratic agendas. The first of these is “Police-Patrol Oversight” which is centralized and active. Essentially, police-patrol oversight continuously monitors an agency with the aims of detecting and remedying any violations as well as pursuing government goals. In contrast to this, “Fire-Alarm” oversight is less centralized. This type of oversight involves less active oversight, with an emphasis on waiting for large violations of legislative rules or goals to enact goals. Both fire-alarm and police-patrol oversight can involve formal and informal activities to regulate agencies (McCubins and Schwartz, 1984).

As the following chapters will demonstrate Congressional oversight of the GSEs consisted of a blend of fire-alarm and police-patrol oversight mechanisms. The existence of these mechanisms throughout the 1990’s and 2000’s serves to counter the claim that Congress largely neglected overseeing Fannie and Freddie. The adequacy of the oversight mechanisms used is largely unrelated to whether oversight was pursued. The next portion of this investigation will detail the direct and indirect influence of the United States government throughout the 1990’s and 2000’s.

Chapter 3

Fannie Mae and Freddie Mac held many advantages owning to their status as GSEs that were outlined in chapter one. Yet along with the advantages came stipulations, regulations, and oversight. This section of the thesis will examine the influence of the United States government on Fannie and Freddie. There are generally two types of influence the government can exert on third parties, direct and indirect influence. This study views direct influence as specific policies and goals enacted that influence the business of Fannie Mae and Freddie Mac. Indirect influence refers to statements made by politicians and regulators, failed legislation, and third-party studies that had the potential to effect the decision making of the GSEs. This chapter will focus solely on direct influence levied by Congress and regulators on the GSEs, with the following chapter examining indirect influence.

3.1 Legislation 1934-1992

Direct government influence, measured by enacted policy measures and goals created by Congress or other GSE regulators, can be viewed historically beginning in the 1930s. It is important to examine the legislation that created and molded the GSEs into the state they were in during the early 2000s. The GSEs that were placed into conservatorship were a product of legislative measures that occurred through 1992. Housing policy, which played a role in shaping the housing market within which Fannie and Freddie operated, is also integral to developing an understanding of how the government impacted the business operations of the GSEs. Within this legislation it is also important to examine mandates created by the regulators of Fannie Mae and Freddie Mac.

In 1934 under the New Deal Congress passed The National Housing Act of 1934. The National Housing Act of 1934 created the Federal Housing Administration (FHA) which empowered a Presidentially appointed administrator to insure banks, trusts companies, personal finance companies, mortgage companies, building and loan associations, installment lending companies, and other approved financial institutions against losses they may sustain as a result of loans and advances of credit made after the passing of the legislation in 1934. Furthermore, the administrator was authorized and empowered to make loans to institutions, which are insured as a result of the act, and to enter into loan agreements with select that meet the standards of the National Housing Act. The act also specifically mentions that the administrator of the FHA is authorized to insure mortgages, specifically for low cost housing (Carliner 305). The National Housing Act served as precursor to Fannie Mae and Freddie Mac. Under this legislation the government was able to, for the first time, provide support to mortgage lenders in order to facilitate the credit market for homeownership. The origination of this legislation stemmed from the government's desire to provide credit to the housing market following the Great Depression. Although the National Housing Act provided the government with the opportunity to facilitate credit within the housing markets, the FHA alone did not bridge the credit gap. This void was largely filled by the creation of Fannie Mae.

In 1938 amendments to the National Housing Act of 1934 created Fannie Mae with the hope that the organization would help facilitate the goal of further providing local banks with federal money to finance home mortgages in an effort to raise levels of homeownership (Carliner, 1998). At its inception Fannie Mae operated as an agent of the FHA. Fannie Mae was designed by the government as a national savings and loans institution in order to give the FHA a tool in its quest to provide credit to mortgage lenders. From this moment on Fannie Mae went through several changes in organization, capital requirements, and mission due to Congressional legislation. The mission to promote American homeownership continued following WWII, when the powers of the FHA, and indirectly Fannie Mae, were expanded by the Truman Administration.

The American Housing Act of 1949 was passed under the Truman Administration as part of the Fair Deal. This Act marked a dramatic expansion of the federal government's influence within the housing industry. The main provisions of the legislation included federal financing for urban renewal programs, federal money allocated for public housing units, and expansion of the powers for the FHA (Carliner, 1998). Although this act did not directly mention Fannie Mae it increased the authorization for mortgage insurance of the FHA and permitted the FHA to provide financing for rural homeowners. Given that Fannie Mae operated under the umbrella of FHA, this act provided more funds to Fannie Mae for mortgage purchases. Shortly after this legislation Congress changed the organizational structure of Fannie Mae, which greatly expanded Fannie's role and more explicitly established government housing initiatives that would persist through the 2000s.

In 1954 Congress passed the Federal National Mortgage Association Charter Act. This legislation marked the first distinct change to the organizational structure of Fannie Mae. This act explicitly gave Fannie Mae a mission. Stating that the purposes of this legislation were to establish the secondary market facilities for residential mortgages, to provide that the operations thereof shall be financed by private capital to the maximum extent feasible, and to authorize the facility (Fannie Mae) to provide stability in the secondary market for residential mortgages, respond appropriately to the private capital market, provide on-going assistance to the secondary market for residential assistance, promote access to manage credit throughout the Nation by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for mortgages, and to manage and liquidate federally owned mortgage portfolios in an orderly manner with a minimum of adverse effect to the residential mortgage market and a minimum loss to the Federal government (FHFA Charter, 1954). This act is significant for two reasons. Primarily this legislation discusses the goals of the United States government to use federal money in an effort to promote mortgage lending and homeownership. Furthermore, the Charter Act reorganized Fannie Mae into a partially privately owned company allowing for stock to be created within the company. This was the first step to Fannie Mae becoming a completely publically traded company. The legislation also marked the first in many pieces of legislation regarding Fannie Mae, and later on, Freddie Mac. Further developments in legislation would expand the powers of the GSEs to allow them to pursue more robust housing initiatives. Future legislation promoting home ownership also created regulatory tools to help guide the GSEs in accordance with government preferences.

The Housing and Urban Development Act of 1965 was passed under the Johnson Administration. This act expanded various forms of federal assistance for redevelopment that were created by the 1949 legislation. Furthermore, somewhat controversially, this act created a rent-supplemental program that provided a large subsidy to qualifying renters (Bratt, 1993). Controversy surrounding this stipulation was largely ideological and focused on the government's role in increasing federal spending to help reduce rent payments. This discussion lasted until President Nixon removed rent subsidies during his presidency (Bratt, 1993). The act directly influenced Fannie Mae by extending their mortgage insurance program by granting the agency more federal capital, which allowed it to further facilitate the secondary mortgage-market. Immediately following the Housing and Urban Development Act Congress enacted legislation that created the United States Department of Housing and Urban Development (HUD). This organization would eventually play a vital role in the regulation of Fannie Mae and Freddie Mac.

A few years later Congress passed the Charter Act of 1968 further changing the organizational structure of Fannie Mae (FHFA Charter, 1968). A decade after receiving semi-private status Fannie Mae grew its debt levels significantly because of its access to the private markets. Legislation in 1968 allowed the government to remove debt incurred by Fannie Mae from the Federal balance sheet by transforming the agency into a private shareholder-owned corporation. Although Fannie became completely privately owned the charter maintained the public housing mission it had previously established, transforming Fannie from a government agency to a government-sponsored enterprise. This marked another historic moment in the evolution of Fannie Mae, which after this legislation, became a privately owned company pursuing government goals. This change was made to decrease the impact of Fannie Mae on the federal balance sheet after the balance sheet had largely expanded during the Vietnam War (Bratt, 1983).

Continuing the housing initiatives under Johnson, Congress passed the Housing and Urban Development Act of 1968. This act portioned Fannie Mae into two entities and created the Government National Mortgage Association (Ginnie Mae). Under this legislation Fannie Mae's responsibilities shifted solely to purchasing mortgage-backed securities that were classified as "conventional" or non-government, and the new entity Ginnie Mae focused on purchasing government-guaranteed mortgages (Bratt, 1983). This legislation, combined with the new charter of Fannie Mae which transformed the company into a privately owned entity, took away an explicit guaranteed government backing for mortgages purchased by Fannie Mae and allowed Ginnie Mae to serve as the only entity that was fully backed by the credit guarantee of the United States government. This action, similar to the changes in the charter, explicitly removed the financial responsibility of Fannie Mae from the United States government.

The government continued to tackle housing initiatives in the 1970's. In 1970 Fannie Mae was listed on the New York Stock Exchange. During that same year due to a large increase in savings & loans companies, the monopoly held by Fannie Mae in the secondary mortgage market, and another housing credit crunch Congress passed the Emergency House Finance Act of 1970 (Carliner, 1998). This legislation made several significant changes to both Fannie Mae and the secondary mortgage market. Most notably the act authorized Fannie Mae to purchase conventional mortgages. The legislation also created the Federal Home Loan Mortgage Corporation or Freddie Mac under the authority of the Federal Home Loan Bank. In addition to providing additional liquidity to the secondary mortgage market Freddie Mac was created with the intention of assisting thrifts in securitizing mortgages.

The next major piece of housing legislation was passed under the Carter administration with the passage of the Community Reinvestment Act of 1977 (CRA). The intention of the Community Reinvestment Act was to address diminishing conditions in American cities, particularly in the low-income and minority areas (Board of Gov. of the Federal Reserve System, 2012). This was not the first act that targeted expanding and improving home-ownership amongst low-income and minority areas. Unlike previous reforms including the 1968 Fair Housing Act, the Equal Credit Opportunity Act of 1974, and the Home Mortgage Disclosure Act of 1975 which all generally focus on the prohibiting discrimination and providing disclosure on mortgage data, the Community Reinvestment Act focused on ensuring credit was available to all communities. The legislation targeted many financial institutions that provided mortgages to increase lending in underserved areas. The CRA charged four supervisory institutions, the Board of Governors of the Federal Reserve System, the Office of Comptroller of Currency, the Federal Deposit Insurance Commission, and the Office of Thrift Supervision with the task of investigating banking institutions to see if they complied with CRA objectives (Fishbein 293-297). After the passage of this act, banks and other lending institutions were unable to grow without submitting documentation to one of these agencies to ensure that they were promoting the lending objectives of the CRA. Congress left the language of the legislation relatively ambiguous which allowed the CRA to serve as political leverage over the financial system to ensure that mortgage-credit was reaching all spectrums of the community (Baldinucci, 1995) The vague language within the act, which does not define terms such as “moderate-and-low” income or “underserved areas,” provided regulators enforcing CRA requirements the ability to be more flexible in their determination of what constitutes compliance with CRA requirements. This allows for these terms to change dynamically across socioeconomic conditions within the United States.

Although it does not directly address Fannie Mae or Freddie Mac, the CRA of 1977 is important to the story regarding Fannie and Freddie and government influence because it reveals the goals of housing policy of the United States Government. One of the housing goals is homeownership. It is also apparent that the government was specifically targeting improving homeownership amongst low-and-moderate income families, and within urban and underserved areas.

As the American financial system became more complex Congress continued to pursue legislation that allowed the mortgage business and the GSEs to operate within new financial markets. Future legislation also served to increase Congressional control over the GSEs as they grew throughout the 1980s and 1990s.

In 1984 Congress passed the Secondary Mortgage Market Enhancement Act. This legislation was important for many reasons, specifically because it allowed banks to hold mortgage related securities, such as MBS (Secondary Mortgage Market Enhancement Act, 1984). This is important because the late 1970's and 1980's served as the primary beginning for the packaging and re-selling of MBS by the GSEs. This act also directly impacted Fannie Mae by raising the loan volume limits on multi-family mortgage purchases and requiring for the first time an annual report from the Department of Housing and Urban Development regarding Fannie Mae's activity. This marked the beginning of an increase direct oversight of Fannie Mae by the HUD.

The Financial Institutions, Reform, Recovery, and Enforcement Act of 1989 was passed in the wake of the saving and loan crisis of the 1980s. This act marked the complete privatization of Freddie Mac by fundamentally establishing that both Fannie and Freddie would operate under similar structures, limitations, and regulations. This legislation also subjected both Fannie Mae and Freddie Mac to HUD oversight (The Financial Institutions, Reform, Recovery, and Enforcement Act, 1989). This oversight would prove instrumental in creating the housing goals in the late 1990s and early 2000s that largely drove the GSEs mortgage purchases. This legislation was largely passed to help ensure that the problems associated with the savings and loans crisis, which ended in a large tax-payer bailout, would not be replicated in the mortgage market dictated by the GSEs.

The year 1992 marked the next major change for the GSEs, with the passage of the Federal Housing Enterprises and Financial Safety and Soundness Act of 1992, which was embedded in the Housing and Community Development Act of 1992. Under this legislation the Office of Federal Housing Enterprise Oversight (OFHEO) was established within HUD. This office became the official regulator of Fannie Mae and Freddie Mac. This legislation also mandated that HUD set official goals for mortgage purchases in low income housing areas for the GSEs (Thomas LOC). This act provided that two different organizations regulate different facets of the GSEs, with OFHEO focusing on the capital adequacy of Fannie and Freddie while HUD specifically monitored the housing mission of the GSEs. This legislation can largely be attributed to Congressional fears that stemmed from the savings and loan crisis. In general Congress wanted more oversight to ensure that the GSEs did not pose a large threat to tax-payers. Similarly, increasing regulation over Fannie Mae and Freddie Mac also provided regulators with an avenue to pursue a government housing mission that became more apparent in the 1990s. This will largely be discussed within the next chapter of this study.

The 1992 legislation marked the last relevant significant change to housing policy that directly impacted the GSEs prior to their conservatorship. Table 1 at the conclusion to this section summarizes the major pieces of legislation that transformed Fannie Mae and Freddie Mac into their status prior to conservatorship. There are two important pieces that must be taken from this timeline of legislation. First and foremost it is important to understand the transformation and current state of the GSEs from their inception through the early 1990s. These two companies both started as federal agencies designed to promote liquidity within the secondary mortgage market became privately owned companies that were regulated by the United States government with the hope of promoting government housing initiatives.

Second, the government initiatives regarding Fannie Mae and Freddie Mac become especially apparent in the 1980s when Congress began to require HUD to look into the financial security and activity of the GSEs. The housing legislation enacted by Congress, beginning in the 1940s through the 1990s, also demonstrated the United States government's commitment to homeownership, affordable housing, and mortgage finance. Throughout multiple administrations, both Democratic and Republican, the government's mission of promoting homeownership can be seen through legislative measures taken to extend credit to homeowners. This commitment to homeownership is important because through HUD and increased oversight of Fannie Mae and Freddie Mac the government was able to further pursue this mission of homeownership. Although legislation directly pertaining to the GSEs may have ceased in the early 1990s direct influence of the United States government continued over Fannie and Freddie through the regulation of both organizations by the OFHEO and HUD.

Table 1 Housing Legislation Summary

200	Created the Federal Housing Administration. Amendments to this act in 1938 created Fannie Mae.
American Housing Act of 1949	Increased federal financing for urban renewal programs, public housing units, and mortgage insurance.
Federal National Mortgage Association Charter Act (1954)	Semi-privatized Fannie Mae and explicitly provided the organization with a federal housing mission.
Housing and Urban Development Act of 1965	Extended more credit to Fannie Mae. Amendments to this act created the Department of Housing and Urban Development.
Charter Act of 1968	Transformed Fannie Mae into the GSE that existed in present day.
Housing and Urban Development Act of 1968	Determined that Fannie Mae's responsibilities would be solely non-government, removing any explicit guaranteed government backing for mortgages purchased by Fannie Mae.
Emergency House Finance Act of 1970	Broadened Fannie Mae's authority in mortgage purchases, created Freddie Mac.
Community Reinvestment Act of 1977	Designed to address diminishing conditions in American cities, particularly in low-income and minority areas by forcing banks to target these areas with housing finance.
Secondary Mortgage Market Enhancement Act (1984)	Allowed banks to hold MBS.
Financial Institutions, Reform, Recovery, and Enforcement Act of 1989	Privatized Freddie Mac by establishing that both GSEs would have similar structures, limitations, and regulations.
Federal Housing Enterprises and Financial Safety and Soundness Act of 1992	Established the OFEHO to maintain the safety and soundness of the GSEs while mandating that HUD set official goals for certain housing areas that must be met by Fannie Mae and Freddie Mac.

3.2 Federal Regulation 1992-Present

The Office of Federal Housing Enterprise Oversight that was created under HUD as a result of 1992 housing legislation and was charged with regulating the GSEs Fannie Mae and Freddie Mac, in part by ensuring their capital standards and their financial safety. In addition to this HUD set “housing goals” for the GSEs and tracked their progress towards this benchmark. These goals and capital standards played a role in determining the risk levels that Fannie Mae and Freddie Mac were able to realize. The capital requirements dictated the leverage the corporations were able to use, and the housing goals largely dictated the mortgages that were purchased and securitized by the GSEs. It is important to view these goals and capital requirements throughout the 1990s and 2000s to determine whether any changes that occurred in these requirements led to any significant changes in financial risk of the GSEs. The housing goals specifically provide a link between government influence and financial risk. The use of HUD and OFHEO largely represented Congress using a police-patrol method of bureaucratic regulation as discussed in chapter two.

Beginning in 1992 OFEHO created capital requirements for Fannie Mae and Freddie Mac that were tested on a quarterly basis to measure the financial risk inherent within each firm. The government’s attitude towards financial risk taking changed in 1989, and, following a tax payer bailout of the thrift industry, Congress was looking for new ways to isolate tax payers from financial downfall. Prior to 1992 Fannie Mae and Freddie Mac were evaluated through a ratio-based capital standard; however, a 1990 Treasury

Department Study found that although the companies at the current time posed no imminent threats of insolvency, they were very under-capitalized to meet unforeseen changes in default patterns or interest rate risk (United States Treasury Department, 1990). This report largely fueled the shift towards newer, stronger risk-based capital standards for the GSEs. Along with calculating capital requirements, OFEHO was also able to enforce these requirements through prompt-corrective-action powers supplemented by an on-site examination process, which allowed the regulator to focus deeply on the operations if each firm, especially if capital requirements were being ignored (Kinsey, 1998).

Fannie Mae and Freddie Mac were subject to three capital standards. Two standards are ratio based and one is based on a stress test that examined each firm's capital levels with different levels of risk exposure to measure their capital adequacy with greater precision. The two ratio gauges were called the minimum and critical capital levels. The minimum capital level is calculated by taking 2.5% of aggregate on-balance-sheet assets and adding .45 percent of the unpaid principal balance of outstanding MBS or equivalent instruments. The critical capital standard is simply one-half of the minimum capital standards (Kinsey, 1998). Originally Fannie Mae and Freddie Mac were subject to stress tests that were used by FDIC for many banking agencies; however, this changed in 1999 through the development of a stress test specific to the GSEs. Beginning in 2001, when the risk-based capital stress test was finalized, each GSE was tested by utilizing two interest rate scenarios. The first interest rate scenario held that the 10-year treasury yields would rise 75% and in another scenario the yields fell 50%. Changes in both scenarios were generally capped at 600 basis points, or 6%. Each GSE was required to hold the capital required to survive a stress test plus an additional 30 percent to cover management and operational risk (Kinsey, 1998).

In addition to providing capital requirements OFHEO regulated the conforming loan limits which Fannie Mae and Freddie Mac were allowed to purchase. Fannie Mae and Freddie Mac were allowed to purchase single family and multi-family loans that met certain standards, including price value. These price values changed over time, first under the supervision of Congress and then, after the passing of the 1992 act, under the supervision of OFHEO. Table 2 on the following page details the increase in conforming loan limits from 1980 through 2008, after conservatorship. This table shows a dramatic increase in the price of loans Fannie and Freddie were able to purchase. Analyzing this data shows a relatively steady increase year-to-year in the conforming loan limit, which is likely correlated with an increase in housing prices and inflation. There are, however, a few dramatic increases to note. Between 1988 and 1989 the conforming loan limits for each segment (one family, two family, three family, and four family) increased between 10 and 30 thousand dollars. A similar increase was seen between 1990 and 1991 and throughout the early part of the 2000's until 2005. These relatively higher conforming loan limit increases, specifically in the early part of the 2000's, allowed the GSEs to significantly expand their portfolios, which will be examined in detail in chapter four.

The decisions made regarding capital and loan limits were made by OFHEO, with increases in the conventional loan limits coming from Congress. Although direct

Congressional regulation of the GSEs became minimized after the development of OFHEO Congress had the ability to change the capital standards or regulators of the GSEs at any time.

Table 2 Fannie Mae and Freddie Mac Convential Loan Limits[4]

Historical Conventional Loan Limits

(Excludes Alaska, Hawaii, the U.S. Virgin Islands and Guam)

Year	1 Unit	2 Units	3 Units	4 Units	Seconds
1980	93,750	120,000	145,000	180,000	N/A ***
1981	98,500	126,000	152,000	189,000	98,500 ***
1982	107,000	136,800	165,100	205,300	107,000 ***
1983	108,300	138,500	167,200	207,900	108,300 ***
1984	114,000	145,800	176,100	218,900	57,000
1985	115,300	147,500	178,200	221,500	57,650
1986	133,250	170,450	205,950	256,000	66,625
1987	153,100	195,850	236,650	294,150	76,550
1988	168,700	215,800	260,800	324,150	84,350
1989	187,600	239,950	290,000	360,450	93,800
1990	187,450	239,750	289,750	360,150	93,725
1991	191,250	244,650	295,650	367,500	95,625
1992	202,300	258,800	312,800	388,800	101,150
1993	203,150	259,850	314,100	390,400	101,575
1994	203,150	259,850	314,100	390,400	101,575
1995	203,150	259,850	314,100	390,400	101,575
1996	207,000	264,750	320,050	397,800	103,500
1997	214,600	274,550	331,850	412,450	107,300
1998	227,150	290,650	351,300	436,600	113,575
1999	240,000	307,100	371,200	461,350	120,000
2000	252,700	323,400	390,900	485,800	126,350
2001	275,000	351,950	425,400	528,700	137,500
2002	300,700	384,900	465,200	578,150	150,350
2003	322,700	413,100	499,300	620,500	161,350
2004	333,700	427,150	516,300	641,650	166,850
2005	359,650	460,400	556,500	691,600	179,825
2006	417,000	533,850	645,300	801,950	208,500
2007	417,000	533,850	645,300	801,950	208,500
2008*G	417,000	533,850	645,300	801,950	208,500
2008*HC	729,750	934,200	1,129,250	1,403,400	208,500

The last segmented area in which HUD was able to enact direct influence over the GSEs is through setting housing goals that the GSEs had to comply with on a year-to-year basis. As seen through legislation starting in the 1940s under Truman the government has always played an influential role in promoting homeownership throughout the United States. The government's desire to promote homeownership is

[4] FannieMae.com

even more prominent in low-income and urban areas, which are areas directly targeted by the CRA of 1977. In 1992, around the same time as the creation of OFHEO the Federal Reserve Bank of Boston published a study regarding mortgage origination in Boston. This prominent study found that African Americans and Hispanics were roughly 60% more likely to be denied a mortgage loan then a Caucasian with similar credit characteristics. The credit characteristics used to evaluate these claims included obligation ratios, credit history, loan to value ratios, and property characteristics (Federal Reserve Board of Boston, 1992).

The conclusions from this paper impacted the government as politicians continued to attempt to reduce discrimination amongst mortgage lending and promote low-income, urban, and “underserved” homeownership. Although Fannie Mae and Freddie Mac do not actually serve as a creditor to mortgage borrowers Congress was able to use their new regulations and the GSEs new regulator to help promote their political agenda. This was done through the use of annual housing goals, which were required by the 1992 legislation regarding financial safety and soundness. Prior to the 1992 act the GSEs’ charters mandated that 30% of their conventional mortgage guarantees were dedicated to low-and-moderate income and urban housing. Following the new legislation, HUD began to set, monitor, and enforce affordable housing goals for targeted areas. Tracking of housing goals included monitoring discrimination in the mortgage purchasing process. Requests for new program approvals were determined by evaluating the GSE’s ability to meet the affordable housing goals set by HUD. By 1995 HUD established three categories that required the GSEs to purchase mortgages classified as (i) low-and-moderate income families, (ii) very-low income families and low-income families in low-income areas, and lastly, (iii) properties located in underserved areas (HUD News Release 1995). As seen by Table 3 the housing goals for Fannie Mae and Freddie Mac increased dramatically throughout the 1990's and 2000's until they were placed in conservatorship (DiVenti 2009) This will be discussed in further detail in chapter five.

Table 3 Affordable Housing Goals[5]

EXHIBIT 1

Levels of the Affordable Housing Goals and Home Purchase Subgoals for Fannie Mae and Freddie Mac Since 1996

	Year												
	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Housing goals													
Low- and moderate-income	40%	42%	42%	42%	42%	50%	50%	50%	50%	52%	53%	55%	56%
Geographically targeted (underserved area)	21%	24%	24%	24%	24%	31%	31%	31%	31%	37%	38%	38%	39%
Special affordable	12%	14%	14%	14%	14%	20%	20%	20%	20%	22%	23%	25%	27%
Special affordable multifamily													
Fannie Mae ($ billions)	$1.29	$1.29	$1.29	$1.29	$1.29	$2.85	$2.85	$2.85	$2.85	$5.49	$5.49	$5.49	$5.49
Freddie Mac ($ billions)	$0.99	$0.99	$0.99	$0.99	$0.99	$2.11	$2.11	$2.11	$2.11	$3.92	$3.92	$3.92	$3.92
Home purchase subgoals													
Low- and moderate-income										45%	46%	47%	47%
Geographically targeted (underserved area)										32%	33%	33%	34%
Special affordable										17%	17%	18%	18%

Sources: "HUD's Housing Goals for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) for the Years 2005-2 and Amendments to HUD's Regulation of Fannie Mae and Freddie Mac; Final Rule," 24 CFR Part 81. Federal Register 69 (211) November 2, 2004; "2009 Enterprise Transition Affo Housing Goals; Final Rule," 12 CFR 1282. Federal Register 74 (53) August 10, 2009

The direct influence of the United States government through Congressional legislation and GSE oversight has changed dramatically throughout history. As demonstrated throughout this chapter the United States Government used its legislative powers to transform Fannie and Freddie from federal agencies into regulated, publicly traded companies that were used to promote a government-housing mission. Despite being agencies of the government, the GSEs posed no financial liability on the federal balance sheet. The government housing mission is clearly evident through both

[5] DiVenti, 2009. Figures represent goals for mortgages guaranteed.

legislation, such as the CRA, and the housing goals imposed on the GSEs beginning in the early 1990's. Chapter five will demonstrate that beginning in 1992, when new credit standards and housing goals that were created, the GSEs began to increase the risk related to their business operations.

The government influence examined within this section is only one way the government was able to impact the GSEs. Indirect government influence, which will be viewed through proposed legislation, Congressional testimony, and informational Congressional studies regarding the GSEs inevitably played a role in shaping the decision making of Fannie Mae and Freddie Mac.

Chapter 4

By utilizing legislation and regulatory oversight the government was essentially able to force Fannie and Freddie to operate within their rulebook. The decision processes of the GSEs were undoubtedly influenced by what they could and could not do which, as seen in the previous chapter, was largely dictated by Congress. The legislature was also able to indirectly influence the GSEs without passing any formal legislation or utilizing a regulator. Congressional testimony, third-party government reports regarding the enterprises, and failed legislation has the ability to implicitly affect the GSE's decision making because of the bureaucratic relationship between the GSEs and Congress. This section will explore the Congressional record and other forms of indirect influence to further demonstrate the government's impact on the operations of Fannie and Freddie.

Congressional testimony is a matter of public record and available through the Library of Congress. Remarks made by politicians have the ability to impact the decisions made by businesses, specifically when the businesses fear increased oversight. This section will examine statements made within Congress throughout the late 1990s through 2006. The 109^{th} Congress which convened in 2007-2008 was largely, in coordination with the Treasury Department and Hank Paulson, responsible for the conservatorship of Fannie Mae and Freddie Mac. Independent reports regarding the GSEs which often guided Congressional discourse and failed legislation related to the GSEs will also be examined. Special attention will be paid to The House Committee on Financial Services (COFS), which largely oversaw potential financial regulation that would have pertained to the GSEs.

4.1 Methodology

In order to determine indirect Congressional influence, the Congressional record was utilized to view statements regarding Fannie Mae, Freddie Mac, and the government's housing goals. To conduct this study The Library of Congress website and the archives from the committee hearings within COFS were utilized to develop a qualitative understanding of the Congressional sentiment towards the GSEs and any potential Congressional preferences that may impact their actions. Given the large breadth of the Congressional record, search terms were utilized in a search that encompassed all House and Senate Committees and all stages of the legislation. Searches were conducted for each Congressional session between the 105^{th} and 109^{th} Congress.

The terms searched included “GSE,” “Fannie Mae,” “Freddie Mac,” “HUD,” “OFHEO,” “Housing Goals,” and “Housing Mission.” After sifting through the search results, which varied in amount by session, statements were chosen as evidence that represented the overall sentiment being portrayed by Congress at a particular moment in time. Statements that dissented from the common opinion are also presented within this study because they demonstrate that concerns regarding the GSEs existed throughout this time period and were made known to legislators. Within the text of this chapter these opinions or statements are noted to be deviating from the overall sentiment of Congress.

In examining the archives of the COFS the hearing archive of each Congressional session between the 105th and 109th Congress were examined. The COFS website lacks a traditional search feature; however, each Congressional hearing with the COFS is labeled with a title. Any title determined to pertain in any way to the GSEs were examined and statements from these hearings that were perceived to be important, either because they contributed to or dissented from the overall sentiment in Congress, were utilized in aiding testimony taken from the Library of Congress and are presented within this investigation. Narrative text or footnotes within the section denote the speaker providing Congressional testimony.

4.2 105th Congress: 1997-1998

The Congressional record largely indicates a positive sentiment towards the GSEs among members of the 105th Congress. During this time period the GSEs had been regulated by OFEHO for roughly 5 years. Although relatively unimportant in the regulatory agenda, the Congressional log demonstrates that legislatures during this time period were appreciative of Fannie Mae and Freddie Mac for advancing America's housing mission. Affordable housing was still a large priority for the United States Government, as demonstrated by Con. Res. 208, which stated that "the priorities of our nation should include providing access to affordable housing that is safe, clean, and healthy and expanding home ownership opportunities…" In regards to the GSEs, the resolution declared that the government needed to "…facilitate the availability of capital for the homeownership and housing production, including by continuing the essential roles carried out by the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal Home Loan Banks[6]" (Sense of Congress Regarding Access to Affordable Housing and Expansion of Homeownership Opportunities, 1998). This resolution is typical of the overall sentiment regarding the GSEs, which were largely viewed positively for the role they had played in expanding homeownership. This nonbinding resolution passed through the House of Representatives and was referred to a Senate committee, but never to the Senate floor. Although this statement serves no binding legislative purpose, it is largely representative of the legislative sentiment in Congress which can be seen through further examination of the Congressional record.

During this Congressional session, just months earlier, Congress commended Fannie Mae for celebrating the 4th year anniversary of its "Trillion Dollar Commitment." This program was designed to make one trillion dollars of real estate financing available to put

[6] Introduced by Congressmen Lazio, New York.

over ten million Americans in their homes. As Congressmen Sabo stated in March of 1998,

> "I rise before you to congratulate Fannie Mae CEO Jim Johnson and all of Fannie Mae's employees and local partners for the tremendous impact they have had on expanding home ownership opportunities in Minnesota as well as the nation…Nationally, Fannie Mae is transforming the housing finance system by removing barriers to homeownership and increasing supply of affordable housing" (Fannie Mae's Four Year Anniversary of Its Trillion Dollar Commitment to Affordable Housing, 1998).

Despite the large positive sentiment that surrounded the GSEs at this time it appears that some members of Congress had begun to grow increasingly aware of Fannie and Freddie's risk levels, primarily due to their investment portfolios. This is apparent through examination of the archives of the COFS.

In March of 1998, around the same time Fannie Mae was commended for its commitment to housing, the Subcommittee on Housing and Community Opportunity convened to discuss mortgage finance. Tom LaMafla, a mortgage analyst, states for the record:

> "There are five important reasons why Fannie and Freddie should be privatized. First, they are siphoning most of the economic value from the mortgage business. Second, their specialized privileges impede private sector growth and financial opportunities. Third, they raise interest rates and indirectly increase the cost of the national debt. Fourth, they repeatedly have abused their charters. Lastly, there is an almost inherent conflict in Fannie and Freddie's public and private roles" (The Role of Mortgage Brokers in the Mortgage Finance Market, 1998).

This clearly demonstrates that, even as early as 1998, some members of Congress were warned of the possible burden Fannie and Freddie presented to tax-payers. Later this year the Subcommittee on Capital Markets, Securities, and Government Sponsored

Enterprises discussed the soundness of the capital positions of the GSEs. Committee testimony demonstrates that, even as early as 1998, before the subprime boom, there was concern raised from officials regarding the investments of the GSEs:

> "Now some GSEs make a market in their own securities. Fannie Mae and Freddie Mac do that. It can be argued that making that market provides justification for an investment portfolio. That doesn't necessarily mean it justifies the existing size of the investment portfolios there. But that would be one case where an investment portfolio may have a mission relationship[7]" (The Federal Housing Board's Responsibility for Safety and Soundness and Mission Regulation of the Federal Home Loan Bank System, 1998).

The overall concerns that were raised within committee testimony by third-party analysts were greeted with minimal concern by Congress. No legislation was proposed and concerns that were raised were not pursued. The record indicates that at this point in time Congress was still incredibly focused on promoting affordable housing without increasing oversight. A hearing in May focused on the FHA and the home finance market revealed these intentions. In a conversation regarding expanding housing to low-income and underserved areas the record states:

> "We have to change the incentives. We have to monitor Fannie and Freddie. I think Representative Kennedy is absolutely right: Fannie and Freddie have no real desire, have shown no real effort, in trying to serve this market, and if we are going to get increased service out of the private market, it's going to come through the efforts of Fannie and Freddie. HUD has to have the resources to improve its monitoring and goal-setting for Fannie and Freddie, and Fannie and Freddie might even try disclosing to us really who they're serving and where their loans are, so we know what they're doing[8]" (Is FHA Limiting Choices for Home Finance?, 1998)

[7] Testimony from Assistant Secretary for Financial Institutions from the Department of Treasury, Richard Carnell.

[8] Statement by Dr. Calvin Bradford, President, Bradford & Associates on behalf of the Fair Housing Alliance

This third-party testimony was greeted with a positive reception from Congress. The commitment to government housing mission sheds some light on why the affordable housing goals for Fannie and Freddie may have increased over time as seen in the previous chapter. This commitment also leads to speculation about why Congress largely ignored potential risks raised by third parties regarding the risk of Fannie and Freddie.

Overall the general sentiment surrounding the GSEs during the 105th Congress was positive because of their role in promoting home ownership within the United States. Despite their past achievements there was still some lingering concern that the GSEs were not doing enough and could expand their roles in promoting the government's housing mission. At this time, concerns regarding the financial risk of the GSEs had been raised to Congress; however, it seems that these concerns were largely ignored because of the GSE's success in meeting the affordable housing goals.

4.3 106th Congress 1999-2000

The 106th Congress as a whole did very little to change its stance towards the GSEs. One thing that is interesting to note is that during this time period Congress charged Fannie Mae and Freddie Mac through Congressional statements, for creating underwriting standards for subprime loans. Faced with the growing problem of predatory lending Representative Fattah stated in May of 2000, "…we need Fannie Mae to do for the so-called sub-prime market what they have done for the conventional mortgage market: establish underwriting standards that would make it harder for predatory lenders to charge consumers 25-point origination fees, pre-payment penalties, and the like"

(Frank Raines' Statement on Predatory Lending, 2000). This testimony shows that Congress was beginning to realize the implications of predatory lending on consumers, as well as the growing subprime market.

Although the positive sentiment regarding the GSEs was relatively unchanged from the 105th to 106th Congress many politicians, in the wake of the dotcom bubble, looked for improved regulation of the GSEs. Representative Ron Paul noted to Congress in November of 2000, "A huge financial bubble has been created by the GSEs, such as Fannie Mae and Freddie Mac. The $33 billion of shareholder equities in these two organizations has been leveraged into $1.07 trillion worth of assets—a bubble waiting to be pricked" (Economic Problems Ahead, 2000).

Concerns about the economic stability of the GSEs led to proposed legislation by Congress to improve regulation of Fannie and Freddie by consolidating regulatory measures. As described in the previous section the GSEs currently had multiple regulators, with OFHEO monitoring their risk levels and HUD monitoring their mission and goals. In addition to consolidating the GSEs under one regulator the proposed legislation (HR 3703) removed their line of credit with the Treasury, limited their non-mission related investments, and imposed stricter credit and capital requirements (The Housing Finance Regulatory Improvement Act, 2000). This legislation was sent to the COFS.

Throughout the 106th session of Congress the Capital Markets Subcommittee met five times to discuss HR 3703, ultimately deciding not to introduce the legislation to the floor. The subcommittee interviewed many people, including the GSE's regulators and consumer protection agencies. Throughout the hearings many aspects of the proposed legislation were commended, but ultimately the committee decided not to pursue the increased regulatory measures for a few reasons. This decision was not taken to a vote within the subcommittee. The committee largely believed that the impacts of the 1992 Safety and Soundness Act were just beginning to take shape, as noted here:

> "The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 is only now beginning to produce its intended results. By the end of this year, OFHEO hopes to finalize its dynamic risk-based capital standard for Fannie Mae and Freddie Mac. That rule will further help to protect taxpayers against systemic risk. HUD will also complete its work on updating the affordable housing goals for the two enterprises. These goals, as I understand, will force the GSEs to aggressively increase lending in underserved areas[9]" (Housing Finance Regulatory Improvement Act—Part 1, 2000).

In addition to anticipating better results and capital standards pursuant to already passed legislation many people, both on the committee and those testifying, were happy with the progress the GSEs had made in regard to creating an environment for equal opportunity housing. As one witness testified in reference to community development, "Again, I want to recognize the good efforts that both institutions have done, particularly Fannie Mae. Freddie Mac is beginning to invest more with the establishment of a new community development lending office in North Carolina, but we certainly look forward to more[10]" (The Housing Finance Regulatory Improvement Act—Part 2, 2000). Testimony such as this likely led to the end of the legislative measures because 'no one wanted to fix what wasn't broken.' As many Congressional members expressed as at the final roundtable

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[9] Testimony from Representative Kanjorski
[10] Peter Skillin, HUD Government Sponsored Enterprise Committee

discussion regarding the legislation, "…I would ask that, as we proceed down this process, that we don't try and fix something that is not broken. I am concerned about trying to create a single regulator for three institutions that are structurally different[11]" (The Housing Finance Regulatory Improvement Act—Part 3, 2000). At this point, some Congressional members also expressed concerns regarding the changing regulations, "I am very skeptical about the provision in terms of eliminating the line of credit[12]" (The Housing Finance Regulatory Improvement Act—Part 3, 2000). Ultimately, Committee Chairman Baker concluded, "I appreciate those who participated in this roundtable today. I frankly have not heard a thing that changes my mind about the underlying elements. If anything, we need to be doing more on the mission side." (The Housing Finance Regulatory Improvement Act—Part 3, 2000).

The failure of HR 3703 and the dialogue surrounding the proposed legislation demonstrated that some members of Congress were beginning to see the need to reform the GSEs as they sensed that they posed a threat to taxpayers. Despite this, the GSEs' ability to deliver results in relation to the housing goals led many politicians to feel that they should be left alone. The message sent to the mortgage giants is clear: keep meeting the housing goals and helping our housing mission and you'll be left alone.

4.4 107th Congress 2001-2002

In May of 2001 the Congressional Budget Office (CBO) published a study regarding the value of the federal subsidies that were given to the GSEs as a result of

[11] Testimony by Congresswoman Jones
[12] Ibid.

their relationship with the United States Government. This report largely drove discussion regarding the costs and benefits of the GSEs throughout the 107th Congressional session. Overall the CBO found that the estimated capitalized value of the subsidies received by the GSEs rose from roughly $6.8 billion in 1995 to $15.6 billion in 1999, before falling back to $13.6 billion in 2000. The federal subsidy that is calculated within the study revolves largely around two ideas. The first portion centers around the number of regulatory and tax exemptions that reduce the GSEs overall costs. The second subsidy relates to the perceived overall credit quality of debt and MBS issued due to an implied federal backing. The subsidy largely grows in correlation to the volume of loans packaged by the GSEs because of the implied federal backing to the increased number of MBS outstanding. The study also attempted to calculate the distribution of the subsidy into three groups: Federal Home Loan Bank (FHLB) stakeholders, mortgage borrowers, and Fannie Mae and Freddie Mac shareholders. The study found that, in 2000, roughly 51% of the subsidy was passed along to mortgage borrowers. Roughly 19% was passed along to FHLB stakeholders, with the remaining 30% percent passed along to shareholders (Congressional Budget Office, 2001). These numbers and estimates drove discussion surrounding the GSEs through 2001.

Immediately following the publication of the CBO study the subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises with the COFS met with the CBO and discussed internally the value of the subsidy and whether any reforms needed to be made. This discussion largely focused on whether the estimated subsidy being granted to the GSEs helped Fannie Mae and Freddie Mac accomplish the goals of promoting homeownership throughout America. As some testimony indicates, "…I believe that Fannie Mae and Freddie Mac are working very hard to make sure that all Americans have the opportunity to own their own home. They believe in 100 percent home ownership for all Americans, and Fannie and Freddie are doing an excellent job in moving individuals into their own homes[13]" (Congressional Budget Office Report on Federal Subsidies for the Housing GSEs, 2001). Many members of Congress even indicated that they were in general not concerned with the large subsidy that was being granted noting that, "My major concern with the GSEs is their ability to carry out their mission, which is to increase home ownership in America" and that "…the two GSEs have become a model for transparency and efficiency for financial companies worldwide[14]" (Congressional Budget Office Report on Federal Subsidies for the Housing GSEs, 2001). The hearings also note that moving forward "…biggest concerns with the GSEs is what we can do to help them be more successful in achieving their mission, including closing the gap in home ownership between whites and minorities[15]" (Congressional Budget Office Report on Federal Subsidies for the Housing GSEs, 2001).

Ultimately throughout the 107th Congress the COFS decided not to pursue any legislation surrounding the GSEs, despite the proposition of H.R. 1409, which again sought to consolidate and improve regulatory control of the GSEs. As Representative Kanjorski noted, "Nearly a decade ago, Congress created a rational, reasonable and responsive system for supervising the GSE activities. That system, with two regulators, is

[13] Testimony by Congressmen Israel
[14] Testimony from Congressmen Meeks
[15] Ibid.

operating increasingly effectively. H.R. 1409 would unfortunately interrupt this continual progress" (Reforming Fannie Mae and Frddie Mac, 2001) Congressional representatives further attempted to push the United States housing mission with Rep. Velazquez stating, "We need to encourage the activities of the housing GSEs. Their mission has become more important than ever" (Reforming Fannie Mae and Freddie Mac, 2001).

General Congressional discourse outside of the House Financial Services Committee also provides evidence that at this point in time Congress was largely concerned with supporting an affordable housing mission without increasing oversight. As Barney Frank noted in January of 2002:

> "To make lasting and meaningful progress on this issue in the new year and beyond, there must be an immediate and demonstrated public commitment at all levels to address the full measure of the nation's affordable housing problem. At present, there are simply not enough resources to support affordable ongoing housing efforts. The lack of political will to increase funding to encourage and provide incentives to produce new affordable housing has and will continue to force families to make unacceptable choices in order to find adequate shelter" (Affordable Housing Shortage Nears Crisis Proportions, 2002).

The need for affordable housing for Americans was also shared in the Senate, where the promotion of housing was often connected with other government initiatives, such as education. As the Senate record indicates, "I am convinced affordable housing is becoming the second most important education program. It breaks my heart: I don't know how these 8- and 9- and 10-year-olds can do well in school when their families move two or three times a year because they do not have affordable housing[16]" (Helping the Helpless, 2002).

The 107th Congress again halted potential legislation against the GSEs despite an estimated a positive financial value of the subsidy guaranteed to the GSEs by the federal government. This bill was again referred to committee, where it died without a committee vote, likely due to a lack of concern regarding increasing regulation amongst COFS members. It is interesting that at this time Congress was not concerned with the large subsidy given that it seemed to be largely subsidizing risk taking. In addition to failing to rein in the GSEs in any capacity politicians continued to focus on the affordable housing mission of the United States strengthening the message that as long as Fannie and Freddie continued to pursue the mission of home ownership they would unlikely be subject to stricter regulations.

4.5 108th Congress 2003-2004

In 2004 OFHEO filed a report with Congress alleging accounting fraud and management failure at Fannie Mae. This report was compiled by the Deloitte Auditing Firm after reviewing over 200,000 documents and e-mails, which uncovered several accounting errors within the financial statements of Fannie Mae which allowed the corporation to boost their earnings per share figure (OFHEO Report, 2004). This investigation was fueled largely by an announcement by Freddie Mac that they "understated earnings" in 2003, which uncovered fraudulent accounting practices at

[16] Testimony by Senator Wellstone

Freddie Mac. This document shaped the discussion surrounding the GSEs during the 108th session of Congress. The increased attention paid to regulating Fannie and Freddie following the previously mentioned accounting scandals represents the fire alarm mechanism of Congressional regulation.

In October of 2004 a COFS subcommittee hearing was scheduled regarding the OFHEO report. Although the hearing did not lead to any legislation, Fannie Mae, prior to Congressional hearings, entered into agreements with OFHEO to change their accounting measures, increase their capital position, and provide greater oversight to their accounting practices (OFHEO Press Release, 2004). Many committee members expressed discontent with Fannie Mae's corporate governance and internal risk models. As noted by Congressmen Baker:

> "The OFHEO report raises serious questions about whether Fannie Mae has adequate internal control procedures, ultimately one of the core aspects of Sarbanes-Oxley. The multiple and conflicting duties of the chief financial officer, who we will hear from this morning, calls into question whether there is adequate separation between the risk-taking and control functions" (The OFHEO Report: Allegations of Accounting and Management Failure at Fannie Mae, 2004)

Concerns over management continued throughout the hearing with Congressmen Oxley noting, "We have recently learned that the corporate structure may have fostered an atmosphere in which senior management may have had undue influence over accounting policies and procedures, and that corporate earnings and management compensation may have been manipulated" (The OFHEO Report: Allegations of Accounting and Management Failure at Fannie Mae, 2004).

Despite the public accounting fraud and the discouragement levied by Congress to Fannie Mae executives, many representatives still seemed to focus solely on the United States housing mission. In fact, negative sentiment may have increased towards the GSEs because of their resistance to the affordable housing goals. As Chairman Baker notes, “I should also note that the resistance the GSEs have expressed toward enhanced housing goals. In light of these revelations (accounting fraud), their opposition makes more sense now more than ever” (The OFHEO Report: Allegations of Accounting and Management Failure at Fannie Mae, 2004). As Barney Frank mentions later in the testimony, “I think what we need to do is to go forward as we’re ready to do with a tougher safety and soundness regulator, but in ways that do not impinge on Fannie’s and Freddie’s ability to do a better job than they have been doing with affordable housing” (The OFHEO Report: Allegations of Accounting and Management Failure at Fannie Mae, 2004). This shows that Congress was beginning to realize the importance of increasing oversight over the GSEs while promoting their housing mission.

The Congressional Record also indicates that potential efforts by the Bush administration to rein in the GSEs were largely opposed because many legislators felt that it compromised the housing agenda:

> “It is my recollection that the Bush administration actually urged this committee and this Congress to take strong action and that at that time that was in the sort of post-Freddie Mac. At that time, many of the Democratic members accused the Bush administration of going on a witch hunt against Fannie Mae of saying that things were right at Fannie Mae, and that OFHEO was doing a wonderful job, and that there was sufficient regulation, that this was simply to accuse the Bush administration of wrong motives.
>
> It was actually a combination of those in the Senate that did not want to take

> action, and members of this committee that disagreed with the Bush administration. One thing the Bush administration was concerned about is the new products that Fannie was offering, and they wanted Treasury to approve those new products[17]" (Hearing on Accounting and Management Issues at Fannie Mae, 2004).

The discussion surrounding the OFHEO report and the GSEs is quite important because the climate, at least in some senses, seems to have shifted slightly from the previous Congress'. The praise that surrounded the GSEs in past sessions of Congress was largely absent, likely due to the accounting fraud that had taken place at both Fannie Mae and Freddie Mac. The accounting fraud committed by the GSEs in the wake of other corporate scandals, such as Enron, also largely contributed to the change of sentiment at this time. Discussion within committee hearings surrounding Sarbanes-Oxley[18] provides some insight into the political context that seemed to contribute to a much larger negative sentiment. This provided a clear message to the GSEs that stricter regulation was perhaps on the way. Although no legislation was pursued at this time discourse indicated that it had become a more pertinent matter to Congress. The Congressional legislature also largely reflected the governments continued commitment towards pursuing the government housing mission.

During this same time period concerns over the GSEs as a potential detrimental effect on the economy were also growing within Congress. As noted by Ron Paul the House of Representatives, "…the two largest GSEs, Fannie Mae and Freddie Mac, have grown so large that they could threaten the foundation of the entire United States

[17] Testimony by Rep. Bachus

[18] Sarbanes-Oxley refers to the Sarbanes-Oxley Act of 2002 which enhanced standards for reporting for all U.S. public company boards in the wake of the Enron scandal.

economy if risks are not properly managed" (The Role of Housing-Related Government-Sponsored Entities in the U.S. Economy, 2004). Congress also noted increased risk taking and deviation from housing goals amongst the GSEs: "It appears as though the increased risk the GSEs have been taking on is not related to their primary operation of purchasing affordable housing loans in the secondary market[19]" (The Role of Housing-Related Government-Sponsored Entities in the U.S. Economy, 2004). Congress appeared to be making these concerns a more pertinent matter:

> "We must act prudently and look at a range of options to ensure the solvency of Fannie Mae and Freddie Mac. We need to guarantee the mission of the GSEs is not compromised but, at the same time, ensure proper oversight and ethical behavior. Fannie Mae and Freddie Mac must continue to bring the American dream to as many people as possible while we strive to reduce the risk of fraud of a GSE derailing the United States economy[20]" (The Role of Housing-Related Government-Sponsored Entities in the U.S. Economy, 2004)

This time frame largely reflects a growing concern within the government about the GSEs. Despite this concern no legislation was enacted to increase regulation over Fannie and Freddie. It does largely appear that the honeymoon between the GSEs and Congress was quickly coming to an end in the years preceding their conservatorship. It seems that because these concerns took hold largely before the conclusion of the 108th Congress investigation into the legislative measures needed to rein in the GSEs had been pushed off into the 109th Congress.

[19] Testimony by Rep. Langevin
[20] Ibid.

4.6 109th Congress 2005-2006

The 109th Congress largely continued where the last session left off, focusing its efforts on reforming the GSEs in the wake of the recent accounting scandals at Fannie Mae. Congress seemed to be becoming increasingly wary of the size of GSE's portfolios of mortgages which left them susceptible to interest rate risk. In discussions for reforming the GSEs, Congressman Garrett noted, "The best way to reduce the systematic risk for the economy is by limiting the amount of mortgages that Fannie and Freddie can hold in their own portfolio" (Regulation of GSEs, 2005). These concerns eventually led to the drafting of the Federal Housing Reform Act of 2005 (Federal Housing Finance Reform Act, 2005). This legislation, which passed through the House of Representatives but never came to a vote in the Senate contained many major changes to the regulatory framework of the GSEs. The measure was referred to The Banking, Housing, and Urban Affairs committee within the Senate where a hearing was scheduled and eventually postponed to an undetermined date. Ultimately, the hearing never occurred and the bill died at the conclusion of Congress.

The bill intended to consolidate the GSEs under a new regulator, expand housing goals, limit conforming loan limits, increase capital requirements, and increase transparency (Federal Housing Finance Reform Act, 2005).

After the failure of H.R. 1461 in 2005 Congress attempted to pass the Federal Housing Enterprise Regulatory Reform Act of 2005 which did not make it through the committee stage of legislation. This act was much more conservative in nature than H.R.

1461 and mainly focused on strengthening the regulatory power of Congress over the GSEs and improving capital requirements (Federal Enterprise Regulatory Reform Act, 2005). This piece of legislation was reported to the Senate floor, with amendments, by the Committee on Banking, Housing, and Urban Affairs but never brought to an official Senate vote. Discussion surrounding the political climate at this time leads to speculation that this matter was largely tabled in the wake of the Hurricane Katrina tragedy. The findings were brought to the Senate floor in late July and Hurricane Katrina occurred in August. Despite the failures of both of these legislative measures it appeared that some members of the government seemed to be realizing that the GSEs posed systematic risks to the economy, which led Congress to attempt to create legislation to help prevent a large taxpayer bailout.

One perplexing element that existed even throughout 2006 is the government's continual persistence on expanding the affordable housing goals without expanding oversight on the GSEs. As the secretary of HUD noted in testimony to the House Financial Services committee:

> "In addition to increasing the housing goals annually from 2005 through 2008, HUD's rule establishes new home purchase subgoals in each of the three goal areas. This is intended to focus the GSEs' efforts on the purchase of home mortgages, not refinancings. HUD projects that over the next four years, GSEs will purchase an additional 400,000 home purchase loans that meet these new and more aggressive goals as a result of the new rule."(Hearing on Oversight of the Department of Housing and Urban Development, 2005).

This on-going pursuit of the United States home ownership mission appeared to be dwarfing relevant concerns regarding the size and risk levels of the GSEs, Fannie and Freddie. Hindsight suggests that before aggressively expanding the housing initiatives of the GSEs Congress should have pursued increased regulatory measures to ensure safety and soundness. Concerns regarding the inherent risk within Fannie and Freddie appeared within the Congressional record; however, no legislative measures were taken. Ultimately, despite relevant concerns, the GSEs were given more aggressive home ownership goals without any increased oversight.

4.7 Concluding Remarks

Analyzing Congressional discourse, failed legislation, and other reports regarding the GSEs shows a changing relationship between Fannie and Freddie and Congress from 1997 to 2006. Initially Congress was reluctant to enact new regulations towards the GSEs because of their ability to promote home ownership. As Fannie and Freddie continued to grow, their risk to the markets increased and legislatures began to become more wary of the mortgage giants. Accounting scandals largely drove the mission for increased oversight, which, by 2006, did not come to fruition. The increasing concern and potential, albeit failed, legislation largely shows Congressional utilization of a fire-alarm approach to bureaucratic control. Despite growing concerns throughout the decade Congress continued to pursue aggressive housing initiatives without expanding regulatory oversight. The pursuit of home ownership goals seemed to largely overshadow the majority of concerns that were brought up regarding the size, stability, and practices of the GSEs. In retrospect it seems that the approach taken to regulate the GSEs was appropriate, however, the actual regulations were lax. It seems that Congress was generally unable to regulate the GSEs because they did not completely understand the complexity of the their business, and the risk levels of loans that they were insuring.

It is important to note that examination of the Congressional legislation indicates there is no divide among Congress members regarding increasing regulation amongst the GSEs. Both Republicans and Democrats within Congress generally appeared to be in unison in their efforts in promoting the United States housing mission without increasing oversight. HUD and OFHEO, which are composed of appointed officials, were also silent on increasing their ability to regulate the GSEs outside their existing powers that stemmed from the legislation in 1992. Between 1992 and 2008 both Democratic and Republican administrations controlled the White House and no large shift in attitude towards the GSEs within HUD is apparent.

The testimony and other evidence presented in the preceding section never directly impacted Freddie Mac or Fannie Mae because no legislation was enacted forcing the GSEs to behave differently. Despite this, these conversations and documents indirectly influenced the way the GSEs operated because of the relationship between Fannie, Freddie, and the government.

Chapter 5

In 2008 Fannie Mae and Freddie Mac were placed into conservatorship by the United States government because they became insolvent. To establish how the GSEs became insolvent is important to look at the risk levels inherent within Fannie Mae and

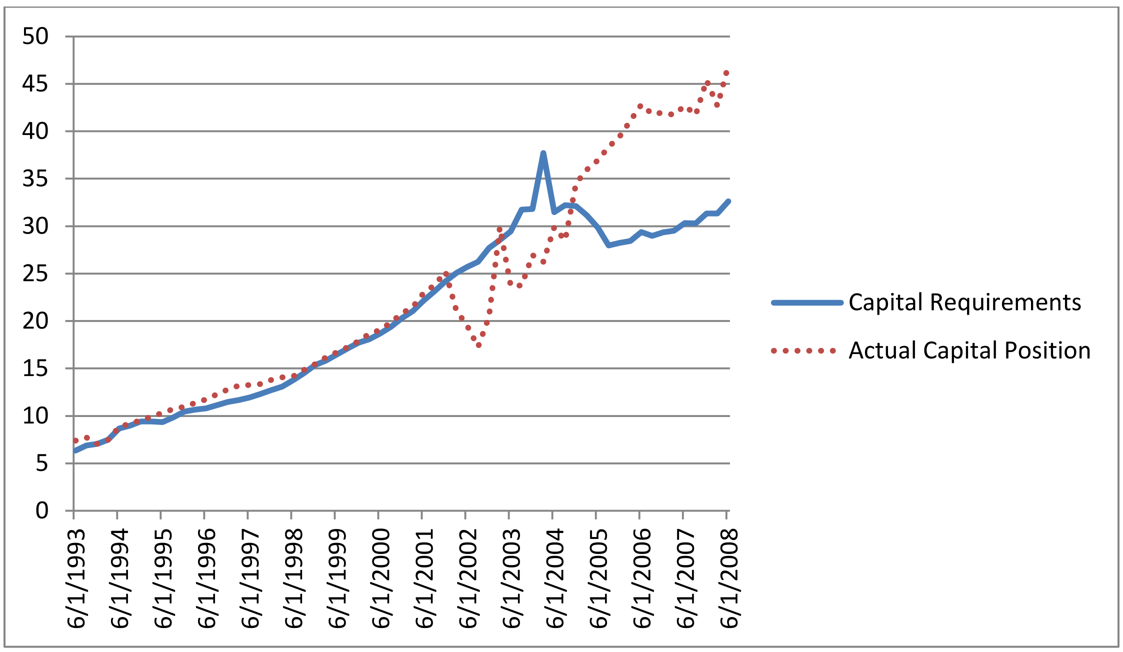
Freddie Mac from the late 20th century through 2008. As this chapter will show the GSEs became insolvent because they began to pursue riskier business operations without increasing their underlying capital. Given the nature of the GSE's business operations there are two distinct forms of risks that need to be evaluated. Both segments of their business, the guarantee business and the investment portfolio business, are subject to default risk and interest rate risk. Default risk refers to the risk associated by guaranteeing a stream of payments on a security if the underlying asset, in this case a mortgage, defaults. Default risk will be analyzed through the use of changing loan-to-value (LTV) standards, growth in guarantees outstanding, and increasing subprime exposure. Interest rate risk refers to the change in value of assets in different interest rate environments. The interest rate risk of Fannie Mae and Freddie Mac will be viewed through the expansion of their retained mortgage portfolio as well as a detailed analysis of their capital positions.. These types of risks will be viewed within the context of the capital requirements used by OFHEO. This study contends that the capital requirements used by the GSEs regulator did not adequately account for the increasing riskiness of their positions.

5.1 Capital Requirements

Chapter three of this study briefly mentions the capital requirements for Fannie Mae and Freddie Mac. It is important to fully understand these standards to analyze the capital positions and risk levels of the GSEs. Following the 1992 legislation the GSEs were subject to three capital standards. Two of these standards, the minimum and critical capital standards, were ratio based. These standards are calculated as a percentage of assets. The minimum capital standard is 2.5% of assets, and the critical capital standard is one-half the minimum standard. The third capital standard utilized a hypothetical risk based stress test that accounts for interest rate increases and decreases, real estate price declines, and mortgage defaults over a ten year period. These conditions were viewed as things that could dramatically change the value of the assets and liabilities associated with the GSEs.

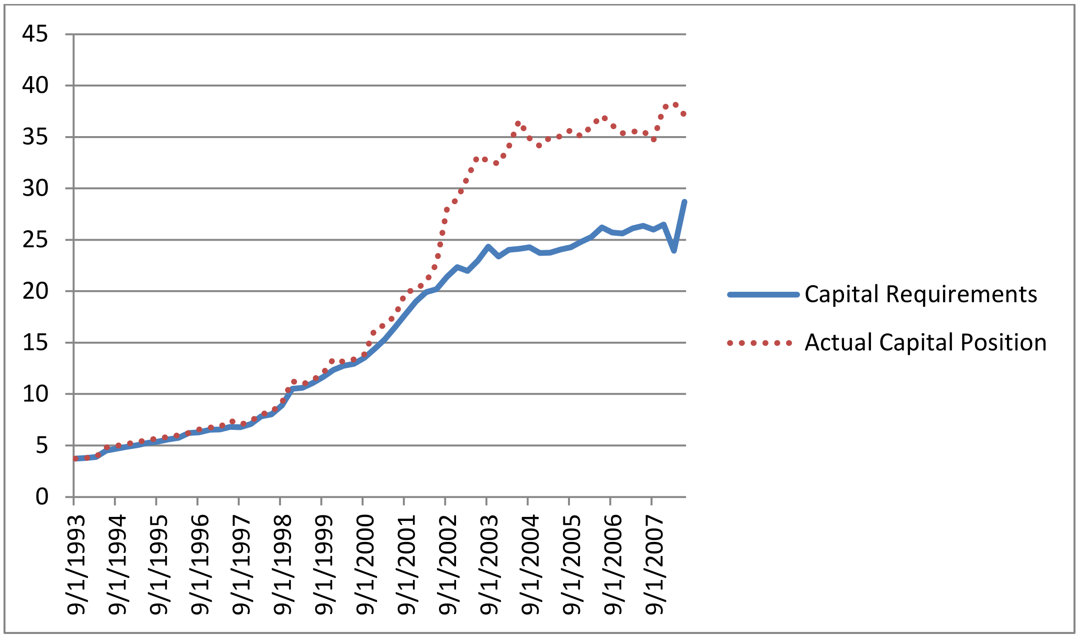
Historic capital requirements are available through the OFHEO. The organization provides minimum capital requirements from 1993 to conservatorship. The risk based capital standards are available from 2002 through conservatorship. The reason data is only available after 2002 is because the stress test wasn't fully refined and implemented until 2001. Capital standards are evaluated on a quarterly basis. Figure 4 on page 65 depicts the minimum capital requirements of Fannie Mae and the organizations capital levels, as measured in billions of dollars. Figure 5 on page 66 presents a similar chart for Freddie Mac. As the data shows throughout the majority of quarters from 1993 through conservatorship, with the exception of Fannie Mae between in 2003-2005, the GSEs were in compliance with their capital requirements. It must be noted that during 2003-2005, Fannie Mae was unable to meet the minimum capital requirement, but was not viewed as undercapitalized by OFHEO because of their ability to meet the risk based capital requirements. Adequate capitalization is especially true in the years just prior to conservatorship where the GSEs appeared to be exceeding their capital requirements with increasing margins. There are two main reasons that the capital requirements did not adequately serve the GSEs. Firstly, two of the capital requirements were ratio based as a percentage of balance sheet assets. Given that Fannie and Freddie held most of their liabilities off-balance sheet the capital standards do not account for a growth in off-balance sheet liabilities. This growth largely occurred through the expansion of the guarantee business through 2008. In addition to this, the capital standards did not fully account for all of the risks inherent in Fannie Mae and Freddie Mac, including those related to the composition of the mortgages guaranteed or held.

Figure 4 Fannie Mae Capital Position[21]



[21] (Federal Housing Finance Agency, 2010). In Billions of US$

Figure 5 Freddie Mac Capital Position[22]

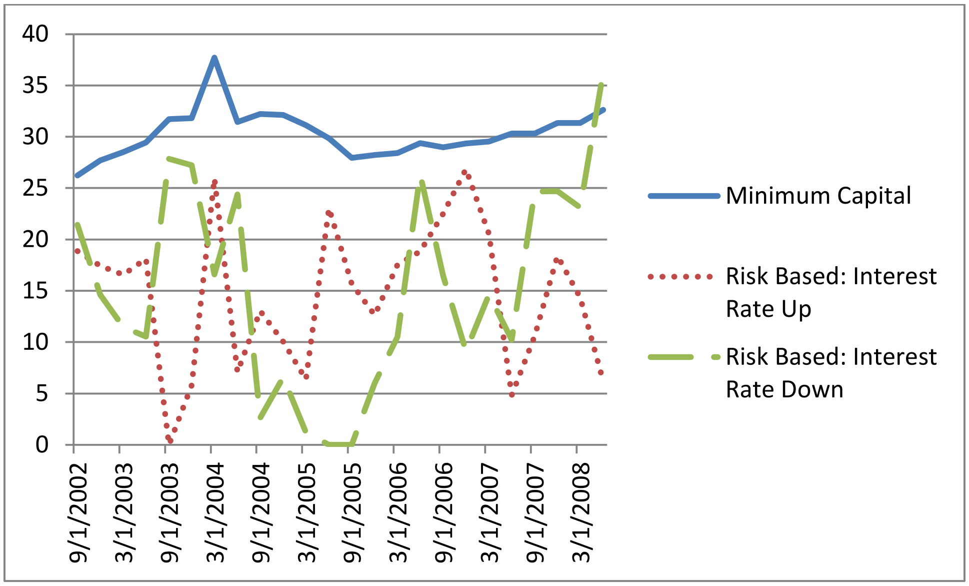


A risk-based stress test was largely created and implemented because many felt that the ratio based capital standards used to evaluate Fannie Mae and Freddie Mac were not stringent enough (Kinsey, 1998). The risk based capital stress test used to evaluate Fannie Mae and Freddie Mac projected credit losses from mortgage defaults and loss severities on a national scale comparable to the worst historical mortgage-default-loss experience in any region of the country. In addition to simulating defaults, the stress test introduced interest-rate shifts with increases of as much as 75% and decreases as much as 50% of their current levels (Kinsey, 1998). Despite attempting to account for more variables, the risk-based stress test largely failed to increase capitalization of the GSEs because the risk based test generally resulted in standards lower than that of the minimum

[22] Ibid.

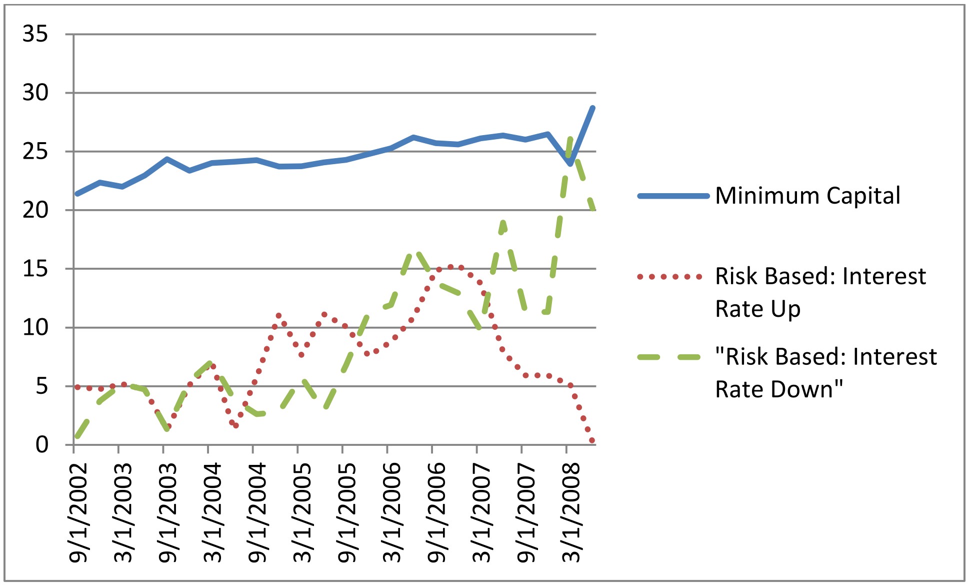
capital standards. This can be seen in Figure 6 below which graphs Fannie Mae's minimum capital requirement and the capital requirements required by each interest rate scenario in the risk based capital test. Figure 7 on the following page presents the same data for Freddie Mac.

Figure 6 Fannie Mae Capital Requirements[23]



[23] (Federal Housing Finance Agency, 2010) In billions of US$.

Figure 7 Freddie Mac Capital Requirements[24]



In a 2006 study the CBO examined the capital standards of the GSEs and discussed the risk based stress test that had begun to take effect in 2002. In their findings they note that the shocks used by the OFHEO to calculate the standards for the test were narrow in scope, limiting the robustness of the test. Similarly, the stress-test assumes that the GSEs stop conducting new business at the outset of the stress period. This assumption is largely consistent with assessing the GSEs ability to survive on past business transactions; however it is unrealistic in nature (Congressional Budget Office, 2006). The capital measures required by OFHEO did little to prevent federal takeover of the GSEs due to undercapitalization. The requirements failed to account for unforeseen events, such as large mortgage defaults that were uncharacteristic of historic averages. As seen in Figure 8 on the following page beginning in 2007 foreclosures rose significantly from historic averages, leaving the GSEs unprepared. The capital standards utilized by

[24] Ibid.

OFHEO were also unable to provide adequate capital measures for the GSEs because Fannie and Freddie were becoming inherently more risky by purchasing and guaranteeing mortgages with higher default risk. The capital standards largely rely on ratios based on percentage of assets. The standards do not account for the riskiness of those assets. If the assets become inherently more risky more capital would be required to guarantee capital adequacy.

Figure 8 Mortgage Foreclosures 1997-2009[25]

[25] Taken From Bloomberg Financial Terminal. X-Axis: Year, Y-Axis: Mortgage foreclosures as a percentage of loan originations.

5.2 Guarantee Risk

The most obvious risk faced by Fannie Mae and Freddie Mac is the stream of payments that they guarantee to the holders of their MBS. As one would expect as a greater volume of MBS are guaranteed and sold to investors the risk of default grows. Table 4 on the following page demonstrates the volume of MBS outstanding for Fannie Mae and Freddie Mac. As evidenced by the chart the volume of loans packaged and guaranteed by the GSEs grew significantly from 1995 through 2008. This large increasing trend in outstanding MBS is due to many reasons. First and foremost, by purchasing, packaging, and guaranteeing more loans, Fannie and Freddie were able to realize higher profits in their guarantee business due to the fact that they receive a guarantee fee for the mortgages they insured. Secondly, especially through the early 2000's the booming real-estate market provided an abundance of loans that could be gobbled up for securitization by the GSEs. Given that the MBS outstanding are composed of mortgages purchased by Fannie Mae and Freddie Mac, the securities become riskier for the GSEs to guarantee if the stream of payments from the packaged mortgages begins to dwindle due to mortgage default or interest rate changes unexpectedly because Fannie and Freddie still need to make payments on the MBS without receiving payments on the mortgages. Significant mortgage defaults mean that Fannie and Freddie need to use their own capital to make timely payments on the MBS without receiving continuing payments from the mortgages. Although many believed that Fannie Mae and Freddie Mac were operating largely within the safer, prime sector of the mortgage market, data available today shows that beginning in 2000 through 2007 the loans purchased by the GSEs were increasingly more risky. This can be seen by examining the changing LTV standards and the increasing exposure to subprime loans.

Table 4 MBS Outstanding[26]

		FNMA		FHLMC	
Y	Q	1-4 Family	Multi	1-4 Family	Multi
1995	Q1	523,903.0	9,459.0	489,114.0	3,080.0
	Q2	533,091.0	10,578.0	495,182.0	3,034.0
	Q3	548,400.0	11,185.0	500,417.0	2,953.0
	Q4	569,724.0	13,235.0	512,238.0	2,813.0
1996	Q1	585,527.0	14,019.0	521,722.0	2,605.0
	Q2	606,271.0	15,014.0	534,238.0	2,433.0
	Q3	619,869.0	16,493.0	543,341.0	2,267.0
	Q4	633,209.0	17,570.0	551,513.0	2,747.0
1997	Q1	645,324.0	18,344.0	560,369.0	2,525.0
	Q2	654,826.0	19,105.0	564,445.0	2,742.0
	Q3	670,677.0	20,242.0	567,340.0	2,580.0
	Q4	687,981.0	21,601.0	576,846.0	2,539.0
1998	Q1	708,125.0	22,707.0	580,715.0	2,429.0
	Q2	737,631.0	23,728.0	607,469.0	2,322.0
	Q3	770,979.0	27,481.0	633,124.0	2,602.0
	Q4	804,204.0	30,313.0	643,465.0	2,994.0
1999	Q1	849,513.0	32,302.0	684,240.0	2,939.0
	Q2	877,863.0	33,572.0	714,844.0	3,241.0
	Q3	903,531.0	34,953.0	735,088.0	3,493.0
	Q4	924,941.0	35,942.0	744,619.0	4,462.0
2000	Q1	932,178.0	43,637.0	752,607.0	4,499.0
	Q2	957,584.0	38,231.0	763,890.0	4,751.0
	Q3	981,206.0	39,622.0	786,007.0	4,884.0
	Q4	1,016,398.0	41,352.0	816,602.0	5,708.0
2001	Q1	1,055,412.0	43,637.0	827,616.0	5,847.0
	Q2	1,116,534.0	47,444.0	867,924.0	5,826.0
	Q3	1,177,995.0	50,136.0	921,709.0	5,781.0
	Q4	1,238,125.0	52,226.0	940,933.0	7,476.0
2002	Q1	1,301,374.0	54,030.0	1,005,136.0	7,342.0
	Q2	1,349,442.0	55,152.0	1,045,981.0	7,280.0
	Q3	1,402,929.0	56,016.0	1,050,899.0	7,277.0
	Q4	1,478,610.0	59,677.0	1,072,990.0	9,072.0
2003	Q1	1,576,495.0	60,979.0	1,064,114.0	8,902.0
	Q2	1,687,263.0	62,633.0	1,042,417.0	8,724.0
	Q3	1,733,853.0	67,675.0	1,082,144.0	13,729.0
	Q4	1,780,884.0	76,161.0	1,141,241.0	16,098.0
2004	Q1	1,802,301.0	75,729.0	1,150,632.0	16,230.0
	Q2	1,803,584.0	75,425.0	1,168,494.0	16,482.0
	Q3	1,816,973.0	75,707.0	1,180,757.0	16,655.0
	Q4	1,673,339.0	69,722.0	1,173,847.0	15,546.0
2005	Q1	1,820,163.0	75,840.0	1,202,023.0	16,955.0
	Q2	1,824,143.0	76,006.0	1,228,600.0	17,330.0
	Q3	1,847,818.0	76,992.0	1,261,865.0	17,799.0
	Q4	1,753,708.0	73,071.0	1,294,321.0	14,503.0
2006	Q1	1,893,881.0	78,912.0	1,356,020.0	19,128.0
	Q2	1,924,275.0	80,178.0	1,381,468.0	19,487.0
	Q3	1,961,316.0	81,721.0	1,416,544.0	19,981.0
	Q4	1,894,396.0	78,933.0	1,442,306.0	20,479.0
2007	Q1	1,943,357.0	80,973.0	1,506,246.0	21,037.0
	Q2	1,999,762.0	83,323.0	1,561,920.0	22,085.0
	Q3	2,081,261.0	86,719.0	1,633,753.0	23,090.0
	Q4	2,206,263.0	91,928.0	1,706,684.0	10,658.0
2008	Q1	2,278,908.0	94,955.0	1,751,647.0	10,939.0
	Q2	2,346,853.0	97,786.0	1,791,127.0	11,185.0
	Q3	2,400,500.0	100,021.0	1,801,666.0	11,251.0
	Q4	2,417,077.0	100,712.0	1,786,906.0	14,829.0

[26] SMIFA.com

5.3 Loan-to-Value Ratios

A loan-to-value ratio is defined quantitatively as the mortgage amount divided by the appraised value of the property. In simple terms, if an individual wishes to purchase a home at $100000 and he or she takes out a mortgage value of $90000 the borrower would be evaluated with a LTV ratio of 90%. Higher LTV ratios indicate greater credit risk. As Fannie Mae and Freddie Mac detail in their financial filings their charter requires some type of credit-enhancement on loans that have an LTV ratio of greater than 80% at the time of purchase. Credit enhancement is provided by one or more of the following conditions: insurance or guarantee by a qualified insurer of the over-80% portion of the unpaid principal balance or the mortgage, a seller's agreement to repurchase or replace the mortgage in the event of default, or retention by the seller of at least 10% participation interest in the mortgage (FNMA and FDMC 2008 Annual Report). Table 5 below details the LTV ratios of Fannie Mae and Freddie Mac from 2000 through 2007.

Table 5 Loan-to-Value of Purchased Mortgages, 1999-2007[27]

LTV Ratios	> 95	90< LTV < 95	80% < LTV < 90%	LTV < 80
All Loans	Fannie Mae			
2005-2007	26%	9.30%	7.40%	57.30%
2001-2004	14.10%	10.90%	9.80%	65.20%
1999-2000	4.40%	18.80%	16.10%	60.70%
All Loans	Freddie Mac			
2005-2007	19.30%	9.20%	8%	64.00%
2001-2004	6.40%	12.70%	9.30%	71.60%
1999-2000	6.10%	20.20%	15.20%	58.50%

[27] (Federal Housing Finance Agency, 2010)

As the table demonstrates loans purchased with a LTV ratio below 90% remained relatively constant, or declined through 2007. However, LTV ratios greater than 95% increased significantly for both institutions. These loans grew from 4.40% between 1999-2000 to 26% between 2005-2007 for Fannie Mae, and 6.10% to 19.30% for Freddie Mac. This clearly shows increasing credit risk in the underlying mortgages purchased by the GSEs during this time period. It may seem that the GSEs were protected in the arena of high LTV mortgages by credit enhancements. However, this was not the case. Credit enhancements are worthless if the mortgage originator providing the guarantee of capital is also inadequacy capitalized. By 2007 over 80 subprime lenders had closed shop, and many of these lenders were selling mortgages to Fannie and Freddie, with higher LTV ratios. This makes the credit enhancements worthless. (Civilis and Gongloff, 2008).

Theoretically speaking LTV ratios do not account for large fluctuations in real-estate prices because they are calculated at moments in time. Given the historical context of real-estate prices shown in chapter one, as well as the sharp decline in prices that began in 2007, the LTV ratios calculated by the GSEs may have actually been riskier than they appeared. Given that the quantitative calculation used to determine a LTV involved an outstanding mortgage in the numerator, which was fixed, and the value of an underlying property in the denominator, which is subject to price fluctuations, LTV by nature are dynamic. Since the value of the underlying asset in the denominator is used as collateral in the event of mortgage default, if the property value changes significantly over time the creditor can either realize a large gain or loss on the underlying asset.

For example, if real-estate prices declined as we saw in 2007 the LTV ratio would actually increase. In 2006 a LTV ratio of 80% would appear quite safe. However, if the mortgage holder defaulted on this mortgage in 2008, after real-estate prices declined, any creditor seizing the underlying asset as collateral would be realizing less value for this asset when they seized it than they would have when they made the loan in 2006. Given that real-estate prices declined sharply following 2007 as seen in Figure 3 Case-Shiller United States Home Price Index Annual Data 1990-2010 many LTV ratios calculated prior to 2007, specifically at the height of the real-estate bubble, increased significantly. Since many mortgage originators use LTV ratios in coordination with credit-scores to define whether loans are prime or subprime an increase in LTV ratios of loans would have the effect that many loans that were originally viewed as prime could be seen as subprime (Sengupta and Emmons 2007). Given the volume of loans purchased by the GSEs, this invariably shows that Fannie and Freddie were exposed to far more risk of losses than they may have internally determined. The deteriorating LTV standards increased the risk associated with the GSEs. This, coupled with both firms increase in actual subprime exposure, greatly changed the risk composition of the GSEs.

5.4 Subprime Exposure

Data surrounding the subprime exposure of the GSEs is largely speculative. The regulators of Fannie Mae and Freddie Mac did not quantify the subprime exposure of the two GSEs at any point preceding the government takeover of the mortgage giants. The only publically recorded data regarding this topic stems from statements made regarding their own exposure to subprime mortgages in their reports and conferences. These filings and statements were written or made largely by company insiders at the GSEs and the data reported regarding subprime exposure has been deemed false. The SEC in 2011 filed lawsuits against executives at Fannie Mae and Freddie Mac for falsifying information regarding their subprime exposure, and within these complaints, the SEC expresses different figures regarding the mortgage giants' exposure to subprime loans between 2006 and 2008. The figures from both 10-k filings and the SEC reports will be used to examine subprime exposure of the GSEs in the late 2000s; however, many scholars have speculated that the mortgage giants begun operating in the subprime market as early as 2000.

One of the difficulties related to quantifying the subprime exposure of Fannie Mae and Freddie Mac relates to the definition of "subprime." Fannie Mae and Freddie Mac use loan originators definitions of subprime, which vary by originator, when categorizing their exposure. This is largely problematic because by purchasing loans of different characteristics from several different lending organizations, some loans that may have equivalent characteristics have the potential to be classified differently by the GSEs. Generally speaking, three terms which the GSEs use, Alt-A, A-, and EA loans, all have the potential to be characterized as subprime depending on their characteristics. As the former CEO of Freddie Mac, Gregory Parseghian indicated, from 2004 to 2008 many loans that were characterized by the GSEs as "prime" had subprime qualities. This study will utilize several third party studies, as well as the SEC complaints to paint a broad picture regarding the GSEs subprime exposure.

A 2010 study published by former Federal Reserve chairman, Alan Greenspan, regarding the subprime lending crisis attempted to quantify Fannie Mae and Freddie Mac's subprime exposure. As detailed in Table 6, the study calculates that between 2000 and 2008 the amount of single-family private label mortgages held by Fannie Mae and Freddie Mac that can be characterized as subprime ranged anywhere from 16 percent to 33 percent of all total subprime MBS outstanding. It is important to note that the largest figure, 33 percent, occurred in 2004 at the height of the subprime market and that Fannie Mae and Freddie Mac seemed to be reducing their exposure to subprime lending, holding only 16.4 percent of all total MBS outstanding in 2008. Figure 2 details the total volume of subprime MBS outstanding from 1995 through 2010.

Table 6 Greenspan: Fannie and Freddie Subprime Exposure in Single-Family Business[28]

			Fannie Mae & Freddie Mac Subprime Single-Family Private Label Mortgage			
	Total Subprime MBS Oustanding (Bil.$)	Change in Total Subprime MBS Oustanding (Bil.$)	Retained in Portfolio (Bil.$)	As a percent of Total Subprime MBS Outstanding	Change from end of previous year (Bil.$)	Change as a percent of Change in Total Subprime MBS Outstanding
2000	88.7					
2001	119.0	30.3	19.0	16.0		
2002	186.2	67.2	24.7	13.3	5.7	8.5
2003	280.8	94.6	66.9	23.8	42.1	44.5
2004	456.5	175.7	150.6	33.0	83.8	47.7
2005	644.3	187.8	179.2	27.8	28.6	15.2
2006	800.9	156.6	169.0	21.1	-10.2	-6.5
2007	774.0	-26.9	133.4	17.2	-35.6	132.5
2008	605.4	-168.6	99.4	16.4	-34.0	20.1

To put these figures in perspective, just prior to the height of the subprime boom shown in Figure 2 the GSEs guaranteed roughly 1/3 of all subprime mortgages outstanding.

Greenspan's data shows an obvious increase in subprime exposure through the early part of the decade. This increase constitutes a significant portion of Fannie Mae and Freddie Mac's single-family private label business. To quantify this further, assuming

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[28] Greenspan, 2010.

Greenspan's calculations, Fannie Mae and Freddie Mac held as much as 179.2 billion dollars of subprime exposure on their combined balance sheets between 2000 and 2010. Specifically, the data table shows significantly increasing levels of subprime exposure between the years of 2003-2005. Although this figure began to decline between 2005 and 2008 it still remained much higher than in years preceding 2004. Data compiled by other sources serve to segment each GSEs direct exposure and provide slightly different figures, but do paint a similar picture of subprime exposure.

In March of 2002 the Urban Institute was contracted by HUD to conduct a third-party report regarding the subprime market. The report, "Subprime markets, the role of the GSEs, and risk-based pricing" was designed to provide HUD with a general idea of the effects of the GSEs expansion and role in the subprime market as well as suggest oversight and monitoring strategies that HUD could utilize to regulate the GSEs. In the report the regulator found that in 2000 Fannie Mae bought roughly $600 million dollars in subprime mortgages. In that same year, Freddie Mac purchased $18.6 billion dollars in subprime mortgages and guaranteed an additional $7.7 billion dollars in subprime transactions. Overall, the study found that these values were small compared to the total size of the subprime market ($160 billion). In percentages, these figures indicated that in 2000 Fannie Mae's purchases comprised roughly .03% of the subprime market, with Freddie Mac accounting for roughly 16.4% (Johnson, et. all 2002). It must be noted that the Urban Institute used Fannie Mae and Freddie Mac's definition of subprime, which was much more conservative than Alan Greenspan's. Other data surrounding subprime exposure of the GSEs is largely absent in published reports excluding the figures provided within the annual 10-k filings. This is relevant because the HUD study utilized data compiled through Fannie Mae and Freddie Mac, which may have been understated.

For Fannie Mae the first mention of the term “subprime” appeared in their 2004 10-k filing; however, they did not provide any figures regarding their exposure. Filings between 2005 and 2007 indicated that in 2005, of their single-family private-label mortgages, roughly .10% could be characterized as subprime in 2005, .20% in 2006, and .30% in 2007. Alt-A exposure was reported to be 8% of their exposure in 2005, with the figures 11% and 12% roughly comprising their exposure in 2006 and 2007 respectively (FNMA 2006 and 2007 Annual Report).

Due to its special privileges as a GSE Freddie Mac chose not to file annual 10-k statements until 2008. The data within an SEC complaint alleged that various public statements made by Freddie Mac executives indicated that in 2006 between .1 and .2% of its single family guarantee business could be characterized as subprime. Similarly, in 2007 through similar statements Freddie Mac executives quantified their subprime exposure as between .2 and .3% (Fannie Mae & Freddie Mac SEC Complaints, 2011). In 2008 during their first 10-Q filings, they reported that they were exposed to the subprime market in their single-family business at roughly .03% (FDMC Quarterly Report, 2008).

The portrait of the subprime exposure painted by Fannie Mae and Freddie Mac to the public was extremely minimal. These statements indicate no cause for concern regarding the firms’ operations in the subprime market. The data within the SEC complaints against Fannie Mae and Freddie Mac indicated much higher levels of subprime exposure. According the SEC in 2006 Fannie Mae allegedly held subprime loans that represented roughly 4.64% of their single family business. Alt-A loans represented roughly 35% of this business. In 2007 these figures were roughly 3.60% and 37% respectively. Similarly, the SEC alleges that between 2006 and 2008 Freddie Mac's subprime exposure in its single family business increased from 10 to 14% (Fannie Mae & Freddie Mac SEC Complaints, 2011).

The figures presented by the SEC present a conflicting view regarding the GSEs subprime exposure then that reported by Fannie and Freddie themselves. The SEC uses data that is slightly more conservative than that used by Alan Greenspan; however, similar to Greenspan the agency finds that the GSEs had much more subprime exposure than they were reporting to regulators and investors. Differences in calculations of subprime exposure between Greenspan and the SEC largely stem from the lack of definition of the term, "subprime." Greenspan was quantifying more loans as subprime than the SEC did. In conversation with former Freddie Mac CEO Mr. Parseghian, he indicated that the lack of definition of subprime was prevalent throughout the mortgage industry. He also speculated that, because of this, it would be difficult for the SEC to hold the executives of Fannie and Freddie responsible for the allegations of misleading investors in regards to their subprime exposure. The SEC details that they largely included EA loans in their calculation of subprime exposure. These loans were not included by Fannie and Freddie. Greenspan does not detail what his calculations included, but it appears that the calculations are accounting for more than just EA loans.

5.5 Interest-Rate Risk

Throughout the 1990s and through conservatorship Fannie Mae and Freddie Mac began to hold larger amounts of mortgages and MBS in their retained portfolio segment. The MBS securities were composed of both Fannie and Freddie MBS and private-label MBS securities. Figure 9 on the following page depicts the growth in their retained mortgage portfolio in relation to MBS outstanding. As the graph shows there was a significant jump in the retained portfolio segment of the GSEs in the late 1990s and early 2000s. Profits generated from guaranteeing MBS was roughly between 19 and 22 basis points. Comparatively, profits on the retained mortgage portfolios are based on the spread between the interest return on the mortgage assets and the interest cost of funding liabilities, which was generally over 100 basis points (Jaffey, 2006). This shows that the increase in the retained portfolio segment can largely be attributed to increasing their profitability: Fannie and Freddie were able to generate higher profit margins on their investment portfolio segment then their guarantee business, making it profitable to expand this segment.

Figure 9 Retained Portfolio Growth[29]

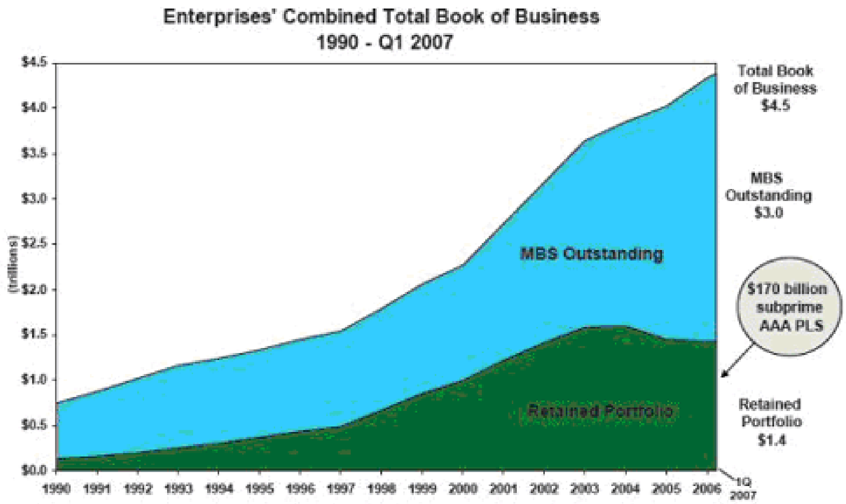


Figure 2
Source: Office of Federal Housing Enterprise Oversight

A mortgage portfolio can be defined as the mortgage assets held, and the bonds and equity used to finance these assets. Using general accounting theory, Assets = Liabilities + Equity. This means that the market value of a firm's equity can be defined as the market value of the mortgage assets – market value of bond liabilities (Jaffey, 2006). Changes in interest rate are some of the most important factors that have the ability to change the market value of both mortgage assets and bond liabilities, and ultimately, total equity. Unexpected changes in interest rates have the potential to cause mortgage assets to fall in value relative to liability values, thus leading to an unexpected decline in the market value of equity. In a case when market value of equity becomes negative, the firm is insolvent and bankruptcy is possible (Jaffey, 2006). When there are sharp increases in

[29] (Federal Housing Finance Agency, 2010)

interest rates, the value of mortgage portfolios tend to decline, which occurred to the Savings & Loan industry in the late 1970's. Given that Fannie Mae and Freddie Mac borrow short and lend long there is a large maturity mismatch between the mortgage assets they hold and the bond liabilities outstanding. Borrowing short and lending long exposes the GSEs to interest-rate risk when interest-rates increase or decrease: if interest rates rise the value of their holdings decline relatively to their debt, and in an falling interest rate environment mortgages are generally prepaid by borrowers, forcing the GSEs to replace the mortgages in a low interest-rate market. As one report detailed in 2006, if interest rates were to change by two percentage points, the value of the portfolio segment of the GSEs could lose more than 18 percent of its initial value if rates were to rise, and more than 25 percent of its value if rates were to fall (Jaffey, 2006).

The interest-rate risk inherent in the retained mortgage portfolio of the GSEs was one that was largely a concern for Congress, as discussed in chapter 3. However, Fannie Mae and Freddie Mac utilized callable bonds and interest-rate swaps to hedge their positions within their retained portfolio segment to minimize their risk (Jaffey, 2006). Callable bonds were utilized to replace prepaid mortgages, and interest-rate swaps are utilized to minimize the impact of interest rate shifts on GSE debt. Mr. Parseghian indicated that, despite Congressional concerns, the retained portfolio segments were relatively safe. He noted that Congress wished that the GSEs would get away from the retained portfolio business and solely be an insurer; however, it ultimately was the insurance business that led to conservatorship.

Despite the hedging of interest rate risk inherent in the retained portfolio segment of the GSEs, the growth of the mortgage portfolio is of concern for simple diversification. It is generally risky for an insurer of mortgages also to only hold mortgage-related securities in their investment portfolios. A large default in mortgages would not allow the GSEs to back their insurance positions with their investment positions. Overall, the risk associated with guaranteeing increasingly risky mortgages combined with the lack of diversification in their overall business model led to eventual undercapitalization.

5.6 Concluding Remarks

Figure 4 and Figure 5 demonstrate that the GSEs continually met their capital requirements through conservatorship. These capital requirements were too small for the GSEs and because they were engaging in increasingly risky practices specifically in their guarantee segments. The increasing exposure to subprime loans and the declining LTV standards in loans purchased by the GSEs changed the risk levels associated with the assets on the balance sheets of the GSEs. This changing level of risk inherent in these assets invariably means that more than 2.5% of total assets were required in capital to guarantee capital adequacy. Mr. Parseghian agreed with this conclusion, and noted that the capital requirements of the GSEs were too small for the risk levels that the institutions were insuring. In short, because the assets the GSEs were purchasing, packaging, selling, and holding were inherently more risky, more capital was required to ensure solvency than the requirements used by OFHEO. The degree to which increasing risk taking initiatives were driven by government influence will be explored in the following chapter within the context of the theoretical literature provided in chapter two.

Chapter 6

This chapter will analyze the possible connection between the increasing risk levels of Fannie Mae and Freddie Mac and the government influence examined in chapters three and four. The relationship between government influence and increasing levels of risk will be placed within the theoretical framework in reference to Congress and the bureaucracy discussed in chapter two to investigate if the influential presence of the government may have led to the increasingly risky nature of Fannie Mae and Freddie Mac.

6.1 The Link Between Risk and Government

Chapter three documented the government housing policy and influence during the late 1990s and early 2000s. Despite an inactive policy environment during this time period the government directly influenced the GSEs by creating government sponsored housing goals and expanding these goals throughout time. As previously discussed the attitude of Congress towards the GSEs changed throughout this time period. Initially Fannie Mae and Freddie Mac were heavily supported by members of Congress because of their ability to promote the government home ownership goals. This sentiment became increasingly negative after accounting scandals. Despite several attempts at increasing regulatory control over the GSEs no formal legislation was enacted, partially because the government was worried about hindering its mission of placing every American in a home. This mission was directly placed within the hands of Fannie and Freddie through the expansion of affordable housing goals by their government regulator. The government often threatened to increase regulatory measures over Fannie and Freddie, but never acted, potentially because of the GSE’s commitment to the affordable housing goals.

The pursuit of the affordable housing goals serves as the most apparent link between government influence and the increasing risk levels of Fannie Mae and Freddie Mac. The government housing goals and affordable housing mission that was explored in chapter two and three largely characterized the interests and preferences of Congress. Based on the theoretical framework presented in chapter two, meeting these goals and promoting the housing mission would be a major concern for the decision makers at Fannie Mae and Freddie Mac because of the perceived actions of Congress that would be coupled with a failure to pursue the Congressional housing goals. This was confirmed through conversations with former Freddie Mac CEO, Gregory Parseghian.

6.2 Evaluating the Data

Facing the threat of increased regulation, analysis of the GSE's housing goal performance shows that from 2003 to 2006, when government sentiment towards Fannie and Freddie was largely negative and potential legislation to regulate the GSEs was an increasingly important discussion within Congress, the GSEs largely exceeded their affordable housing goals by an increasing margin. The increasing concern of Congress is evident through the testimony of Chairman Baker (2004), Representative Langevin (2004), and the failure of H.R. 1461 (2005) and the Federal Housing Enterprise Regulatory Reform Act of 2005[30]. Table 7 on the following page summarizes the performance of the GSEs and the margins in which they exceeded their housing goals between 1996 and 1998. This data is also summarized in table 8 from 2001 to 2007 on page 88. Presumably the GSEs began to outperform their housing goal benchmark at a greater margin to restore themselves to the good graces of Congress and restore the positive reputation that surrounded the enterprises during the late 1990s when politicians were commending the GSEs for their pursuit of the American housing initiatives.

[30] This testimony and failed legislation is examined in detail in chapter four.

Table 7 Housing Goal Performance 1996-2000[31]

Housing Goals					
Low-and-Moderate Income	**1996**	**1997**	**1998**	**1999**	**2000**
Fannie	45.60%	45.70%	44.40%	45.90%	49.50%
Freddie	41.10%	42.60%	42.90%	46.10%	49.90%
Goals	40.00%	42.00%	42.00%	42.00%	42.00%
Fannie Spread	5.60%	3.70%	2.40%	3.90%	7.50%
Freddie Spread	1.10%	0.60%	0.90%	4.10%	7.90%
Underserved Areas	**1996**	**1997**	**1998**	**1999**	**2000**
Fannie	28.10%	28.80%	27.00%	26.80%	31.00%
Freddie	25.00%	26.30%	26.10%	27.50%	29.20%
Goals	21.00%	24.00%	24.00%	24.00%	24.00%
Fannie Spread	7.10%	4.80%	3.00%	2.80%	7.00%
Freddie Spread	4.00%	2.30%	2.10%	3.50%	5.20%
Special Affordable Housing	**1996**	**1997**	**1998**	**1999**	**2000**
Fannie	15.40%	17.00%	14.30%	17.60%	19.20%
Freddie	14.00%	15.20%	15.90%	17.20%	20.70%
Goals	12.00%	14.00%	14.00%	14.00%	14.00%
Fannie Spread	3.40%	3.00%	0.30%	3.60%	5.20%
Freddie Spread	2.00%	1.20%	1.90%	3.20%	6.70%

[31] (Federal Housing Finance Agency, 2010). Figures represent loans purchased and originally packaged by Fannie Mae and Freddie Mac.

Table 8 Affordable Housing Goals Performance 2001-2007[32]

Housing Goals							
Low-and Moderate Income	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Fannie	51.50%	51.80%	52.30%	53.40%	55.10%	56.90%	55.50%
Freddie	53.20%	50.30%	51.20%	51.60%	54.00%	55.90%	56.10%
Goals	50.00%	50.00%	50.00%	50.00%	52.00%	53.00%	55.00%
Fannie Spread	1.50%	1.80%	2.30%	3.40%	3.10%	3.90%	0.50%
Freddie Spread	3.20%	0.30%	1.20%	1.60%	2.00%	2.90%	1.10%
Underserved Areas	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Fannie	32.60%	32.80%	32.10%	33.50%	41.40%	43.60%	43.40%
Freddie	31.70%	31.00%	32.70%	32.30%	42.30%	42.70%	43.10%
Goals	31.00%	31.00%	31.00%	31.00%	37.00%	38.00%	38.00%
Fannie Spread	1.60%	1.80%	1.10%	2.50%	4.40%	5.60%	5.40%
Freddie Spread	0.70%	0.00%	1.70%	1.30%	5.30%	4.70%	5.10%
Special Affordable Housing	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Fannie	21.60%	21.40%	21.20%	23.60%	26.30%	27.80%	26.80%
Freddie	22.60%	20.50%	21.40%	22.70%	24.30%	26.40%	25.80%
Goals	20.00%	20.00%	20.00%	20.00%	22.00%	23.00%	25.00%
Fannie Spread	1.60%	1.40%	1.20%	3.60%	4.30%	4.80%	1.80%
Freddie Spread	2.60%	0.50%	1.40%	2.70%	2.30%	3.40%	0.80%

In the latter part of the 1990s when Congressional sentiment was positive, as seen by testimony from Congressmen Sabo (1998), Representative Kanjorski (2000), Congresswoman Jones (2000)[33], the GSEs were exceeding their housing goals at a higher margin than in 2001 and 2002. Representative Kanjorski is of specific note because his

[32] Ibid.

[33] This testimony is examined in detail in chapter 4.

preferences clearly changed in the latter half of the 2000s. This provides some evidence to suggest that the GSEs were in fact acting with Congressional influence in mind. To determine that this influence led to their increasing risk levels it is important to examine loans that were purchased to meet government housing goals.

Expanding home ownership opportunities in underserved areas and amongst low-income borrowers doesn't inherently mean that exposure to subprime or bad loans are increasing. Examining the LTV ratios of the GSEs shows increasing credit-risk exposure from 1999 to 2007 as the affordable housing goals created by HUD began to expand. This was summarized previously in table 5. A different picture is seen when examining the loans that were purchased in accordance with housing goals. Table 9 below shows that the volume of loans that meet one or more of the affordable housing and have LTV ratios greater than 90%. These values are summarized in total volume and as percentages of total mortgages purchased.

Table 9 LTV > 90% Meeting One or More Affordable Housing Goals[34]

	2000	2001	2002	2003
Fannie Mae	153994	231149	264317	330930
% of Total Loans	13.13%	16.58%	17.51%	19.10%
Freddie Mac	132448	156617	145193	120951
% of Total Loans	14.64%	15.29%	14.14%	14.82%
	2004	**2005**	**2006**	**2007**
Fannie Mae	242590	242212	312999	418488
% of Total Loans	16.16%	8.36%	11.53%	13.68%
Freddie Mac	100708	184743	153299	266430
% of Total Loans	11.18%	6.25%	6.37%	11.67%

[34] (Federal Housing Finance Agency, 2010)

As the chart shows, the total volume of loans meeting affordable housing goals that have higher LTV ratios was undoubtedly increasing. However, analyzing these as a percentage of total mortgage purchases shows that these loans were relatively small in comparison to their total business. Trend analysis shows that the riskier loans constituted a larger portion of the total purchased from 2000 to 2003. They began to decline as a percentage of total loan purchases from 2003 to 2005, and began to increase again slightly through 2007. This shows that during a time period when Congressional sentiment was largely negative from 2003 to 2005, as a percentage of their total business, the volume of riskier loans purchased in accordance with the affordable housing goals was actually declining.

It is interesting to see that the sharp decline in purchase of riskier loans in relation to the affordable housing goals coincided with the change in sentiment towards the GSEs. 2003 and 2004 marked a time period where Fannie and Freddie came under increased scrutiny for their accounting scandals and faced the prospect of increasing regulations. Assuming that Fannie and Freddie pursued increased credit risk to meet housing goals that would stave off regulation, the GSEs should show increasing LTV ratios during this time period; however, the data indicates otherwise. It appears that executives within Fannie and Freddie actually took measures to reduce their perceived risk as they feared stricter regulations while they continued to pursue the housing initiatives.

The decline in riskier loans that met affordable housing goals between 2003 and 2005 correlates with an increasing spread in meeting affordable housing goals. This contradicts the idea that pursuing government housing initiatives led to an increase in credit risk for the GSEs. The increase in MBS outstanding discussed earlier demonstrates that the credit risk that existed due to outstanding guarantees increases as the GSEs were purchasing and packaging more loans, which does conform to their pursuit of the government housing mission. There is no evidence available that shows that the quality of loans packaged became increasingly more risky in pursuit of the affordable housing goals. In fact, the decline in riskier loans measured by LTV ratios in pursuit of the housing mission between 2003 and 2005 largely shows that Fannie and Freddie were able to meet housing goals and increase the MBS outstanding without purchasing loans that had riskier LTV standards.

In addition to examining LTV ratios, chapter five provided some evidence regarding the increase in exposure to subprime loans for Fannie Mae and Freddie Mac from 2000 to 2007. Utilizing Alan Greenspan’s calculations, which presents the most liberal definition of subprime exposure discussed in the previous chapter, the subprime exposure of Fannie Mae and Freddie Mac increased dramatically from 2002 to 2005. After 2005 the firms began decreasing their subprime exposure slightly, although it still remained significant. The increase in exposure is correlated with the increase in affordable housing goal performance discussed within this chapter. Given the lax standards of reporting required by federal regulators, there is no definitive information that suggests that the increased subprime exposure of the GSEs during this time period was driven by their desire to meet affordable housing initiatives.

It is impossible to conclusively link the increasing subprime exposure detailed in chapter five to the affordable housing goals for many reasons. Loans that are designed to serve low-income and underserved areas cannot be automatically characterized as subprime, although there is some empirical evidence that supports this claim. A third party study done in 2000 showed that a much higher proportion of minority and lower income borrowers were served by subprime lenders than prime lenders. Similarly, the study found that subprime lenders were more likely to operate in urban underserved areas (Johnson et. al, 2002). These market trends provide speculative evidence that the subprime loans purchased by Fannie Mae and Freddie Mac did indeed target individuals that were served by the government's affordable housing goals. It must be noted that this study was done before the dramatic increase in subprime lending: a similar study done in 2006 after the explosion of the subprime market may have yielded different results. Mr. Parseghian commented that the affordable housing goals set by HUD were largely a headache for the GSEs, and that many of the markets in which the housing goals were set to serve were dominated by the subprime market. He also indicated that the GSEs would have been able to meet their affordable housing goals without over exposing themselves to riskier loans.

Despite existing speculative evidence regarding the subprime market, it is impossible to definitively show that the loans Fannie and Freddie purchased to meet housing goals were subprime. The difficulty in this matter is complicated by the lack of definition of subprime and the alleged falsified reporting of subprime exposure by the GSEs. The later complication and the lack of exactness in figures of subprime exposure by the GSEs available to regulators make it impossible to show a link that connects increasing subprime exposure directly with the housing goals. Although it is obvious that subprime exposure increased as Fannie and Freddie continued to pursue government housing initiatives, nothing suggests that the subprime loans were purchased for this purpose. Any conclusions of this nature would be presumptuous.

The lack of evidence linking government influence and government goals to the increasing risk levels of Fannie Mae and Freddie Mac show that an investigation into the role of government policy and influence on the increasing risk taking initiatives of the GSEs that led to their conservatorship fails to support the claim that government influence led to the demise of the GSEs. It is impossible to truly separate the risk taking initiatives of the GSEs from the government regulatory environment because hindsight suggests that had the enterprises been more closely watched and regulated it is possible that their increasing risk positions would have been mitigated to minimize a potential burden on taxpayers. Despite the apparent failure of the regulatory mechanisms used to maintain the safety and soundness of the GSEs the use of the OFHEO represents a Congressional usage of police patrol regulation over a bureaucratic organization. The increased attention paid to the GSEs after their accounting scandals also shows that fire alarm oversight was at times pursued. Overall, the lack of definition of the word subprime makes it truly difficult to evaluate just how risky Fannie and Freddie were becoming. The following chapter considers alternative explanations of why Fannie Mae and Freddie Mac began to operate in the subprime market and increase the risk levels of their businesses from the late 1900s through the early 2000s.

Chapter 7

One alternative explanation why Fannie Mae and Freddie Mac increased their risk appetites until they were placed under conservatorship is profit-seeking and compensation structures. This explanation is emphasized in the SEC complaints and comments from former Freddie Mac CEO, Gregory Parseghian. This explanation and others are presented within this chapter as more plausible explanations than government influence for the increasing risk taking initiatives associated with Fannie Mae and Freddie Mac that led to their conservatorship.

7.1. Market Share

In all annual report filings, public companies disclose risk factors that have the potential to materially affect their bottom line. In 2005, Fannie Mae discussed the growth of subprime mortgage market. Fannie Mae noted that because they operate outside of this market, the loss of market share could contribute to a smaller bottom line (FNMA 2005 Annual 10-K). These concerns were also relevant to Freddie Mac, since they operated largely in the same market, with similar constraints to subprime exposure. According to the SEC, by 2005 the combined market share of Fannie Mae and Freddie Mac had fallen to approximately 42% from highs of 60% (Freddie Mac SEC Complaint, 2011). The loss of market share by Fannie Mae and Freddie Mac was examined in further detail by the SEC.

The SEC Complaint filed against executives of Fannie Mae detailed that Fannie Mae's share of total mortgage loan originations fell from 40% in 2004 to 20% in 2005. In response to this, Fannie Mae pushed to increase its market share by increasing its exposure to reduced documentation loans, which increased year over year roughly 50% in 2004 and 40% in 2005 (Fannie Mae SEC Complaint, 2011). A similar allegation against Freddie Mac stated that between 2006 and 2007 Freddie Mac grew its exposure of subprime or subprime-like loans from 10 to 14 percent of their total portfolio to capture more market share.

In conversations with Mr. Parseghian, he indicated that Fannie Mae and Freddie Mac could have avoided the subprime market, or created risk constraints internally to limit their subprime exposure, but declined to do these things because it was largely unprofitable. The discussion into profits further explains why market share was so important to Fannie Mae and Freddie Mac's executives.

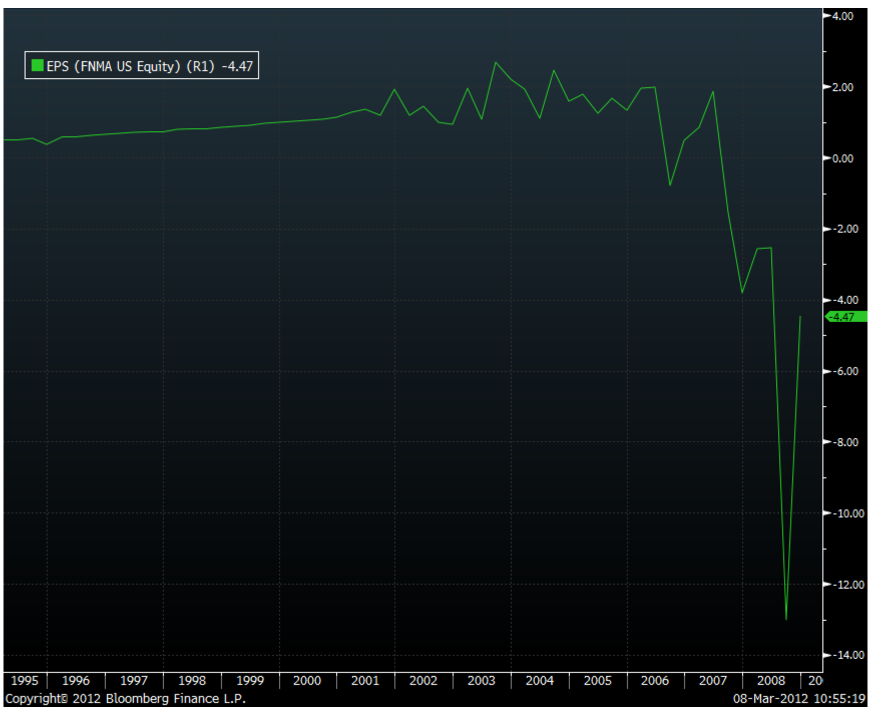
7.2 Market Share and Profits

Given the way Fannie Mae and Freddie Mac generate revenue, a decline in market share might lead to a decline in profits. If a decline in market share were to lead to decreased revenue the firm would suffer profitability. As publically traded companies, it is logical to assume that a decline in revenue translates through their income statement into a lower earnings-per-share (EPS) figure, which ultimately results in a lower stock price. This lower stock price is unfavorable to investors, and company executives who hold stock within their company. The value of Fannie Mae and Freddie Mac stock was largely important to shareholders, who would obviously not like to see the value of their investments depreciate in value. In addition to wanting to please shareholders, the executives at Fannie Mae and Freddie Mac were invariably tied to their earnings performance through their compensation structure, which provided personal incentive to take risks to avoid market share losses.

7.3 Compensation Structure

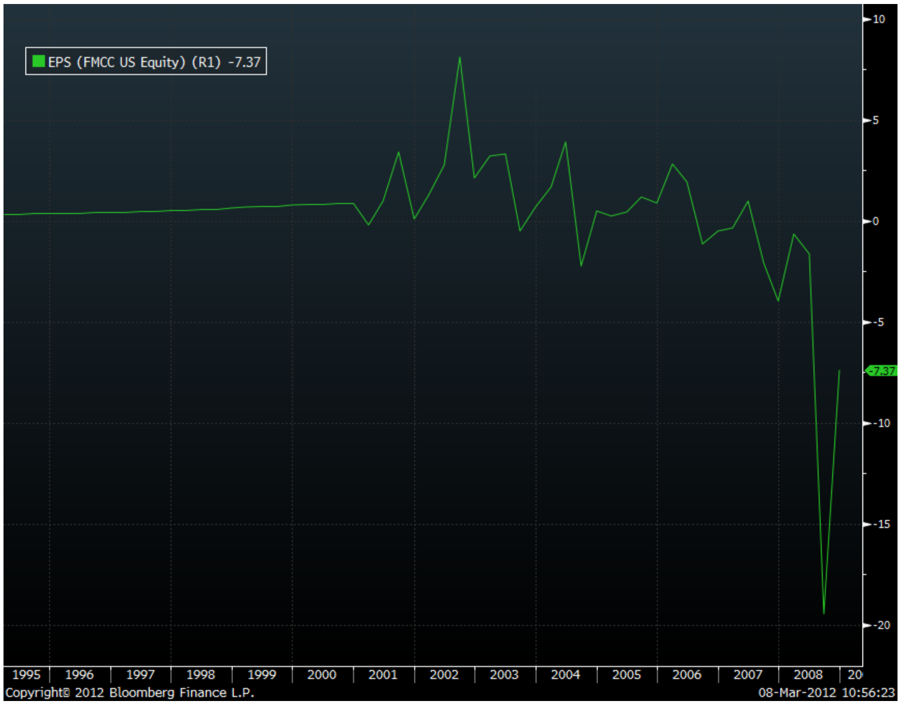
The compensation structure for the executives of Fannie Mae and Freddie Mac are largely similar to those of executives at Wall Street banks. Executive compensation plans at the GSEs are composed of a large stock and earnings based component. There is also a component, although significantly smaller, that links executive compensation to affordable housing goals (Emmons and Sierra, 2004). This means that the compensation of executives at the GSEs was tied to the GSE's performance that was evaluated by the stock price and the earnings produced. Figure 10 on the following page shows the earnings per share of Fannie Mae from 1995 to 2008. Figure 11 on page 98 provides a similar chart for Freddie Mac. The charts show that the EPS figures of the GSEs began becoming more volatile and showing declines around the same time that the SEC alleged the two began to increase subprime exposure. This volatility seemed to increase around 2003, which is when the Greenspan data shows the GSEs began to increase their exposure to the subprime market. As EPS began to shrink, executives at Fannie and Freddie began to take back market share through increasing their exposure to the subprime market to return their EPS to where it had been in the early 2000's. This is likely related to the financial gain realized by the executives for increasing EPS. Simply put, executives at Fannie Mae and Freddie Mac had monetary incentives to increase their market share and produce higher profits. They were able to realize short-term gain by taking long term risks. This information, when taken with the allegations by the SEC, provides much more evidence for why the GSEs would choose to engage in riskier practices through the early 2000's.

Figure 10 Fannie Mae EPS 1995-2008[35]



[35] Taken from Bloomberg Financial Terminal.

Figure 11 Freddie Mac EPS 1995-2008[36]



7.4 Government Impact and Alternative Explanations

Given that this paper largely investigates the role of government in the eventual failure of the GSEs, it is important to note that in the 1992 legislation that drastically changed the oversight of the GSEs, Congress mandated “pay for performance” as a substantial component of the GSEs total executive compensation (Emmons and Sierra, 2004). This shows that, although the government may have not directly influenced Fannie and Freddie to engage in riskier practices, they created the policy that encouraged executives to take on risk. It is difficult to truly blame Congress for this because it is impossible to fathom they could have imagined the problems that this would cause 15 years later. In addition to the profit seeking initiatives of the executives of Fannie Mae

[36] Ibid.

and Freddie Mac there are a few other alternative explanations that are beyond the scope of this study that also may address why Fannie Mae and Freddie mac began to operate in a riskier market. It is possible that the reason these two institutions failed is because of inadequate regulation by the United States government. Perhaps regulation was unable to fully tackle all of the problems and risks associated with the GSEs because throughout the late 1900s and 2000s financial innovation largely outpaced the knowledge of the regulators charged with maintaining safety and soundness, leaving the regulators ill prepared to minimize the problems associated with the changes in the complexity of the financial and mortgage markets. It is also possible that the GSEs were adequately regulated and capitalized, but were unable to meet their obligations in 2008 because the collapse of the housing bubble and failure of the subprime and financial markets was an unforeseeable event of historic nature, similar to a Great Flood. Any definitive conclusions surrounding these explanations are outside the scope of this paper, but investigation into them would serve to further advance the discourse surrounding the failure of Fannie Mae and Freddie Mac.

Conclusion

The data within this thesis suggests that government influence on Fannie Mae and Freddie Mac did not play a substantial role in the increased risk taking initiatives of the corporations that led to their conservatorship. This study suggests that although the regulatory tools used by Congress may have been inadequate, this inadequacy is largely related to a lack of understanding of the financial risk of both GSEs. Bureaucratic theory suggests that one of the reasons Congress utilizes bureaucracies is because Congress does not possess the tools or knowledge to fully regulate all facets of industry. In the era preceding the financial meltdown, financial innovation largely outpaced the abilities of even the regulatory bodies to adequately assess and control risk. In the future, the failures of Fannie Mae and Freddie Mac and the consequences for the American taxpayer need to be considered when evaluating the future of the housing GSEs, as well as any other government-sponsored enterprise that may operate in private markets while possessing a government mission.

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Appendix

Glossary of Terms

Alternative A-Paper (Alt-A) – United States mortgage that is considered riskier than a prime mortgage but not amongst the riskiest mortgages originated. The loans are generally characterized by less than full documentation, higher loan-to-value ratios, and lower credit scores than loans made to prime borrower.

Bureaucracy – organization of non-elected officials of a government or organization who implement the rules, laws, and functions of their institution.

Conservatorship – occurs when an entity set up by the government or a court order takes over an organization that can no function on its own due to legal or financial distress.

Department of Housing and Urban Development (HUD) – developed in 1965 by Congressional legislation HUD was largely in charge of promoting the government's housing mission by creating affordable housing goals for Fannie Mae and Freddie Mac beginning in 1992.

Extended Approval (EA) – Loans developed through an internal program at Fannie Mae that is designed to expand business to customers who would otherwise not qualify for them. This program provides fixed rates for customers with a history of credit problems. These loans are generally characterized by Fannie Mae as "higher risk."

Federal Home Loan Mortgage Corporation (FMCC) – Commonly known as Freddie Mac, FMCC was created in 1970 to expand the secondary market for mortgages by serving in a similar role as the government-sponsored enterprise, Fannie Mae. Intentionally designed to provide thrift institutions with more liquidity Freddie Mac developed into a competitor to Fannie Mae by providing liquidity within the mortgage market by purchasing, securitizing, and re-selling mortgages that meet certain criteria.

Federal Housing Administration (FHA) – United States government agency created as a part of the National Housing Act of 1934 with the intention of insuring loans made by banks and other private lenders. Became part of the Department of Housing and Urban Development in 1965.

Federal National Mortgage Association (FNMA) – Commonly known as Fannie Mae, FNMA as founded in 1938 and is a government-sponsored enterprise that is largely responsible for facilitating liquidity within the mortgage market by purchasing, securitizing, and re-selling loans that meet certain criteria.

Government-Sponsored Enterprise (GSE) – a financial services corporation created by the United States Congress with the purpose of enhancing the flow of credit into a targeted sector of the economy.

Loan-to-Value (LTV) – Ratio used to gauge the risk of a mortgage. Defined as the loan value divided by the value of the underlying property. Higher LTV ratios are viewed as more risky.

Mortgage-Backed Security (MBS) – an asset backed security that is composed of a collection of mortgages. The holder receives a stream of payments, similar to a bond, that is a result of the timely mortgage payments of the borrowers whose loans are underlying the asset.

Office of Federal Housing Enterprise Oversight (OFHEO) – created by 1992 legislation, OFHEO is a department within HUD that was in charge of ensuring the capital adequacy of the GSEs.

Securitization – financial practice of pooling various types of contractual debts and selling the consolidated debts as bonds or other types of financial securities.

Subprime mortgage – Refers to a mortgage origination with inherent more risk due to documentation standards, loan-to-value ratios, property value, or credit score. Subprime loans are defined differently by different institutions making characterizing subprime exposure of institutions difficult.