Bob Faaborg **A True Story:**

Brian drove up the driveway to his house with tears in his eyes. He knew this would be the last time he would see it before tomorrow's foreclosure. He and his wife had purchased it for $650000 five years ago primarily because it had enough acreage for their dogs and horses. They thought they could afford the house because his wife's real estate income and his salary as a police officer totaled over $170,000 a year - plus they had saved enough for a down payment of 20%. But by 2011 house prices in Arizona were tumbling. His wife's real estate income disappeared. Worse, partly because of their financial worries, they had divorced. He now owed more than the market value of the house and he couldn't make the mortgage payments on his salary alone. He had given away their horses but managed to find an apartment that would accept his dogs. Tears fell again as he picked up his phone to tell his daughter that he would be unable to continue helping her with her college expenses.

What happened to Brian captures the devastating effect of the housing crisis far better than a series of statistics. But that's not to say that the statistics aren't devastating as well. Nationally, home prices peaked in May of 2006 then tumbled 40% by May of 2009. More than one-half of the real estate wealth of American households was gone. Nearly six million houses were lost to foreclosure and other related actions. The American dream had become an American nightmare. And Fannie Mae was at the core of the meltdown.

Bill has just described the history of Fannie Mae from its creation up to 1990. I'll now continue its history arguing that, while in the beginning Fannie was a relatively benign, small organization, it eventually metastasized into a cancerous, ravenous too-big-to-fail financial monster. Or, as an infamous Cincinnatian might put it: Fannie Mae was good <u>in the beginning</u>. By September 2008, seventy years after its creation by Congress, Fannie Mae had to be bailed out by the government and put into a conservatorship where it remains to this day.

I believe a principal reason for Fannie's failure rests on its intrinsically contrary dual mandate. On the one hand, as a private financial institution, Fannie had a fiduciary duty to its shareholders to maximize its profits. Yet, Fannie also had been given a public mission to support and help finance home ownership for Americans. This public mission was made explicit and more specific in a congressional housing act passed in 1992. Among the public goals specified in this act, Fannie Mae was given target percentages to support mortgages for low and moderate-income families and to increase the affordability for housing for underserved areas such as innercity, minority and immigrant households. President Clinton in 1999 further increased the affordable housing financing targets requiring Fannie to make 50% of new mortgages "affordable". Thus, Clinton could say that he helped create 28 million homeowners without asking Congress to appropriate a single dollar since Fannie Mae was conveniently off budget due to its alleged private status.

Note that while Democrats have generally supported Fannie Mae much more than Republicans, on nearly all important votes, politicians from both parties have rallied behind it. President George W. Bush even made Fannie a significant part of what he called the "ownership society."

Some claim that this bipartisan affordable housing policy is the primary cause of the financial housing crisis and Fannie's demise. They argue that financial institutions made housing affordable by lowering underwriting credit standards for obtaining a mortgage. And this is exactly what happened. However, Fannie's role in the housing collapse involves much more than its affordability mission. Once it was privatized under President Johnson, Fannie Mae's managers had a fiduciary duty to maximize shareholders profits. And boy did they deliver profits both to their shareholders and to themselves. From 1995 to 1999 Fannie's average return on equity, a measure of profitability, was 24% compared to about 15% for large private banks. Of course, this growth meant Fannie had to vastly increase the number of mortgages they owned or guaranteed. By 2000 Fannie Mae and Freddie Mac had $1.4 trillion worth of debt, an amount approximately equal to the total debt of every one of America's state and local governments.

By the mid-nineties, Fannie and Freddie owned or guaranteed about one-half of all home mortgages in the United States. Many believe that this astounding growth and ever increasing market share was primarily due to the widespread belief that as government sponsored entities, they had the backing of the government. As Fed Chairman Alan Greenspan put it, investors had "concluded that the government will not allow [them] to default." This perceived government backing allowed Fannie and Freddie to borrow at low interest rates that were not available to even the highest-rated banks and to essentially borrow without limit. This made the financial mortgage market anything but a level playing field.

And Fannie and Freddie had other market advantages. Their regulators gave them much lower capital requirements than those required of private banks. This higher degree of leverage led to even higher rates of profits. Of course, this degree of leverage also resulted in a much higher degree of risk, but if Uncle Sam has your back, who cares.

These advantages and more meant that Fannie and Freddie gradually captured most of the traditional mortgage market. By October of 2007 over 70% of U.S. mortgage securities sold to investors were guaranteed by either Fannie or Freddie.

With their market rapidly disappearing, private lenders increasingly turned to markets that regulators asked Fannie and Freddie to avoid, especially lending to risky borrowers. Nonprime mortgages increased from 14% in 2000 to 50% of originations by 2006. Adjustable rate mortgages increased to 45% of all mortgages. As competition increased for the remaining potential market share, mortgage-underwriting standards slipped further and further. Some lenders required little or no down payment. Worse, others allowed borrowers to take out a second loan to cover fees and the down payment. Credit histories were ignored or overlooked. Previous policies of requiring borrowers to document their income were dropped in so called "low-doc" or "no-doc" loans. Interest-only loans required only the interest on the loan to be paid. Worse yet, some lenders allowed payments of less than the interest due shifting the shortfall to the principal owed on the house.

Having exhausted much of its traditional housing market, even Fannie Mae began to compete in the riskier nonprime or even sub-prime markets by lowering its own underwriting standards. Fannie at times reduced the required down payment to less than 5% and began to lend to individuals with a history of delinquencies. It followed the private market by offering "low doc" loans. As a result, Fannie and Freddie captured 30% of the nonprime loan market.

Fannie and Freddie's growth was greatly aided and abetted by Wall Street. Along with large private banks and investment houses, they would pool a bundle of mortgages together and sell securities backed by these mortgages to investors. The assumption was that housing prices are stable and generally increase over time. Thus, by purchasing a security backed by a large bundle of mortgages, investors supposedly would be avoiding most risk. The large rating agencies such as Standard and Poors encouraged these assumptions by giving these so-called mortgage-backed securities their highest ratings. The demand for such securities was enormous especially since those sold by Fannie and Freddie were guaranteed by them. At one time, mortgage-backed securities represented the largest fixed income market in the world. Unfortunately, this demand and the enormous profits generated by this market further aided the downward spiral in underwriting standards. There just weren't enough eligible homeowners to fill the ever increasingly supply of loans.

Fannie Mae's incredible growth in the last two decades not only fed the pockets of Fannie's shareholders but also made her managers extremely wealthy since much of their compensation was tied to the value of Fannie's stock. In the nine years during which Jim Johnson served as Fannie's CEO, he took home over $100 million. Franklin Raines, his successor from 1998-2003, collected total compensation of over $90 million. Unfortunately for Raines, his desire to maximize Fannie's stock price led him to oversee fraudulent accounting practices in order to show consistent high profit growth. He and other top executives were eventually fired.

Nonetheless, all of these factors led to astounding growth for Fannie Mae amidst an historic bubble in the housing market. From 1995 to 2006 house prices tripled. Household mortgage debt increased from 50% of GDP in 1996 to nearly 90% of GDP by 2006.

The increasing volume of subprime loans and the decline in mortgage underwriting standards inevitably precipitated one of the greatest collapses in the housing industry since the Great Depression. Because of falling house prices and overleveraged households, by 2008 twelve million households, nearly one in six, owed more on their mortgages then their house was worth.

They and much of the mortgage financial industry were heavily overleveraged. And as Warren Buffet describes being overleveraged in a declining market, "You don't knows who's swimming naked until the tide goes out." Fannie and Freddie were clearly swimming naked. However, until house prices started falling, their inherently problematic business model and credit risk were hidden.

Fannie and Freddie and private financial institutions holding mortgage debt or mortgage-backed securities began to suffer catastrophic losses. In order to avoid a total collapse in the housing market, on September 7, 2008 the U.S. government took the unprecedented step of placing Fannie and Freddie totally under their control. The U.S. Treasury and the Federal Reserve invested massively in both Fannie and Freddie placing them under a government conservatorship.

Note that Fannie Mae wasn't put into a receivership or allowed to declare bankruptcy. Instead the U.S. Treasury took control of the company, purchasing 79.9% of its outstanding common stock. Why not take ownership of the entire company? Because of an arcane accounting rule any ownership less than 80% allowed the government to keep Fannie's massive debt off the government's balance sheet. Fannie's shares fell to pennies on the dollar but its debt was fully protected. Believing that the capital reserves of both Fannie and Freddie were insufficient to cover their losses from mortgage defaults, the Treasury purchased a chunk of their debt and their mortgage-backed securities. Not to be outdone by the Treasury, the Federal Reserve bought an additional $1.25 trillion in Fannie and Freddie mortgage-backed securities plus additional amounts of their debt. These two Federal Reserve purchases resulted in an unprecedented doubling of the Fed's balance sheet.

Why such a massive taxpayer bailout? If the U.S. allowed Fannie and Freddie to default on their debts, given their implied backing by the U.S. government, the world might lose faith in the government's willingness and ability to repay its debts including trillions of dollars in U.S. treasuries. The world's biggest debtor just couldn't afford to lose its creditors' faith.

Bob Faaborg The "Con" Position

Why I believe Fannie Mae should be gradually phased out

Many wish to keep Fannie Mae though with important changes in policy. Unfortunately, I believe that Fannie has intrinsic features that are at the very least problematic and possibly make it inherently unsustainable.

First among these characteristics was Fannie's quasi-governmental status. Crucially, Fannie's debt was believed, accurately as it turned out, to be backed by the U.S. government. This results in multiple serious problems. It gives Fannie an unfair market advantage since the implied government guarantee lowers its costs. This becomes even worse during periods when the mortgage market is viewed as risky since investors flee to the perceived safer debt of Fannie Mae. Fannie also profited from a line of credit with the U.S. Treasury. Even more, unlike private financial institutions, it was exempt from state and local taxes and did not have to report to the SEC.

These advantages along with many other government subsidies for housing such as the tax deduction for mortgage interest led to dislocations in the housing market and overinvesting in housing. Moreover, given their perceived safety, government guarantees also eliminate investor concerns over the quality of loans.

Some argue that Fannie's problems can be fixed by additional regulation and higher capital requirements. First, this ignores the issue of whether such regulation is at all politically likely. Moreover, any regulations that result in Fannie's debt being perceived as safer will only exacerbate its market advantage.

I'm also becoming convinced that given the immense strength of the housing, industrial, financial complex, it is highly unlikely that the necessary regulations will ever be legislated or enforced. The history of Fannie is a history of political cronyism and regulatory failure. In part this was due to the political revolving door between government and Fannie's management as well as because of Fannie's highly effective lobbying campaigns and political influence. Fannie spent millions annually on lobbyists even exceeding the lobbying expenses of the nation's largest banks. At one time it employed 23 DC lobbying firms.

Using a brilliant political strategy, Fannie set up 50 regional partnerships throughout the country. Whenever the company supported a housing project in a Congressman's district, it made sure that a representative from Fannie Mae appeared at press conferences congratulating him or her on bringing affordable housing to their constituents. Fannie bought additional influence directly through its political contributions.

Fannie Mae even set up a charitable foundation that Fannie used to further its political influence. For example, it donated funds to a charity founded by the mother of one of Fannie's strongest supporters, Representative Barney Frank of Massachusetts. Frank and Maxine Waters of California were two of the most ardent supporters of the affordability mandate. Together they helped prevent Fannie's weak regulator from increasing its capital reserve requirements. And like countless other politicians, they received substantial campaign contributions from Fannie. Incidentally, Barney had other ties to Fannie. Guess who hired Barney's partner, Herb Moses, as an executive - none other than Fannie Mae.

The Fannie Mae Foundation even began paying for advertising lauding Fannie Mae's contribution to affordable housing. The Foundation went so far as to pay for ads in the 1996 presidential primaries attacking Steve Forbes' platform favoring a flat tax that would remove the mortgage interest deduction. Think of it. A government sponsored agency using its funds in a presidential campaign.

Even though Fannie had its critics and there were attempts by the Bush administration and some in Congress to limit its growth, these efforts were largely frustrated. The regulatory agency set up in 1992 was placed in Housing and Urban Development and had none of the stricter capital and other requirements of banking regulators. Worse, the agency that regulated Fannie was not empowered to regulate its capital holdings and had to have its budget approved by Congress annually. Fannie's regulator even had to ask Congress to approve any change in policy. This meant Fannie's friends in Congress could effectively control it.

And boy did Fannie have friends and connections though I only have time to mention a few of these. The list includes countless politicians from both parties including congressmen and others who benefited from campaign contributions and even received low cost loans from Fannie's principal client, Countrywide. Among those receiving cut-rate mortgages were Chris Dodd, Barbara Boxer and Donna Shalala. Two of Fannie's CEO's, Jim Johnson and Franklin Raines were prominent in Democratic politics before and after serving for Fannie. Raines had spent two years on the Clinton campaign. After he resigned from Fannie, Johnson became an advisor to both the Kerry and Obama presidential campaigns. Believe it or not, Franklin's full name is Franklin Delano Raines.

Trying not to appear overly influenced by Democrats, Fannie made sure to involve notable Republicans such as Newt Ginrich and Jim Buckley, Bill's brother. They hired Kenneth Duberstein, President Reagan's chief of staff, as a lobbyist.

Probably the most egregious example of influence peddling and the revolving door involved Jim Johnson. In 1999 after stepping down from Fannie, Goldman Sachs named Johnson to its board of directors and appointed him chair of their compensation committee. Guess whose compensation Johnson helped determine? The CEO of Goldman, Hank

Paulsen, the very man who as Secretary of the Treasury would oversee the bailout of Fannie Mae.

Fannie Mae had become a political powerhouse. It had in effect emasculated its regulatory agency becoming a prime example of what's called regulatory capture. Even the recent Dodd-Frank bill has no explicit provisions involving Fannie Mae except for calling for a study of the company. Dodd-Frank even exempts it from many rules that apply to private banks including the Volcker Rule limiting speculative investing. But that shouldn't surprise you given that both Dodd and Frank counted themselves as friends of Fannie. Fannie and Freddie may sound like the name of a vaudeville comedy act, but the laugh is on us, the American taxpayer.

My skepticism about the possibility of successful governmental regulation of Fannie Mae rests on its history. The housing industry and its allies are just too powerful. Eventually Fannie or its replacement will return to political cronyism, the revolving door and regulatory capture.

Some argue that quasi-governmental institutions like Fannie and Freddie are necessary for a viable housing market. Yet, only two other developed nations, Japan and Canada, have anything similar to these institutions. Moreover, their Fannie's are much smaller than ours (Pun intended.) And neither country operates under an affordability mandate. It's important to point out that no other nation even remotely lavishes the excessive government subsidies and generous tax policies on their housing and mortgage industries. Yet, many other countries have similar rates of home ownership and even similar affordability levels. In fact, the U.S. ranks seventeenth in home ownership.

In the last few decades some foreign banks began to securitize bundles of mortgages and sell them to third parties, but no country approaches even one-half of our level of securitization. Continental Europe also differs from our practices by generally continuing to require a down payment of 20%. As a result mortgage debt in the EU averages 50% of GDP while in the U.S. such debt tops 90% of GDP. The almost complete collapse of private sector mortgage lending was unique to the United States.

It is true that some banks in Europe had to be bailed out especially in Germany. But I find it fascinating that these German bailouts led the EU to ban all governmental guarantees of banks on the grounds that such guarantees grossly interfere with free markets. And I thought it was Europe that was the Socialist.

In closing, let me thank Bill Sena for graciously agreeing to participate in this budget with a financial neophyte. When Bill suggested the topic I really hadn't developed any views about Fannie Mae and I must admit I am a bit surprised with the positions I've taken. But, I assure you, they rest on my political and economic principles, and, as Groucho Marx said, "Those are my principles and if you don't like them, I have others."

Thank you.