U.S. House of Representatives

Committee on Oversight and Government Reform

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The Role of Government Affordable Housing Policy in Creating the Global Financial Crisis of 2008

STAFF REPORT
U.S. HOUSE OF REPRESENTATIVES
111TH CONGRESS
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
JULY 7, 2009

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INTRODUCTION

The housing bubble that burst in 2007 and led to a financial crisis can be traced back to federal government intervention in the U.S. housing market intended to help provide homeownership opportunities for more Americans. This intervention began with two government-backed corporations, Fannie Mae and Freddie Mac, which privatized their profits but socialized their risks, creating powerful incentives for them to act recklessly and exposing taxpayers to tremendous losses. Government intervention also created "affordable" but dangerous lending policies which encouraged lower down payments, looser underwriting standards and higher leverage. Finally, government intervention created a nexus of vested interests – politicians, lenders and lobbyists – who profited from the "affordable" housing market and acted to kill reforms. In the short run, this government intervention was successful in its stated goal – raising the national homeownership rate. However, the ultimate effect was to create a mortgage tsunami that wrought devastation on the American people and economy. While government intervention was not the sole cause of the financial crisis, its role was significant and has received too little attention.

In recent months it has been impossible to watch a television news program without seeing a Member of Congress or an Administration official put forward a new recovery proposal or engage in the public flogging of a financial company official whose poor decisions, and perhaps greed, resulted in huge losses and great suffering. Ironically, some of these same Washington officials were, all too recently, advocates of the very mortgage lending policies that led to economic turmoil. In a number of cases, political officials even engaged in unethical conduct, helping their political allies, family members and even themselves obtain lucrative positions in the mortgage lending industry and other benefits. At a time when government intervention in private markets has become alarmingly common, government "affordable housing" initiatives offer important lessons about the dangers of government efforts to manipulate or conjure outcomes in the market.

EARLY HISTORY OF FANNIE MAE AND FREDDIE MAC

Prior to the creation of Fannie Mae, there was no national mortgage market in the United States. Instead, the mortgage industry was concentrated primarily in urban banking centers, making affordable home financing difficult to come by for many rural residents. The widespread banking failures of the Great Depression exacerbated this problem. In response, Congress passed the National Housing Act of 1934, creating the Federal National Mortgage Association, or Fannie Mae, as a purely governmental agency. Fannie Mae purchased home loans from mortgage lenders and financed these purchases by issuing government bonds. Fannie, and its congressionally-chartered competitor Freddie Mac, removed the burden of these liabilities from bank balance sheets, freeing up capital that otherwise would have been tied down to protect the banks from the risk of loan default. As policymakers intended, this service increased the amount of money local banks could lend to homebuyers – it increased the liquidity of the mortgage market.

In 1968, President Lyndon Johnson, facing mounting budget deficits and criticism over American involvement in Vietnam, contrived a scheme to reduce government debt by privatizing Fannie Mae. Enacted as part of the Housing and Urban Development Act of 1968, this maneuver amounted to an accounting sleight-of-hand that removed Fannie Mae's large liabilities from the Federal balance sheet in a single stroke. In reality, however, the markets never truly believed that the newly-designated government-sponsored enterprise ("GSE") was in fact a private company.

Fannie and Freddie: Why They Dominated the Mortgage Market

Fannie Mae's and Freddie Mac's dominance in the secondary mortgage market was made possible by numerous competitive advantages stemming from their unique relationship with the federal government. These advantages for the two GSEs were justified by the government as an implicit subsidy to American homeowners in the form of reduced mortgage rates. With the help of these subsidies, Fannie and Freddie were able to squeeze out their competition and corner the secondary mortgage market. At their height, they controlled over three-quarters of the secondary market for prime mortgages in the United States. Wall Street and others were left with the nonprime, non-conforming market, mainly risky subprime and Alt-A loans.[1]

Their chief advantage began with their government sponsored mission: Fannie and Freddie were charged by Congress with keeping the secondary mortgage market liquid and increasing the availability of affordable housing. They enjoyed a $2.25 billion line of credit from the U.S. Treasury. Because of this mission and their special connection to the Federal government, the market viewed them as extensions of the U.S. government and therefore "too big to fail." No other private companies could borrow money at such an affordable rate. Private debt markets were willing to lend the GSEs money at an interest rate not much greater than the "risk-free" rate they charged the U.S. government itself.

As a business model, Fannie and Freddie would sell bonds in the debt markets at a relatively low cost and use the borrowed money to turn around and purchase mortgages from primary lenders like Countrywide Financial that dealt directly with customers seeking home loans. Oftentimes, they would then bundle many of these mortgages into securities and either sell them to investors, who paid Fannie and Freddie a fee to guarantee payment in the event the mortgages defaulted. The GSEs could also hold the securities in their own portfolios, making profits off the difference between their low cost of debt and the higher rates borrowers paid on their mortgages.

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[1] Federal bank regulators have defined subprime borrowers as those with multiple recent mortgage delinquencies, foreclosures or bankruptcies, a high probability of default as indicated by a credit score below 660, and/or a debt service-to-income ratio of 50 percent or greater. *See* http://www.federalreserve.gov/Boarddocs/SRletters/2001/sr0104a1.pdf. Investopedia.com defines Alt-A mortgages as "types of loans [that] are attractive to lenders because the rates are higher than rates on prime classified mortgages, but they are still backed by borrowers with stronger credit ratings than subprime borrowers. However, with the higher rates comes additional risk for lenders because there is a lack of documentation - including limited proof of the borrower's income."

Another advantage Fannie and Freddie enjoyed was that Congress, by statute, allowed them to operate with much lower capital requirements than their private sector competitors. Federally-regulated banks are required to hold 4 percent capital against their mortgages. By federal law, however, Fannie Mae and Freddie Mac were only required to hold 2.5 percent capital against their on-balance sheet mortgages, and only 0.45 percent against mortgages they guaranteed.[2] According to one witness who testified before the Committee on the role of the GSEs in the financial crisis, "the capital requirements were an anomaly that artificially restrained depository institutions from competing effectively with the GSEs."[3] Much like the borrowers who took advantage of government efforts to lower down payments on mortgages, low capital requirements allowed Fannie Mae and Freddie Mac to use huge amounts of leverage. During hearings on the collapse of Wall Street investment bank Lehman Brothers, Members of the Committee were outraged to learn that Lehman Brothers was leveraged at a ratio in excess of 30-to-1. However, Fannie and Freddie used their congressionally-granted advantages to leverage themselves in excess of 70-to-1, and even did so in an undiversified market – housing. Furthermore, because their abnormally low capital requirements were set by U.S. law, the GSEs' weak regulator, the Office of Federal Housing Enterprise Oversight ("OFHEO") that was supposed to regulate the safety and soundness of the companies, could not raise the GSEs' capital requirements or limit their borrowing to address their overleveraging without congressional action. This exposed the GSEs and – ultimately, the taxpayers – to tremendous latent risks in the event of a housing market collapse.

Fannie Mae and Freddie Mac were also allowed to sell debt to banks in the guise of "preferred shares," and the government even encouraged banks to hold this debt, which exposed them to catastrophic consequences in the event of a GSE collapse. Only about 50 percent of the capital the GSEs held consisted of equity raised from the sale of common stock and retained earnings. The other 50 percent was raised through the sale of preferred stock to banks at below-market rates.[4] Fannie and Freddie were able to do this because federal bank regulators allowed federally-regulated national banks to apply a risk-weighting of just 20 percent against GSE preferred stock.[5] This stands in stark contrast to their holdings of other preferred stock, which required risk weighting of 100 percent. In other words, the federal government encouraged regulated banks to purchase GSE preferred stock by allowing them to hold 80 percent less capital against it compared to similar assets, providing a major subsidy to their purchase of what amounted to cheap borrowing by Fannie and Freddie.

Fannie Mae and Freddie Mac were also exempt from key regulatory and market oversight. For example, their congressional charters exempted them from oversight by

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[2] *See* P.L. 102-550, Sec. 1362.
[3] See Arnold Kling, testimony before the House Oversight and Government Reform Committee, (December 9, 2008).
[4] *See* Edward Pinto, testimony before the House Oversight and Government Reform Committee, (December 9, 2008).
[5] *See* Office of the Comptroller of the Currency, Interpretive Letter #964, (May 2003), *accessed at* http://www.occ.treas.gov/interp/may03/int964.pdf.

the Securities and Exchange Commission ("SEC"): the GSEs are the only publicly-traded corporations exempt from SEC oversight. It was not until scandals in 2003 and 2004 revealed that the companies had used non-approved accounting practices to manipulate earnings that they agreed to "voluntary" SEC filings. The GSEs were also exempt from market oversight of the quality of their mortgage-backed security issuances. The GSEs packaged much of their $5 trillion in mortgages into mortgage-backed securities. These securities were sold to investors, who received the interest and principal payments associated with the underlying mortgages much like a bond. Fannie and Freddie also guaranteed investors that they would take the loss if the security went bust due to defaults among the underlying mortgages. Mortgage securitization is a useful financial tool that can be used to increase liquidity and spread risk. However, as with most tools, securitization can become dangerous when not used with the proper safety precautions.

One critical safety precaution is a credit rating derived from a risk analysis of the mortgages that underlie a mortgage-backed security. During the Committee's investigation of the root causes of the financial crisis, it became evident that the so-called "Big Three" credit rating agencies had become hopelessly compromised, issuing top-line "AAA" ratings on the mortgage-backed securities and collateralized debt obligations of many Wall Street firms.[6] However, Fannie Mae and Freddie Mac securities were exempt from even this flawed process. Instead, all GSE securities carry an implicit "AAA" rating because of the federal government's backing. As the quality of the mortgages the GSEs were willing to buy declined, this exemption became increasingly dangerous to taxpayers.

These competitive advantages and exemptions from regulatory oversight allowed Fannie Mae and Freddie Mac to muscle out their competition and grow to dominate over three-quarters of the secondary market for prime mortgages in the United States. The GSEs entered the 1990s as financial giants that, by most accounts, had successfully helped usher in affordable housing opportunities for Americans while practicing sound lending principles: a requirement for a substantial down payment and reasonable assurances that a borrower could repay a home mortgage.

THE POLITICIZATION OF MORTGAGE LENDING

As publicly traded corporations, the GSEs faced the obligation of all corporations – to maximize the value of shareholders' equity. This meant seeking out profitable opportunities to invest in housing and, to the maximum extent possible, pushing the envelope of innovation in mortgage finance to compete for market share. However, unlike any other publicly traded corporation, Fannie Mae and Freddie Mac also answered in a very direct way to the federal government and elected officials in a manner reminiscent of the "crony capitalism" of countries such as Russia or China, which preserve a large state-owned enterprise sector. Fannie and Freddie answered to the Department of Housing and Urban Development ("HUD"), which set quotas for GSE investment in affordable housing, as well as to Congress and the White House, which

[6] The "Big Three" are Moody's Investors Service, Standard & Poor's, and Fitch Ratings.

sought to use them as vehicles to advance the politically popular goal of increasing the national homeownership rate. This was done directly through legislation and regulation which mandated affordable housing lending and indirectly through political pressure from politicians and advocacy groups. This created incentives for Fannie and Freddie to curry political favor with Congress and necessitated a massive lobbying effort which GSE executives termed "political risk management." As the New York Times summarized it:

> Fannie Mae, the nation's biggest underwriter of home mortgages, has been under increasing pressure from the Clinton Administration to expand mortgage loans among low and moderate income people and felt pressure from stock holders to maintain its phenomenal growth in profits.[7]

In the early 1990s, Fannie and Freddie began to come under considerable pressure to lower their underwriting standards, particularly on the size of down payments and the credit quality of borrowers. A deeply flawed 1992 study published by the Federal Reserve Bank of Boston, purporting that minorities faced discrimination in mortgage lending, was particularly influential at the time. This study has since been shown to have been based on inaccurate data, including loans which were supposedly made to borrowers with a negative net worth. When researchers ran the models again after correcting the flawed data, the discrimination that had been the study's central finding disappeared.[8] Yet the damage had been done and Congress seized on the study as part of a major legislative reorganization of the GSEs' function.

In 1992, Congress passed the Federal Housing Enterprises Financial Safety and Soundness Act, which created an "affordable housing mission" for Fannie Mae and Freddie Mac. This legislation directed HUD to establish three separate quotas requiring the GSEs to set aside a certain percentage of their yearly mortgage purchases to loans with affordable characteristics. These quotas were expressed as the minimum share of mortgages that Fannie and Freddie purchased every year which had to be made to "low- and moderate-income families … low-income families in low-income areas and very low-income families," as well as borrowers in "central cities, rural areas, and other underserved areas."[9] Congress granted HUD the authority to adjust these three affordable housing quotas for the GSEs over time, allowing both Democratic and Republican Administrations to consistently make campaign promises to boost homeownership through government intervention in the market. Consequently, under both the Clinton and Bush Administrations, HUD dramatically increased these quotas, which reached their zenith when the Bush Administration raised them to 56 percent, 27 percent and 39 percent, respectively.

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[7] *See* Steven A. Holmes, "Fannie Mae Eases Credit to Aid Mortgage Lending," *The New York Times*, (September 30, 1999) *accessed at* http://www.nytimes.com/1999/09/30/business/fannie-mae-eases-credit-to-aid-mortgage-lending.html.

[8] *See* Stan J. Liebowitz, "Anatomy of a Train Wreck: Causes of the Mortgage Meltdown," *Independent Policy Report*, (October 3, 2008), accessed at http://www.independent.org/pdf/policy_reports/2008-10-03-trainwreck.pdf.

[9] *See* note 2 at Title XIII.

HUD's affordable housing quotas represented major departures from the GSEs' prior commitment to underwriting only sustainable mortgages. Fannie Mae's original congressional charter acknowledged the risks involved in low down payment loans because it allowed Fannie to purchase loans with less than a 20 percent down payment only in concert with certain mitigating factors such as private mortgage insurance or a repurchase agreement with the mortgage originator.[10] The establishment of the HUD quotas broke this convention and set the stage for the dramatic politicization of mortgage lending.

In 1994, Fannie Mae CEO Jim Johnson announced the company's first affordable housing initiative, the $1 trillion "Opening the Doors to Affordable Housing" program. Johnson, a long-time friend of both President Clinton and Treasury Secretary Robert Rubin, took the helm of Fannie in 1991 after a stint at Lehman Brothers. In an article entitled "Fannie Mae's Trillion-Dollar Giveaway," written about this initial affordable housing initiative, the Los Angeles-based Family Savings Bank criticized Fannie Mae's past practices for relying too heavily on borrowers' income and debt levels when underwriting loans. Although some would consider using such metrics to be prudent, the article stated that these guidelines "must have been written sometime in the 1800s." It praised Mr. Johnson's $1 trillion commitment because it would introduce "qualifying flexibility," for low-income borrowers, allowing them to reduce their down payments to as little as 3 percent. The article cited "pressure from President Clinton's administration," as the primary influence on Fannie Mae's decision to lower its lending standards.[11]

The GSEs also allowed politicians to claim credit for earmark-like affordable housing initiatives in their districts without having to appropriate the money in Congress. In 1994, Johnson opened Fannie Mae's first "partnership office" in a congressional district. These partnership offices "issued thousands of press releases" featuring Members of Congress assisting Fannie Mae with affordable housing initiatives.[12] They also had a reputation for hiring relatives of Members of Congress as employees.[13] This political strategy won Fannie and Freddie allies on Capitol Hill who would prove invaluable in fending off calls to rein in their risky borrowing and lending practices.

In 1995, Johnson seeded the Fannie Mae Foundation with $350 million of Fannie stock. The company used this foundation to spread millions of dollars around to politically-connected organizations like the Congressional Hispanic Caucus Institute.[14] It also hired well-known academics to write papers that gave an aura of academic rigor to policy positions favorable to Fannie Mae. For example, one paper coauthored by now-Director of the Office of Management and Budget Peter Orszag, concluded that the chance was

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[10] *See* Federal National Mortgage Association Charter Act, *accessed at* http://www.fhfa.gov/GetFile.aspx?FileID=29.

[11] *See* Valencia Roner, "Fannie Mae's Trillion-Dollar Giveaway," *Black Enterprise*, (November 1, 1994).

[12] *See* Bethany McLean, "Fannie Mae's Last Stand," *Vanity Fair*, (February 2009).

[13] See Peter J. Wallison and Charles W. Calomiris, "The Last Trillion-Dollar Commitment," *American Enterprise Institute Financial Services Outlook*, (September 2008), accessed at http://www.aei.org/docLib/20080930_Binder1.pdf.

[14] *See* note 12, *supra*.

minimal that the GSEs were not holding sufficient capital to cover their losses in the event of a severe economic shock. The authors suggested that "the risk to the government from a potential default on GSE debt is effectively zero," and that "the expected cost to the government of providing an explicit government guarantee on $1 trillion in GSE debt is just $2 million."[15] As of May 14, 2009, the taxpayers had already been exposed to $700 billion of GSE bailouts, including $59.8 billion of capital injections by the U.S. Treasury, $73 billion of GSE debt purchases by the Federal Reserve, and $567.3 billion of direct purchases of GSE mortgage-backed securities by both the Fed and Treasury.[16]

CLINTON ADMINISTRATION REFORMS – CRA AND THE NATIONAL HOMEOWNERSHIP STRATEGY

1995 was a pivotal year in the politicization of mortgage lending. In that year, the Clinton Administration implemented a major reform of the Community Reinvestment Act ("CRA") and issued its National Homeownership Strategy ("the Clinton Strategy"), both of which increased pressure on Fannie and Freddie to loosen their lending standards.

The CRA was originally passed in 1977 to prevent banks from engaging in "redlining" – refusing to lend to otherwise credit-worthy borrowers in lower-income neighborhoods. Until 1995, the legislation was largely ineffective because it was very broad in its directives to both banks and regulators. For example, while the legislation called for federally-regulated banks to meet "the credit needs of [their] entire community, including low- and moderate-income neighborhoods," it also directed the regulators to "encourage" banks to achieve this goal. It went on to require regulators to "consider" any failure when banks seek approval from the government for actions such as mergers and acquisitions.[17] It was not surprising that this expansive language was not effective in achieving compliance, as demonstrated by the relative infrequency of CRA enforcement actions against banks.

However, in 1995, the Clinton Administration implemented a major regulatory reform of CRA which emphasized "performance-based evaluation." The impact of this reform was that regulators would no longer rate banks based on their efforts to lend to customers using equitable procedures but rather on the volume of their lending. According to one academic study of CRA, this regulatory change marked "a shift of emphasis from procedural equity to equity in outcome." Furthermore, the "lending test" component of the regulatory review process, which was the "most heavily weighted component of CRA

[15] *See* Joseph E. Stiglitz, Jonathan M. Orszag and Peter R. Orszag, "Implications of the New Fannie Mae and Freddie Mac Risk-based Capital Standard," *Fannie Mae Papers*, (March 2002).
[16] *See* U.S. Department of the Treasury, "Monthly Treasury Statement of Receipts and Outlays of the United States Government," (April 30, 2009), *accessed at* http://fms.treas.gov/mts/mts0409.pdf. *See also*, Board of Governors of the Federal Reserve System, "Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks," (May 14, 2009), accessed at http://www.federalreserve.gov/releases/h41/Current/h41.pdf.
[17] *See* AKM Rezaul Hossain, "The Past, Present and Future of Community Reinvestment Act (CRA): A Historical Perspective," (October 2004) at 13.

examination," included criteria for the "use of innovative or flexible lending practices." As demonstrated time and again by congressional advocates of affordable mortgage lending, "innovative and flexible" means reduced down payments and riskier, unsustainable lending.[18] This shift of regulatory emphasis from ensuring equitable lending procedures to ensuring equitable lending outcomes regardless of borrowers' ability to repay was subtle but significant. When combined with the endorsement of "flexible and innovative" mortgage underwriting, this change in the CRA represented a troubling move away from prudent and sustainable mortgage lending towards government endorsement of lower quality lending to those of modest means.

Although the annual value of CRA home mortgage lending increased some 250 percent between 1996 and 2008, CRA lending never exceeded about 3 percent of total originations.[19] While CRA cannot be directly blamed for the huge volumes of risky nonprime mortgages that were eventually purchased by Fannie, Freddie and Wall Street investment houses, CRA continued a pattern of behavior of lowering mortgage underwriting standards in order to drive up the national homeownership rate.

The other important event of 1995 was the release of the Clinton Administration's *National Homeownership Strategy*. The document's foreword, penned by HUD Secretary Henry Cisneros, cited President Clinton's directive to "lift America's homeownership rate to an all-time high by the end of the century." Among the methods the Strategy proposed to achieve this bump in the homeownership rate was lower down payments. It observed that, "low- and moderate-income families often cannot become homeowners because they are unable to come up with the required downpayment." It goes on to direct that, "lending institutions, secondary market investors [Fannie Mae and Freddie Mac are the dominant players in the secondary market], and other[s]…should work collaboratively to reduce homebuyer downpayment requirements." The Clinton *Strategy* also called for increased use of "flexible underwriting criteria," which it said could be achieved in concert with "liberalized affordable housing underwriting criteria established by…Fannie Mae and Freddie Mac." It also called for "financing strategies, fueled by the creativity and resources of the private and public sectors to help homeowners that lack cash to buy a home or to make the payments."[20]

The Clinton *National Homeownership Strategy* made only a passing acknowledgement of the risks associated with reducing borrowers' equity in their mortgages and instituting "flexible underwriting standards:"

> The amount of borrower equity is an important factor in assessing mortgage loan quality. However, many low-income families do not have access to sufficient funds for a downpayment.

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[18] *Id*. at 54-57.

[19] CRA volume data *accessed at* http://www.ffiec.gov/craadweb/national.aspx, total subprime mortgage originations *accessed at* www.mortgagedaily.com.

[20] See U.S. Department of Housing and Urban Development, *The National Homeownership Strategy: Partners in the American Dream*, (May 1995).

Instead it praised lenders for their efforts thus far toward reducing this "barrier to home purchase" but urged that "more must be done." The report noted that in 1989 only 7 percent of mortgages had less than a 10 percent down payment but that by 1994 this had increased to 29 percent. The *Strategy* praised lenders for developing "innovative low-down payment programs" and applauded Fannie Mae for announcing 3 percent-down payment mortgages. HUD also issued new rules that allowed the GSEs to count subprime mortgages made to low-income borrowers toward their affordable housing goals.

In retrospect, President Clinton's rebranding of prudent down payments of 10 to 20 percent as "barrier[s] to home purchase" takes on great significance. As with the 1995 CRA reform and the Clinton Administration's decision to allow the GSEs to count subprime loans toward their affordable housing goals, this represented a shift in government policy from one that emphasized equity of procedure to equity of outcome. This emphasis on equity of outcome inevitably created tremendous pressure on regulated institutions to make more loans to low-income borrowers. It also created pressure for secondary market investors such as Fannie Mae and Freddie Mac to buy these loans. The correspondingly lower emphasis on how the loans were being made inevitably meant less attention would be paid to their quality and sustainability.

A Freddie Mac spokeswoman later acknowledged that the Clinton HUD's decision on subprime loans "forced us to go into that market to serve the targeted populations that HUD wanted us to serve." Clinton's HUD Assistant Secretary William C. Apgar, Jr. has since called the decision a "mistake," while his former advisor Allen Fishbein called the loans that the GSEs started buying to meet their affordable housing goals "contrary to good lending practices," and examples of "dangerous lending."[21] President Clinton himself acknowledged his role in efforts to loosen mortgage lending standards when he admitted that "there was possible danger in his administration's policy of pressuring Fannie Mae…to lower its credit standards for lower- and middle-income families seeking homes."[22] These accumulated government affordable housing policies, including the Clinton *Strategy,* trapped millions of Americans in mortgages they could not afford.

LOWER LENDING STANDARDS SPREAD AND CAUSE THE HOUSING BUBBLE

Risky mortgage lending, particularly loans with very low down payments, contributed directly to the rise of a housing bubble. Had this risky lending been contained within the low-income segment of the market targeted by politicians advocating more "innovation" in "affordable lending," the damage to the wider economy might have been minimal. However, these "innovations" in "flexible" loans products spread beyond just affordable lending into the entire U.S. mortgage market. The lure of reduced underwriting standards

[21] *See* Carol D. Leonnig, "How HUD Mortgage Policy Fed the Crisis," *The Washington Post*, (June 10, 2008).
[22] *See* Walter Alarkon, "Clinton Rejects Blame for Financial Crisis," *The Hill*, Sept. 9, 2008, *accessed at* http://thehill.com/leading-the-news/clinton-rejects-blame-for-financial-crisis-2008-09-25.html.

held true not just for borrowers of modest income but for those at all income levels. Although the erosion of mortgage underwriting standards began in Washington with initiatives like the CRA as a way to reduce "barriers to homeownership," this trend inevitably spread to the wider mortgage market. One observer noted:

> Bank regulators, who were in charge of enforcing CRA standards, could hardly disapprove of similar loans made to better qualified borrowers. This is exactly what occurred.[23]

Borrowers – regardless of income level – took advantage of the erosion of underwriting standards that started with government affordable housing policy. As one study observed,"[o]ver the past decade, most, if not all, the products offered to subprime borrowers have also been offered to prime borrowers."[24] For example, Alt-A and adjustable-rate mortgages became incredibly popular with borrowers – who were generally not low-income – engaging in housing speculation. As home prices continued their dizzying rise, many people decided to cash in by buying a house with an adjustable-rate mortgage featuring a low introductory teaser rate set to increase after a few years. These borrowers, confident in the oft-cited assertion that U.S. home values had never before fallen in the aggregate, planned to sell or refinance their investment before the mortgage rate adjusted upward, pocketing the difference between the initial purchase price and the subsequent appreciation in value. However, buyers failed to grasp the effect of a government policy that had quietly eroded the prudential limits on mortgage leverage, creating a dangerous speculative bubble.

As the size of down payments for mortgages fell, so too did borrowers' equity stake in the homes they purchased. This had two important effects. First, it eliminated the borrower's "skin in the game," increasing the likelihood that he or she would walk away from the mortgage if times got tough. It also increased the borrower's leverage (debt) as measured by the Loan-to-Value ratio.[25] This leverage allows borrowers to purchase more expensive houses than they would otherwise be able to afford at a given level of income.

It was this process of steadily increasing leverage that drove the complete decoupling of home prices from Americans' income and fed the growth of the housing bubble. As the average down payment shrank and leverage correspondingly increased, the amount of mortgage debt relative to borrowers' income increased. This increasing leverage in turn eroded the power of supply and demand to restrain irrational price increases. In a normal housing market, free of government intervention, an increase in home prices would have been restrained when the marginal, or next, home seller tried to charge a price too high

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[23] *See* Peter J. Wallison, "Cause and Effect: Government Policies and the Financial Crisis,", *American Enterprise Institute Financial Services Outlook*, (November 2008), *accessed at* http://www.aei.org/docLib/20081203_1123724NovFSOg.pdf..

[24] *See* James R. Barth, Tong Li, Triphon Phumiwasana, and Glenn Yago, "Surprise: Subprime Mortgage Products Are Not The Problem!" (December 2007), accessed at http://www.milkeninstitute.org/pdf/Sub-prime-Mortgage-Products.pdf.

[25] According to Investopedia.com, "leverage" is, "the amount of debt used to finance a firm's assets. A firm with significantly more debt than equity is considered to be highly leveraged. Leverage is most commonly used in real estate transactions through the use of mortgages to purchase a home."

for prospective borrowers to afford. This home seller would have been forced to cut his or her unreasonable price.

Once government-sponsored efforts to decrease down payments spread to the wider market, home prices became increasingly untethered from any kind of demand limited by borrowers' ability to pay. Instead, borrowers could just make smaller down payments and take on higher debt, allowing home prices to continue their unrestrained rise. Some statistics help illustrate how this occurred. Between 2001 and 2006, median home prices increased by an inflation-adjusted 50 percent, yet at the same time Americans' income failed to keep up. For the 30 years prior to 2000, the ratio of U.S. home prices to income averaged only about 4-to-1 – in other words, the average American lived in a home costing four times his annual income. In just five years, from 2000 to 2005, that ratio doubled to 8-to-1. As a result of homes becoming more expansive and seemingly less affordable, the only way for many Americans to buy a home during the housing bubble was to dramatically increase their leverage. It is not surprising, then, that between 2000 and 2006 mortgage debt in the U.S. increased by 80 percent. According to one early warning in 2006, the odds against such an increase in the price-to-income ratio occurring naturally were greater than 300-to-1.[26]

Government actions distorted the housing market, yet advocates of affordable housing policies, such as Congressman Barney Frank (D-MA), have asserted that those who criticize these policies seek to place blame for the financial crisis solely on borrowers of modest means.[27] This misses the mark entirely. In fact, responsibility for the erosion of mortgage lending standards, which began with government affordable housing policy, rests squarely on the policy makers who advocated these ill-conceived policies in the first place. Borrowers quite naturally responded to the incentives they were given, irrespective of their socioeconomic status, and risky lending spread to the wider mortgage market.

SPECIAL INTERESTS: THE RISE OF THE "AFFORDABLE" HOUSING COALITION

Under continuing political and economic pressure, the trend toward lowering mortgage lending standards continued apace throughout the 1990s. The GSEs altered their automated mortgage underwriting criteria to encourage banks to make loans to borrowers with damaged credit, in large part to satisfy the Clinton Administration's demand that the GSEs do more to increase homeownership among low-income and minority borrowers as laid out in the Administration's affordable housing strategy.[28] In this vein, Johnson's

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[26] *See* Andrew LaPerriere, "Housing Bubble Trouble: Have we been living beyond our means?" *The Weekly Standard*, (April 10, 2006).
[27] *See* Glen Johnson, "Frank Says GOP Housing Attacks Racially Motivated," *Associated Press*, (October 6, 2008).
[28] According to Investopedia.com, "automated underwriting" is "a computer-generated loan underwriting decision. Using completed loan application information, an automated underwriting system retrieves relevant data, such as a borrower's credit history, and arrives at a logic-based loan decision. Automated underwriting engines can provide near-instantaneous loan approval or denial decisions;

successor, Fannie Mae CEO Franklin Raines said that the company had "expanded home ownership for millions of families in the 1990's by reducing down payment requirements."[29] Raines told the Mortgage Bankers Association that he and Freddie Mac CEO Richard Syron "made no bones about their interest in buying loans made to borrowers formerly considered the province of nonprime and other niche lenders." Raines said his goal was, "to push products and opportunities to people who have lesser credit quality."[30]

Fannie Mae and Freddie Mac would ultimately announce over $5 trillion in affordable housing initiatives. Many of these loans came increasingly from large non-bank mortgage lenders like Countrywide Financial Corporation, the country's largest mortgage lender and a major innovator in pushing subprime loans. These non-bank lenders rose to fill the void in mortgage lending left in the wake of the savings and loan crisis, and they grew rapidly in response to government policies that encouraged lower lending standards. A symbiotic relationship developed between these non-bank lenders and the GSEs. For example, Fannie Mae under CEO Jim Johnson reached a "strategic agreement" with Countrywide CEO Angelo Mozilo, under which "Countrywide agreed to deliver a large portion of Fannie's annual loan volume in exchange for special financing terms."[31] In fact, Countrywide regularly accounted for 10 to 30 percent of all the loans purchased by Fannie Mae in a given year. In the words of Mozilo: "If Fannie and Freddie catch a cold, I catch the fucking flu."[32]

Freddie Mac also joined in the subprime action, according to internal documents obtained by the Committee. For example, Freddie developed a plan to partner with non-bank mortgage lender Ameriquest by installing its automated underwriting software on-site.[33] Fannie and Freddie both used their automated underwriting software to divert subprime and Alt-A loans from private label securitizers on Wall Street, driving up demand for risky junk mortgages. By 1997, Fannie Mae was offering to buy loans with only a 3-percent down payment, and by 2001 was offering to buy zero-down payment loans.[34]

Not only could these loans be used to satisfy the government's demand for more low-down payment affordable mortgages, they turned out to be highly profitable as well. Combined with the value of their government subsidies and their ability to operate without far-flung retail operations, the GSEs were phenomenally profitable. Fannie Mae enjoyed perhaps the highest level of net income per employee in the world – about

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therefore, implementing automated underwriting systems can save a considerable amount of time, as manual underwriting can take as long as 60 days to complete. In addition to the time savings, automated underwriting is preferred because it is based on algorithms, eliminating human bias. Freddie Mac maintains and markets a large automated underwriting engine known as Loan Prospector, and Fannie Mae has an automated underwriting engine known as Desktop Underwriter."

[29] *See* note 7, *supra*.

[30] *See* Neil Morse, "Looking for New Customers," *Mortgage Banking*, (December 1, 2004), *in* note 13, *supra*.

[31] *See* Glenn R. Simpson, "Countrywide Made Home Loans to Gorelick, Mudd," *The Wall Street Journal*, (September 25, 2008).

[32] *See* Paul Muolo and Matthew Padilla, *Chain of Blame*, New York: John Wiley & Sons, (2008), at 112.

[33] *See* Freddie Mac*,* document produced to the Committee, Bates FMAC0013683-FMAC0013692.

[34] *See* note 23, *supra*.

$900,000 per employee according to one estimate.[35] The GSEs paid their executives handsomely as well. Fannie CEO Franklin Raines earned over $90 million in compensation during his six-year tenure.[36] Fannie and Freddie paid billions more to their shareholders every year in dividends. Thus, government subsidization of GSE operations amounted to little more than corporate welfare. Indeed, both the Congressional Budget Office and the Federal Reserve found that only about half of this taxpayer subsidy ever came back to the taxpayers in the form of lower mortgage rates.[37]

Similarly, Wall Street investment houses like Lehman Brothers, Bear Stearns, and Merrill Lynch, which came to specialize in packaging and investing in the lowest-quality tranches of mortgage-backed securities, profited hugely from the increased volume that government affordable lending policies sparked. Private-label securitization of subprime mortgages grew from $60 billion-a-year in 1997 to nearly $500 billion-a-year by 2006.[38] These firms could not compete in any segment of the market Fannie and Freddie chose to close off to them because the GSEs could always undercut Wall Street's costs by virtue of their government-granted competitive advantages. However, as with the GSEs' relationship to non-bank lenders such as Countrywide, Wall Street formed its own symbiotic relationship with Fannie and Freddie. Wall Street firms profited from buying and selling GSE mortgage-backed securities, which because of the government backing were deemed to be as safe as Treasury bonds – but with a higher yield. For their part, the GSEs became the largest purchasers of the "AAA"-rated tranches of Wall Street's private-label securities, while Wall Street invested in the lower-quality portions. However, without the GSEs' participation, it is unlikely that Wall Street could have formed these pools of toxic mortgages, making Fannie and Freddie the indispensable actors in the subprime market.[39] This resulted in consistent downward pressure on down payments and on the credit quality of borrowers, fueling the housing bubble.

The nexus of political advocates of affordable housing, non-bank mortgage lenders like Countrywide, the homebuilding industry, and Wall Street firms came together to create a powerful affordable housing coalition led by Fannie Mae and Freddie Mac and their congressional allies. This group of vested interests used its money, power and influence to protect its political prerogatives and profits, blocking repeated attempts at reform and distorting the relationship between government and business. Between 1998 and 2008, Fannie Mae and Freddie Mac spent over $176 million on lobbyists.[40] They paid lobbyists to influence Members of Congress to block legislative proposals that would have stripped

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[35] *See* Owen Ullmann, "Crony Capitalism: American Style," *The International Economy*, (July/August 1999).

[36] *See* OFHEO, "Report of the Special Examination of Fannie Mae," (May 2006), *accessed at* http://www.fhfa.gov/webfiles/747/FNMSPECIALEXAM.pdf.

[37] *See* Congressional Budget Office, "Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac," (May 1996), at xiv, *accessed at* http://www.cbo.gov/ftpdocs/0xx/doc13/Fanfred.pdf. See also, Wayne Passmore, Board of Governors of the Federal Reserve System, "The GSE Implicit Subsidy and the Value of Government Ambiguity," (2005), at 3, *accessed at* http://www.federalreserve.gov/Pubs/feds/2005/200505/200505pap.pdf.

[38] Data from Standard & Poor's and Moody's, *accessed at* www.mortgagedaily.com.

[39] *See* note 13, *supra*.

[40] *See* www.opensecrets.org.

them of their preferential advantages. The GSEs even paid lobbyists just so they would not lobby against them. As one person who was offered money not to lobby against the GSEs noted, Fannie and Freddie could rely on a simple and politically powerful message touting their commitment to homeownership to blunt any efforts to rein them in.[41] If that failed, according to one congressional staffer who preferred anonymity, the GSEs could take a tougher line:

> Fannie has this grandmotherly image, but they'll castrate you, decapitate you, tie you up and throw you in the Potomac. They're absolutely ruthless.[42]

When Congressman Jim Leach (R-IA) proposed assessing a fee on the GSEs to offset the federal subsidy they receive on their cost of borrowing, "it took just twelve hours for Fannie to blow the idea out of the water." Fannie Mae also forced then-Treasury Secretary Larry Summers to "tone down" a report that was originally going to criticize the cozy relationship between the federal government and the GSEs.[43] When Congressman Paul Ryan (R-WI) sought to increase regulation of the GSEs, Fannie Mae sent lobbyists to harass him in his Wisconsin congressional district, going so far as to call his constituents and accuse him of seeking to increase mortgage rates, generating 6,000 angry responses to his office. When Ryan transferred to a committee without direct oversight of the GSEs, Fannie CEO Raines sent him a "congratulatory" note. "He meant good riddance," said Ryan.[44] When Congressman Christopher Shays (R-CT) introduced legislation to end the GSEs' unique exemption from SEC registration, he "had lobbyists literally barging into my room," while Fannie CEO Raines reportedly called the lawmaker to ask, "What the hell have [you] done?" The GSEs retaliated by ending their home-buying forums in Shays' congressional district in an attempt to hurt him politically.[45] Congressman Cliff Stearns (R-FL), who scheduled hearings on Freddie Mac's use of improper accounting procedures in 2004, had his jurisdiction over the GSEs stripped by House Speaker Dennis Hastert (R-IL), who assigned the task to Michael Oxley (R-OH), who was the most frequent featured guest at 19 of the fund-raisers Freddie Mac held for members of his committee.[46]

Just as the perils of opposing the vested interests of the affordable lending coalition were rife, so the rewards for supporting them were lucrative. From 2000 to 2008, the GSEs and their employees contributed nearly $15 million to the campaigns of dozens of Members of Congress on key committees responsible for oversight of Fannie and Freddie.[47] At the time federal regulators seized the insolvent companies, sitting Members of Congress had received over $4.8 million in political contributions since 1989, with over $3 million of that coming from the GSEs' political action committees. Of that total,

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[41] *See* Bara Vaida, "Battling Fannie and Freddie," *National Journal*, (October 18, 2008).
[42] *See* note 35, *supra*.
[43] *Id*.
[44] *See* Paul A. Gigot, "The Fannie Mae Gang," *The Wall Street Journal*, (July 23, 2008).
[45] *See* Matthew Murray, "A $90 Million Package Gets Lambasted Again," *Roll Call*, (December 10, 2008).
[46] *See* note 44*, supra*. *See also* Pete Yost, "Freddie Mac Lobbyist Staged 50 GOP Fund-Raisers as Congress Let Legislation Die," *The Associated Press*, (July 18, 2003).
[47] *See* Common Cause, "Ask Yourself Why…They Didn't See This Coming," (September 24, 2008), *in* note 13, *supra*.

57 percent went to Democrats, and 43 percent to Republicans.[48] Not all of this fundraising was in compliance with federal law. In 2006, Freddie Mac paid the largest fine in Federal Election Commission history – $3.8 million – for improperly using corporate resources to hold 85 fundraisers for Members of Congress, raising a total of $1.7 million.[49]

Fannie Mae and Freddie Mac regional partnership offices provided millions in additional contributions to politicians who supported them by funding affordable housing projects in congressional districts. For example, one press release from the office of Senator Charles Schumer (D-NY) read, "Schumer Announces up to $100 Million Freddie Mac Commitment to Address Fort Drum and Watertown Housing Crunch." The release touted that, "Schumer has frequently partnered with Freddie Mac on creative, affordable housing initiatives around the state," and that Freddie had committed to purchase $100 million of loans originated by HSBC bank, including "low-down payment loans."[50] These politicians could then claim credit with their constituents for bringing home these earmark-like subsidies which didn't have to go through the scrutiny of the normal appropriations process.

Fannie and Freddie also served as a revolving door for powerful former politicians, their aides and even their family members. Jim Johnson managed Walter Mondale's 1984 presidential campaign, chaired the vice presidential selection committee for presidential candidate John Kerry, and was involved in President Barack Obama's vice presidential selection process. Franklin Raines had been President Clinton's Director of the Office of Management and Budget. Former Clinton Deputy Attorney General Jamie Gorelick served as Vice-Chairman of Fannie Mae and earned over $26 million in compensation.[51] Former Fannie Senior Vice President John Buckley had served as a Republican Congressional staffer and senior advisor to the presidential campaigns of Ronald Reagan in 1984 and Bob Dole in 1996. Another former Fannie Senior Vice President, Arne Christenson, had been a senior advisor to Republican House Speaker Newt Gingrich.[52] The son of Republican Senator Bob Bennett worked for Fannie Mae's Utah regional office, while Democratic Representative Barney Frank's partner, Herb Moses, worked at Fannie Mae from 1991 to 1998 as Assistant Director for Product Initiatives while Frank sat on the House Banking Committee with responsibility for oversight of the GSEs.[53]

Until President George W. Bush ended the practice, the President of the United States appointed five members to the GSEs' boards. This was a unique arrangement among

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48 *See* Open Secrets, "Update: Fannie Mae and Freddie Mac Invest in Lawmakers," *accessed at* http://www.opensecrets.org/news/2008/09/update-fannie-mae-and-freddie.html.

49 *See* Federal Election Commission press release, "Federal Home Loan Mortgage Corporation ("Freddie Mac") Pays Largest Fine in FEC History," (April 18, 2006), *accessed at* http://www.fec.gov/press/press2006/20060418mur.html.

50 *See* Senator Charles Schumer press release, (November 20, 2006), *accessed at* http://schumer.senate.gov/SchumerWebsite/pressroom/record.cfm?id=266131.

51 *See* note 36, *supra*.

52 *See* note 35, *supra*.

53 See note 12, *supra*. See also Bill Sammon, "Lawmaker Accused of Fannie Mae Conflict of Interest," *Fox News*, (October 3, 2008), accessed at http://www.foxnews.com/story/0,2933,432501,00.html.

publicly-trade companies and solely a function of their hybrid public-private nature. These board positions were highly lucrative sinecures with which Presidents could reward their political allies. Typically, those appointed to the board by the President served for very short periods of time and contributed very little to the day-to-day operations of the company, yet were paid handsomely. For example, current White House Chief of Staff Rahm Emanuel was appointed to the board of Freddie Mac by President Clinton in February 2000, where he served for only 14 months and in return received $320,000 in compensation. He also sold Freddie Mac stock worth between $100,001 and $250,000. He did not serve on any of the board's working committees and the board itself met no more than six times a year. Clinton also appointed lobbyist and golfing partner James Free and former aide Harold Ickes to the Freddie Mac board.[54]

Other members of the affordable lending coalition also were involved in buying influence among Washington figures. One of the most notable examples was Countrywide's use of preferential mortgages to curry favor with so-called "VIPs." Countrywide CEO Angelo Mozilo styled this the "Friends of Angelo" program. Officials with direct responsibility for overseeing GSE operations, including Senators Christopher Dodd and Kent Conrad and HUD Secretary Alphonso Jackson (responsible for setting the GSEs' affordable housing quotas), received sweetheart mortgages from Countrywide. Key congressional staffers with responsibility for oversight of Fannie and Freddie also received sweetheart mortgages, including Clinton Jones III, Republican Chief Counsel of the House Financial Services Committee, which oversees the GSEs. Jones eventually left his job in Congress to join Fannie Mae as a vice president.[55] Another staffer who received a sweetheart mortgage from Countrywide was Joyce Brayboy, Chief of Staff to Congressman Mel Watt. Watt is a member of the House Financial Services Committee and the Congressional Black Caucus, a group noted for its strong support of the GSEs' affordable housing "mission." High-level GSE executives were also beneficiaries of Mozilo's largesse, including Fannie Mae CEO Jim Johnson, who also was a key conduit for referring other "VIPs" to the program, Franklin Raines, and Fannie Vice Chair and former Clinton Justice Department official Jaime Gorelick.[56]

SCANDALS AT FANNIE AND FREDDIE

In 2003, Fannie Mae and Freddie Mac were at the height of their power. They dominated the secondary mortgage market, including a combined exposure of $372 billion to subprime mortgages made to borrowers with FICO scores below 660, 81 percent of the total market.[57] Wall Street firms were responsible for a mere 19 percent of this market. However, accounting scandals were about to hammer the GSEs' share prices, threaten

[54] *See* Bob Secter and Andrew Zajac, "Rahm Emanuel's Profitable Stint at Mortgage Giant," *The Chicago Tribune*, (March 26, 2009).
[55] *See* Dan Golden, "Angelo's Fannie Pack," *Conde Nast Portfolio*, (July 17, 2008).
[56] *See* House Oversight and Government Reform Committee, "Friends of Angelo: Countrywide's Systematic and Successful Effort to Buy Influence and Block Reform," (March 19, 2009) *accessed at* http://republicans.oversight.house.gov/media/pdfs/20090319FriendsofAngelo.pdf. *See also* note 31, *supra*.
[57] *See* Edward Pinto, information provided to the Committee on Oversight and Government Reform, based on an analysis of securities filings and mortgage market data.

their market share, and create an urgent need for a pro-active political influence strategy to blunt calls for reform.

In 2003 and 2004, it became known that GSE executives had manipulated accounting rules to maximize profits and executive compensation, breathing new life into efforts by the Bush Administration and some in Congress to properly regulate them. This in turn forced the GSEs to seek shelter with their congressional benefactors, the advocates of affordable housing policy.

As part of their highly profitable business model, Fannie Mae and Freddie Mac both built up huge investment portfolios of mortgages and mortgage-backed securities, from which they earned the principal and interest payments. This was both the most profitable and the riskiest part of their business model. Part of the risk was that the companies had to use complex hedging operations to compensate for the inherent volatility of an undiversified portfolio of home mortgages in order to maintain the illusion of smooth and steady earnings growth. If Congress became aware of the risks they were taking, the GSEs feared it would have greatly strengthened calls to rein in the companies' over-leveraging by increasing their capital requirements. While this would have protected taxpayers by increasing the regulatory capital cushion beneath the GSEs' investments, the companies opposed it because it threatened their profitability.

Conducting the necessary hedging of the GSEs' portfolio perfectly was impossible, particularly with prices rising so rapidly during the growth of the housing bubble. Officials at Fannie and Freddie decided to cheat by manipulating the companies' earnings with improper accounting practices in order to hide volatility from their investors and the government. An internal Freddie Mac investigation revealed this improper behavior, forcing the board to promptly oust the company's top leadership in June 2003 and announce that it would restate earnings. It turned out that Freddie Mac had been underreporting earnings on derivatives and bonds that had dramatically increased in value due to falling interest rates between 2000 and 2003 by $5 billion. Freddie did so to maintain the illusion of the steadily increasing returns its investors had come to expect, disguising the increasingly volatile nature of its undiversified investments in the housing market.

The fact that Freddie's Board of Directors had been briefed on management's plan to massage earnings yet did not question it raised serious doubts about the board's motivations and effectiveness. In its report on the scandal, OFHEO singled out the presidentially-appointed board members such as Rahm Emanuel, who sat on the Board at the time it was apprised of the improper accounting scheme, as an "anachronism" which should be "repealed so shareholders can elect all Directors."[58] This was a stinging indictment of the crony capitalism that led directly to lax oversight and perverse incentives for the GSEs to behave improperly.

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[58] *See* OFHEO, "Report of the Special Examination of Freddie Mac," (December 2003), at vi, *accessed at* http://www.fhfa.gov/Preview-FHFAWWW/webfiles/749/specialreport122003.pdf.

To its credit, OFHEO responded to revelations of fraud at Freddie Mac, and launched an investigation of Fannie Mae as well. In 2004, OFHEO announced that Fannie Mae had also "deviated from generally accepted accounting principles in order to conceal losses, reduce volatility in reported earnings, present investors with an artificial picture of steadily growing profits, and to meet financial performance targets that triggered the payment of large bonuses" to its executives.[59] The SEC conducted an independent review that confirmed OFHEO's findings of improper behavior, and within weeks the leadership team led by Mr. Raines resigned from Fannie Mae. Fannie was forced to revise its earnings downward by $6.3 billion. OFHEO found that "Fannie Mae's executives were precisely managing earnings to the one-hundredth of a penny to maximize their bonuses while neglecting investments in systems internal controls and risk management."[60] The regulator found that earnings management, "made a significant contribution to the compensation of [CEO] Franklin Raines."[61] Raines ultimately earned over $50 million at Fannie Mae while Freddic Mac CEO Leland Brendsel earned almost $20 million in salary, bonuses and dividends at Freddie Mac.[62]

The accounting scandals caused outrage on Capitol Hill and prompted Members of Congress and the Bush Administration, including Federal Reserve Chairman Alan Greenspan, to seek reform legislation that would have limited the GSEs' risky mortgage portfolios and high-leverage debt issuance by empowering their regulator to require them to hold additional capital. In response, Fannie Mae and Freddie Mac sought protection from their strongest political protectors, the advocates of high-risk affordable lending. The GSEs essentially doubled down on risky low down payment lending to shore up support on Capitol Hill and fend off attempted regulation. GSE congressional supporters, many of whom sat on key committees charged with oversight of the housing and mortgage industries, made repeated public statements in support of the push to reduce the quality of underwriting at the GSEs and to block congressional efforts at better regulation.

For example, at a hearing of the House Financial Services Committee on the GSE accounting scandals, Congresswoman Maxine Waters (D-CA) publicly praised the GSEs for implementing their "affordable housing mission, a mission that has seen innovation flourish, from desktop underwriting to 100 percent [zero-down payment] loans."[63] And in a speech delivered at the swearing-in ceremony of the Congressional Black Caucus in 2005, Franklin Raines' successor, Fannie Mae CEO Daniel Mudd, sent a clear signal to congressional advocates of loosened lending standards that his company sought political cover in order to blunt efforts to address the serious structural problems posed by the GSEs. Mudd told the assembled Members that he was "humbled…to reaffirm the friendship and the partnership between Fannie Mae and the Congressional Black

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[59] *See* Mark Jickling, Congressional Research Service, "Accounting Problems at Fannie Mae," (December 7, 2006).

[60] *See* OFHEO press release, "Fannie Mae Façade," (May 23, 2006), *accessed at* http://www.fhfa.gov/webfiles/2095/52306fnmserelease.pdf.

[61] *Id*.

[62] *See* Fannie Mae document produced to the Committee, Bates FM-COMP-COGR-00009. *See also* Freddie Mac document produced to the Committee.

[63] *See* House Financial Services Committee hearing, (September 25, 2003).

Caucus," and noted that "[s]o many of you have been good friends to Fannie Mae and our [affordable housing] mission…You've been friends through thick and thin." In reference to the accounting scandal, Mudd noted:

> We have indeed come upon a difficult time for Fannie Mae. There is much to be done inside my company and I humbly ask you to help us and to help me. If there are areas where we are missing, if there are areas where we could do better, we'd like to hear it from our friends and I'd be so bold as to say, our family first.

He noted pointedly that "Fannie Mae has lent more money to more minorities and more underserved individuals than any single company in history," and reassured Members that "you will see Fannie Mae reaching out and listening to the [Congressional Black] Caucus" and opined that "you are also the conscience of Fannie Mae, keeping us on course to serve those who need serving most."[64]

This speech by Fannie Mae's CEO reveals much about the unique relationship between the GSEs and congressional advocates of lower mortgage lending standards. The company was desperate to maintain its unfair competitive advantages granted by Congress in the wake of the accounting scandals and increased calls to strip it of some of those privileges. Its leadership clearly decided that the best strategy was to play up the politically popular albeit short-sighted goal of lowering their standards in order to increase the national homeownership rate and please their political benefactors. That the effect of this strategy was to trap Americans in unsustainable mortgages and feed the growth of a housing bubble merely heaped insult upon injury.

REFORM OF FANNIE AND FREDDIE THWARTED: FOR A PRICE

The GSEs' political risk management succeeded in thwarting congressional and Bush Administration attempts at reform. In 2004, Senators Hagel, Sununu, Dole, and McCain, took up Fed Chairman Alan Greenspan's call to create stronger regulatory oversight of the GSEs and limit the amount of leverage GSEs could use to invest in risky mortgage lending. While this would not have interfered with the GSEs' role in providing a secondary mortgage market, it would have reduced their ability to fund high-risk lending with borrowed money and cut into the companies' fabled profit margins and executive compensation. However, when the Senate Banking Committee took up the legislation, S.1508, Democrats and some Republicans opposed it as originally drafted. For example, the legislation was approved by the Committee only after Senator Robert Bennett, whose son was employed by the Fannie Mae partnership office in Utah, attached an amendment that stripped the provision which would have allowed a new regulator to limit the GSEs' leverage.[65] This led the Bush Administration to withdraw its support from the weakened legislation, which ultimately failed to pass the full Senate.

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[64] *See* Daniel Mudd speech, (January 4, 2005), *accessed at* rtsp://video.c-span.org/project/c04/c04010405_cbc.rm.

[65] *See* note 12, *supra*. See also Leslie Paige, Citizens Against Government Waste, "GSE Reform in Critical Stage," (May 1, 2004), accessed at http://www.cagw.org/site/News2?page=NewsArticle&id=7769.

A similar scenario unfolded in 2005 when the Senators reintroduced their GSE reform language. Once again the bill, S.190, failed to get a single Democratic vote in the Banking Committee. Among the Democrats who voted against the bill were Senator Christopher Dodd, who received a sweetheart mortgage from Countrywide, and Senator Charles Schumer, who had so prominently advertised a $100 million Freddie Mac affordable housing program in his state. Without any Democratic support, the legislation failed to garner sufficient support for a vote on the Senate floor and was never enacted.

The House of Representatives also took up GSE reform in 2005 with the passage of H.R. 1461. However, the legislation did not allow the new federal regulator it would have created to limit the size of the GSEs' portfolio. As a result, the Bush Administration, citing Fed Chairman Alan Greenspan's insistence on the need for such a measure, once again withdrew its support and the bill died.

In return for political protection from oversight and reform, however, Fannie Mae and Freddie Mac were forced to placate their congressional protectors with an ever-increasing commitment to high-risk lending. That Fannie and Freddie felt such political pressure is made clear in an email exchange at Freddie Mac regarding the company's decision to not place an upper limit on the number of defaulting affordable loans the company was underwriting. Freddie Mac's senior vice president in charge of its affordable housing mission admitted that the higher default rates typical of lower-quality affordable mortgages could do serious "[h]arm to households and neighborhoods." This grim reality notwithstanding, "[t]ipping the scale in favor of no cap [on defaults] at this time was the pragmatic consideration that [it] would be interpreted by external critics as additional proof that we are not really committed to affordable lending."[66] Clearly the GSEs feared a backlash from powerful advocates of looser mortgage standards so much that they could not even agree to place limits on how many defaults they would tolerate for one of their more risky loan products, irrespective of the obvious damage this lending was doing to families and neighborhoods.

Politicians who favored reduced lending standards in the name of increasing the homeownership rate among their constituents cheered on these efforts. For example, members of the Hispanic Caucus in the U.S. House of Representatives formed a special housing initiative called *Hogar* to encourage increased lending to Latino borrowers in their districts through reduced standards. These lawmakers received financial and policy support from the subprime lending industry as well as from Fannie Mae and Freddie Mac, which in return received congressional support for their drive to make low-quality loans. According to one report, for $150,000 in campaign contributions a year, subprime lenders could supply a research fellow to produce studies for *Hogar* that would in turn be used by industry lobbyists to push low-quality mortgage lending among Latino borrowers. For $100,000 a year in donations, the congressional group "offered to provide news releases from the Hispanic Caucus promoting a lender's commercial products for the Latino market." Freddie Mac partnered with *Hogar* to produce a study of Latino homeownership in 63 congressional districts which found that Latino homeownership

[66] *See* Freddie Mac document produced to the Committee, Bates FMAC0013801-FMAC0013802.

had increased thanks to "new flexible mortgage loan products" and recommended "further easing of down-payment and underwriting standards."[67] Indeed, according to the U.S. Census Bureau, Latino homeownership increased by 47 percent during the housing bubble, from 4.1 million to 6.1 million between 2000 and 2007. This was an astonishing rate of increase at a time when the national homeownership rate rose by just 8 percent.

Along with political pressure from Congress for more low-quality affordable housing loans, Fannie Mae and Freddie Mac also caved in to the temptation to lower their standards in an attempt to take market share away from Wall Street. This pressure amplified the effect of the push by politicians to lower their underwriting standards in order to do more risky affordable lending. These dual pressures were noted in an email from Freddie Mac's chief risk officer:

> [T]he push to do more affordable business and increase share means more borderline and unprofitable business will come in. The best credit enhancement is a profit margin and ours is likely to get squeezed as we respond to these market pressures.[68]

But even as Fannie and Freddie acted to placate political allies who they needed to help thwart reforms, some GSE employees were beginning to develop a new fear. A Fannie Mae presentation obtained by the Committee explicitly acknowledged conditions indicative of a housing bubble, including an overheated market and the proliferation of increasingly risky mortgages. Yet when faced with the choice of "staying the course" or "meeting the market where it is," the presenters recommended developing "underground" efforts to delve into subprime and "alternative" markets in order to avoid becoming "less of a market leader."[69]

One case study that illustrates the dual pressures of the politicization of mortgage lending and the push for market share is the internal debate at Freddie Mac over its purchase of No-Income, No-Asset ("NINA") mortgages, a type of Alt-A loan. These risky loans did not verify a borrower's income or assets. The company's chief risk officer warned his fellow executives in 2004 that the mortgages in question would prove to be dangerously risky and that Freddie Mac would likely give in to the temptation to continue lowering its standards to attract market share. "In 1990 we called this product 'dangerous' and eliminated it from the marketplace," he wrote to his colleagues.[70] He also warned that these mortgages were "disproportionately targeted towards Hispanics," making "[t]he potential for the perception and the reality of predatory lending with this product…great".[71] He also predicted that these loans were going to "borrowers who would have trouble qualifying for a mortgage if their financial position were adequately

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[67] *See* Susan Schmidt and Maurice Tamman, "Housing Push for Hispanics Spawns Wave of Foreclosures," *The Wall Street Journal*, (January 5, 2009).
[68] *See* Freddie Mac document produced to the Committee, Bates FMAC0013756.
[69] *See* Fannie Mae document produced to the Committee, Bates FM-COGR_00177162 – FM-COGR_0177172.
[70] *See* Freddie Mac document produced to the Committee, Bates FMAC0013672.
[71] *See* Freddie Mac document produced to the Committee, Bates FMAC0013739.

disclosed," with first-year delinquency rates ranging from 8 percent to 13 percent.[72] However, according to another executive, the company pushed ahead, buying billions of dollars worth of these loans "to ensure we hit share objectives and continue to diversify our customer base."[73]

Freddie Mac executives sought to control the risk of these junk mortgages by implementing certain minimum parameters such as only buying loans made to borrowers with at least a 680 credit score. However, in a nod to the competitive pressures of the market, the chief risk officer warned that "we have already had requests from [J.P. Morgan] Chase and Wells [Fargo] to allow this offering to go to 660 [credit scores]," and that competition between Fannie and Freddie "will likely compete the borrower profile [down] to a level where understanding income and assets really does matter. I don't know how to put the genie back in the bottle."[74] He continued:

> I know this is where the market is evolving…Having said that, we did no-doc lending [in the late 1980s and early 1990s], took inordinate losses and generated significant fraud cases. I'm not sure what makes us think we're so much smarter this time around.[75]

Another Freddie Mac executive admitted that pressure to reduce underwriting quality and purchase these loans was "largely driven by a need to allow lenders to compete" with reduced documentation mortgages at Countrywide and Bank of America.[76] At the same time, the chief risk officer also acknowledged that, "the push to do more affordable business and increase share means more borderline and unprofitable business will come in."[77]

FALLOUT: TAXPAYERS PAY FOR FANNIE'S AND FREDDIE'S BINGE ON RISKY MORTGAGES

As long as housing prices continued to rise, the GSEs' exposure to risky nonprime loans remained manageable. With the bursting of the bubble, however, the underlying weaknesses of Fannie Mae and Freddie Mac, caused by years of purchasing low-quality loans and dangerously high levels of leverage, began to show. In 2007, the GSEs reported combined losses of over $5 billion, the first full-year loss for Fannie Mae since 1985 and the first ever for Freddie Mac. These losses were dwarfed in 2008, however, when the GSEs reported combined year-end losses in excess of $108 billion. The companies' share prices plummeted by 60% between July 2007 and July 2008.[78]

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[72] *Id*.
[73] *See* Freddie Mac document produced to the Committee, Bates FMAC0013673.
[74] *See* Freddie Mac document produced to the Committee, Bates FMAC0013675.
[75] *See* Freddie Mac document produced to the Committee, Bates FMAC0013676.
[76] *See* Freddie Mac document produced to the Committee, Bates FMAC0013757.
[77] *See* note 68*, supra*.
[78] *See* Mark Jickling, Congressional Research Service, "Fannie Mae and Freddie Mac in Conservatorship," (September 15, 2008).

In response to these mounting losses, Congress finally passed much-needed reform legislation, the Housing and Economic Recovery Act of 2008 ("HERA"), which was signed into law on July 30. HERA created a new regulator, the Federal Housing Finance Authority ("FHFA") to replace OFHEO. Congress gave the new agency the power to review and approve new types of mortgages, set capital requirements, limit the GSEs' portfolio sizes, and force them to sell assets. FHFA was also granted the power to place Fannie and Freddie into conservatorship and reorganize them in order to prevent their insolvency.[79]

These reforms came too late to protect taxpayers from a huge government bailout. On September 7, 2008, FHFA, in consultation with Treasury Secretary Henry Paulson, exercised its new authority and placed Fannie Mae and Freddie Mac into conservatorship, wiping out common shareholders and taking on the responsibility for running the companies. In addition to the collapse of the GSEs' share price and their mounting losses, one of the factors in this decision appears to have been Treasury's discovery that the GSEs had overstated their capital reserves by $64 billion by relying on government-granted tax credits which they would probably never be able to use and were therefore worthless. Treasury also discovered that the GSEs were not marking losses on their subprime and Alt-A loans to market and were carefully managing their public reporting of these losses.[80] Finally, the full extent of the GSEs' involvement in risky lending had started coming to light. For example, in its 2007 10-K, filed in February 2008, Fannie Mae finally disclosed its large exposure to first mortgages with so-called "silent seconds" – second loans made to cover down payment and closing costs. Freddie Mac divulged its own exposure to such risky mortgages in its second quarter 10-Q filed in August 2008.

During the House Oversight and Government Reform Committee's investigation starting, in the fall of 2008, it became clear that Fannie Mae and Freddie Mac were in fact leaders in risky mortgage lending. According to an analysis presented to the Committee, between 2002 and 2007, Fannie and Freddie purchased $1.9 trillion of mortgages made to borrowers with credit scores below 660, one of the definitions of "subprime" used by federal banking regulators.[81] This represents over 54% of all such mortgages purchased during those years. If one factors in Alt-A and adjustable-rate mortgages, this analysis found that, at the end of 2008, Fannie and Freddie were still exposed to $1.6 trillion of risky default-prone loans. Thus, at year-end 2008, Fannie Mae and Freddie Mac were responsible for 34 percent of all outstanding subprime mortgages and 60 percent of all outstanding Alt-A mortgages in the United States.[82]

Fannie and Freddie were not only enabling a huge amount of subprime and Alt-A lending – the extremely high delinquency and default rates on these mortgages demonstrate that the GSEs were directly damaging both themselves and their borrowers. At year-end

[79] *See* Congressional Research Service, "Housing and Economic Recovery Act of 2008," (December 5, 2008).
[80] *See* Gretchen Morgenson and Charles Duhigg, "Mortgage Giant Overstated the Size of Its Capital Base," *The New York Times*, (September 7, 2008).
[81] *See* note 57, *supra*.
[82] *See* Edward Pinto, presentation to the American Enterprise Institute, "How Serious Is the Mortgage Problem That Will Confront President Obama?" (January 16, 2009).

2008, Fannie's and Freddie's main line of business by volume continued to be backing safe mortgage lending, with 66 percent of their exposure consisting of prime loans. As of December 31, 2008, this 66 percent exposure to prime mortgages, even with the deterioration in the housing market, was only suffering a serious delinquency rate of about 0.5 percent, accounting for only 10% of the GSEs' total losses. On the other hand, nonprime loans, which accounted for only 34% of the GSEs' risk exposure at the end of 2008, were suffering a 6% delinquency rate, accounting for 90% of the GSEs' losses.[83] Put another way, the GSEs'nonprime loans were 14 times more likely to be in serious delinquency than their prime loans. In the end, failures on nonprime GSE mortgages may account for the failure of roughly 1 in 6 home mortgages in the U.S., or 8.8 million foreclosures.[84]

The continuing losses caused by Fannie and Freddie's binge on junk mortgages have already cost the taxpayers dearly. Under the terms of their conservatorship, the U.S. Treasury is committed to inject up to $400 billion of capital into Fannie and Freddie to offset their losses and maintain solvency. These capital injections take the form of Treasury purchases of preferred stock in the companies. As of April 30, 2009, the Treasury had spent $59.8 billion on such purchases.[85] In addition, the Federal Reserve has also pledged to purchase GSE debt issuances, of which the Fed had bought nearly $77 billion worth as of May 20, 2009.[86] Finally, both Treasury and the Fed continue to purchase massive amounts of GSE mortgage-backed securities directly – over $567 billion-worth as of May 20, 2009.[87] The sum of these federal aid packages brings the total current taxpayer exposure to GSE liabilities to over $700 billion.

Even more than Wall Street firms, Fannie and Freddie used high leverage to borrow money and gamble on low-down payment affordable and speculative mortgages. Unlike Wall Street, however, the GSEs did this with the mandate and the blessing of Congress and successive Administrations, which encouraged them to use their government-granted competitive advantages to engage in a race to the bottom, boosting the national homeownership rate for political gain.

All told, the government experiment in unsustainable affordable mortgage lending based on low down payments and "flexible" credit criteria has sucked the equity out of the U.S. housing market, trapped millions of Americans under crushing debt, and seriously damaged global financial markets. In 2006, the value of U.S. housing was estimated at $22 trillion. By October 31, 2008 this had fallen to $18.5 trillion. As of the end of 2008, there was about $12 trillion in mortgage debt, of which 42 percent consisted of default-prone loans, with 70 percent of all mortgage debt guaranteed by the federal government. This means that at the end of 2008, the U.S. housing market had a loan-to-value ratio of

[83] *Id.*
[84] *Id.*

[85] *See* U.S. Department of the Treasury, "Monthly Treasury Statement of Receipts and Outlays of the United States Government," (April 30, 2009), *accessed at* http://fms.treas.gov/mts/mts0409.pdf.
[86] *See* Board of Governors of the Federal Reserve System, "Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks," (May 20, 2009), *accessed at*, http://www.federalreserve.gov/releases/h41/Current/h41.pdf.
[87] *See* notes 85 and 86, *supra*.

66 percent. If U.S. housing prices fall an additional 15 percent to $11 trillion by the end of 2009, the U.S. housing market will be leveraged at a ratio of 110 percent, meaning the market on average will be in negative equity, or "under water."

These statistics are alarming enough on their own, but the real tragedy of the government's affordable housing policy is the impact on average Americans, particularly those of modest means. Millions of these borrowers, who were supposed to have been helped by federal affordable housing policy, have now been forced into delinquency and foreclosure, destroying their asset base, their credit, and in some cases their families. For example, Latino homeowners, who once appeared to be among the most frequent beneficiaries of affordable housing policies, are now the victims of the policies that their political representatives in Washington once championed. According to the Pew Hispanic Center, nearly one-in-ten Latino homeowners said they had missed a mortgage payment or were unable to make a full payment, while 3 percent said they have received a foreclosure notice in the past year. At the same time, 62 percent of Latino homeowners said there have been foreclosures in their neighborhoods and 36 percent say they are worried about their own homes going into foreclosure.[88]

The consequences of these policies have also brought the entire global financial system to the brink of collapse, destroying trillions in equity and untold numbers of lives. It is essential to reexamine the borrow-and-spend, high-leverage policies that became prevalent in the mortgage market as a result of well-intentioned-but-reckless decisions made by elected officials on behalf of the American people. Without such a return to fiscal discipline and responsibility, we will continue making the same mistakes that led us to the current financial crisis.

Learning the Right Lessons

Washington must reexamine its politically expedient but irresponsible approach to encouraging higher levels of homeownership based on imprudently small down payments and too little emphasis on borrowers' creditworthiness and ability to repay their loans. Unfortunately, very few elected officials would be comfortable echoing Yale University economist and housing expert Robert Shiller, who writes: "[T]he subprime housing dilemma in the United States points up the problems with over-promoting homeownership. Homeownership, for all its advantages, is not the ideal housing arrangement for all people in all circumstances."[89] However, failing to learn the mistakes of our overleveraged binge on mortgage debt will almost certainly doom the country to repeating the same mistakes again and again.

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[88] *See* Mark Hugo Lopez, Gretchen Livingston and Rakesh Kochhar, Pew Hispanic Center, "Hispanics and the Economic Downturn: Housing Woes and Remittance Cuts," (January 8, 2009) at i.
[89] *See* Robert J. Shiller, *The Subprime Solution*, Princeton, NJ: Princeton University Press, (2008), at 6.

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