CONFERENCE DRAFT

The Failure of Fannie Mae and Freddie Mac
And the Future of Government Support for the Housing Finance System

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Thank you for the invitation to exchange views with this distinguished group of scholars and practitioners in the fields of housing, community development, and housing finance. This conference provides an excellent opportunity to place the failure of Fannie Mae and Freddie Mac into the larger context of the future of the troubled housing finance system.

In my remarks today I would like to invite discussion of three major sets of issues: (1) why Fannie Mae and Freddie Mac failed, (2) lessons we can learn from their failure, and (3) considerations regarding future government support of the residential mortgage market.

1. Why Fannie Mae and Freddie Mac Failed

On September 7, 2008, Fannie Mae and Freddie Mac voluntarily went into conservatorship. As they recognize their losses it becomes clear that taxpayer costs from the government backing of the two companies will be substantial.

The failure of Fannie Mae and Freddie Mac cannot be attributed solely to the housing credit bubble and collapse. Rather, it would appear that the collapse of the housing credit bubble was a precipitating event that (1) could have been avoided by more prudent practices by the GSEs and their management and (2) revealed shortcomings in the GSE as an institutional form.

Fannie Mae and Freddie Mac committed serious misjudgments that helped to bring about their insolvency. The most serious misjudgments involved the companies' resistance to accepting more effective supervision and capital standards. For years, starting with their successful efforts to weaken the legislation that established their regulator, the Office of Federal Housing Enterprise Oversight (OFHEO),[1] the two companies managed to fend off capital standards that would have reduced their excessive leverage and provided a cushion to absorb potential losses. In 2007 Freddie Mac concluded a stock buyback program that further weakened the company's ability to withstand a financial shock. As late as March 2008 Freddie Mac defied calls to increase its capital cushion.[2] As late as summer 2008 Fannie Mae continued to resist legislation that would give a federal regulator the discretion to set higher capital standards.[3]

[1] Among the many reports documenting the successful efforts of Fannie Mae and Freddie Mac at weakening the regulator and their capital standards, see, e.g., Carol Matlack, Getting Their Way, *National Journal*, October 27,1990, pp. 2584-2588; Jill Zuckman, "Bills To Increase GSE Oversight Move Ahead in House, Senate," *CQ Weekly*, August 3, 1991; Stephen Labaton, "Power of the Mortgage Twins: Fannie and Freddie Guard Autonomy," *New York Times*, November 12,1991, p. D1; Kenneth H. Bacon, "Privileged Position: Fannie Mae Expected to Escape Attempt at Tighter Regulation," *Wall Street Journal*, June 19,1992, p. A1.

[2] David S. Hilzenrath, "Chief Says Freddie Won't Raise Capital; Mortgage Financier Cites Responsibility to Shareholders, Won't Increase Loan Capacity," *Washington Post*, March 13, 2008, p. D4.

[3] Steven Sloan, "Fannie CEO Details Issues with GSE Bill," *American Banker*, June 5, 2008.

The companies fought for high leverage because this benefited their shareholders and managers, at least until the companies failed. Freddie Mac reported returns on equity of over 20 percent for most years since it became an investor-owned company in 1989, reaching highs of 47.2 percent in 2002 and 39.0 percent in 2000. Fannie Mae reported earnings of almost as much, reaching a high of 39.8 percent in 2001. The two companies fought higher capital requirements because more capital would have diluted those returns to shareholders.

The two companies compounded the problem of their self-inflicted structural vulnerabilities with a series of misjudgments that involved taking on excessive risk just at the point that housing prices were peaking. According to press reports, the chief executives of both Fannie Mae and Freddie Mac disregarded warnings from their risk officers and sought to catch up with the market by greatly increasing their purchases of risky loans.[4]

Freddie Mac reported in its 2007 Annual Report that,

> "The proportion of higher risk mortgage loans that were originated in the market during the last four years increased significantly. We have increased our securitization volume of non-traditional mortgage products, such as interest-only loans and loans originated with less documentation in the last two years in response to the prevalence of these products within the origination market. Total non-traditional mortgage products, including those designated as Alt-A and interest-only loans, made up approximately 30% and 24% of our single-family mortgage purchase volume in the years ended December 31, 2007 and 2006, respectively."[5]

Fannie Mae's 2007 Annual Report states:

> "We are experiencing high serious delinquency rates and credit losses across our conventional single-family mortgage credit book of business, especially for loans to borrowers with low credit scores and loans with high loan-to-value ("LTV") ratios. In addition, in 2007 we experienced particularly rapid increases in serious delinquency rates and credit losses in some higher risk loan categories, such as Alt-A loans, adjustable-rate loans, interest-only loans, negative amortization loans, loans made for the purchase of condominiums and loans with second liens. Many of these higher risk loans were originated in 2006 and the first half of 2007."[6]

Fannie Mae reported that purchases of interest-only and negative amortizing ARMs amounted to 7% of its business volume in 2007 and 12% in each of 2006 and 2005. Moreover, Alt-A mortgage loans "represented approximately 16% of our single-family business volume in 2007,

[4] David S. Hilzenrath, "Fannie's Perilous Pursuit of Subprime Loans: As It Tried to Increase Its Business, Company Gave Risks Short Shrift, Documents Show," *Washington Post,* August 19, 2008, p. D01; Charles Duhigg, "At Freddie Mac, Chief Discarded Warning Signs," *New York Times*, August 5, 2008; Charles Duhigg, "The Reckoning: Pressured To Take More Risk, Fannie Reached Tipping Point, *New York Times*, October 5, 2008.
[5] Freddie Mac, *Annual Report*, 2007, p. 13.
[6] Fannie Mae, *Annual Report*, 2007, p. 24.

compared with approximately 22% and 16% in 2006 and 2005, respectively."[7] Both companies also invested in highly rated private-label mortgage-related securities that were backed by Alt-A or subprime mortgage loans, amounting to total holdings by the two companies of over $ 200 billion in 2007.[8]

In short, the mix of private incentives and government backing created a dynamic that led not only to the hubris that brought about the meltdown of internal controls at both Fannie Mae and Freddie Mac a few years ago,[9] but also to their insolvency in 2008.

That said, Fannie Mae and Freddie Mac did not cause the housing bubble or the proliferation of subprime and other mortgages that borrowers could not afford to repay. In analyzing the dynamics of Fannie Mae and Freddie Mac I discovered a phenomenon that can be called Stanton's Law: *risk will migrate to the place where government is least equipped to deal with it.*[10] Thus, the capital markets arbitraged across regulatory requirements and ultimately sent literally trillions of dollars of mortgages to Fannie Mae and Freddie Mac, where capital requirements were low and federal supervision was weak.

However, the capital markets also found other places where government could not manage the risk, including structured investment vehicles of commercial banks, private securitization conduits, and collateralized debt obligations that were virtually unregulated except by the vagaries of the rating agencies and exuberance of the market during the housing bubble. Huge volumes of subprime, alt-A, interest-only and other toxic mortgages went to these parts of the market. As the bubble reached its limits and began to deflate the GSEs tried to catch up and regain the market share that they had lost to the new competition.

II. Lessons From the Failure of Fannie Mae and Freddie Mac

Many other kinds of financial institution have failed in the current debacle, including commercial banks, thrift institutions, mortgage companies, insurance companies and hedge funds. Among all of these, the government-sponsored enterprise manifests specific shortcomings that call the value of this institutional form into doubt.

In making their mistakes, Fannie Mae and Freddie Mac revealed the inherent vulnerabilities of the government-sponsored enterprise (GSE) as an organizational model.[11] First, the GSE lives

[7] *Ibid*, pp. 128-9.
[8] Fannie Mae, *Annual Report*, 2007, p. 93; Freddie Mac, *Annual Report*, 2007, p. 94.
[9] Thomas H. Stanton, "The Life Cycle of the Government-Sponsored Enterprise: Lessons for Design and Accountability," *Public Administration Review*, September/October 2007.
[10] This dynamic was first presented in my testimony before the Senate Banking Committee in a hearing on *The Safety and Soundness of Government Sponsored Enterprises*, October 31, 1989, p. 41, pointing out that increases in stringency of capital requirements and government supervision for thrift institutions after the savings and loan debacle would drive many billions of dollars of mortgages from the portfolios of savings and loan associations to Fannie Mae and Freddie Mac because their capital standards and government oversight were much weaker.
[11] A government-sponsored enterprise is a government chartered, privately owned and privately controlled institution that, while lacking an express government guarantee, benefits from the perception that the government stands behind its financial obligations. See, Ronald C. Moe *and* Thomas H. Stanton, "Government Sponsored Enterprises as Federal Instrumentalities: Reconciling Private Management with Public Accountability," *Public*

or dies according to its charter and other laws that determine the conditions under which it operates. That means that GSEs must balance their profit goals against public purposes and the interests of stakeholders that can influence their charters.

Second, the GSE combines private ownership with government backing in a way that creates a political force that can dominate virtually any safety-and-soundness framework. GSEs select their chief officers in good part based on ability to manage political risk rather than on their ability to manage two of the largest financial institutions in the world. Consider these issues in turn.

The GSE business model, involving private ownership and public purposes, is difficult if not impossible to manage.

The GSE business model, involving private ownership and public purposes, is difficult if not impossible to manage. Fannie Mae and Freddie Mac were more vulnerable than commercial banks or other federal instrumentalities to the contradictions between the requirement to serve private shareholders and the need to serve public purposes that stakeholders, including members of Congress, guarded and enforced.

It has long been recognized that GSEs are a special type of federal instrumentality, i.e., a private institution chartered under law to swerve public purposes. Other federal instrumentalities include most commercial banks and thrift institutions and other for-profit and nonprofit institutions.[12] In contrast to those other instrumentalities, the officers and directors of Fannie Mae and Freddie Mac seem to have had a much more difficult time balancing their fiduciary responsibilities to shareholders against the public purposes of their charter acts and pressure from stakeholders to carry out public purposes that may not have helped the GSEs to protect themselves as sources of long term strength to the housing market.

Perhaps most eloquent on this issue was Daniel Mudd, the former CEO of Fannie Mae, who testified in December 2008 that:

> "I would advocate moving the GSEs out of No Man's Land. Events have shown how difficult it is to balance financial, capital, market, housing, shareholder, bondholder, homeowner, private, and public interests in a crisis of these proportions. We should examine whether the economy and the markets are better served by fully private or fully public GSEs."[13]

Administration Review. July/August 1989. This definition is consistent with the definition Congress enacted in amendments to the Congressional Budget Act of 1974, codified at 2 U.S.C. Section 622 (8).

[12] See, e.g., Thomas H. Stanton, *A State of Risk: Will Government-Sponsored Enterprises be the Next Financial Crisis?*HarperCollins, 1991, Appendix A ("Laws, Cases, and other Legal Sources on Government-Sponsored Enterprises"); and Thomas H. Stanton, "Federal Supervision of Safety and Soundness of Government-Sponsored Enterprises," *The Administrative Law Journal*, Summer 1991.

[13] Daniel H. Mudd, Written Statement, Before the Committee on Oversight and Government Reform U.S. House of Representatives, December 9, 2008, available at http://oversight.house.gov/story.asp?ID=2252, accessed February 7, 2009. Richard Syron, Freddie Mac's former CEO, pointed to the same issue:

> "Freddie Mac is a shareholder-owned corporation, chartered for the public purpose of supporting America's mortgage finance markets, and operating under government mandates. We had

There were several reasons why Fannie Mae and Freddie Mac were so susceptible to being whipsawed between their fiduciary obligations to shareholders and their public purposes. A major source of mischief was the fact that the two companies were chartered by act of Congress rather than by a federal regulator. Members of Congress constantly could pressure Fannie Mae and Freddie Mac to undertake unwise lending policies, for fear that Congress otherwise might impose higher capital requirements or other restrictions that were unwelcome to shareholders. Mr. Mudd testified, for example, that he felt pressure to increase Fannie Mae's market activity even as other institutions were stepping back because of declining market conditions.

In addition, the GSEs selected a political strategy of achieving short-term goals at the potential cost of longer term achievements. Their refusal to accept bank-type capital requirements and a bank-type supervisory framework for accountability has already been mentioned. The GSEs marshaled so much political power that they simply dominated their environment and dampened feedback signals that might have helped company officials to make better decisions.[14] In return, however, the GSEs had to buy off stakeholders with large volumes of mortgage purchases that they, or at least their risk officers, knew were unwise.

Those interested in seeing some of the pressures on the companies and the nature of mistakes that the GSEs made in 2005-7, including overriding warnings from risk officers but assuming that credit risk would be appropriately managed, and seeking yield and market share despite added risk from nontraditional mortgage products, may wish to consult confidential company documents that the House Committee on Oversight and Government Reform released on December 9, 2008.[15]

In their governance shortcomings the two GSEs compounded the more general problem that the current debacle has revealed. Alan Greenspan put it best:

> "I made a mistake in presuming that the self interest of organizations, specifically banks and others, was such that they were best capable of protecting their own shareholders and the equity in the firms."[16]

> obligations to Congress and to the public to promote our chartered purposes of increasing affordability, liquidity and stability in housing finance, which included some very specific low-income housing goals. We also had obligations to our regulator to pursue our goals in a manner that was prudent and reasonable. And, at the same time, we had fiduciary obligations to our shareholders that were the same as any other publicly traded company. Freddie Mac always worked hard to balance these multiple obligations, and for decades the company was effective."

Richard F. Syron, Statement, Before the Committee on Oversight and Government Reform U.S. House of Representatives, December 9, 2008, available at http://oversight.house.gov/story.asp?ID=2252, accessed February 7, 2009.

[14] This problem is analyzed with respect to the two GSEs' failed internal controls in Thomas H. Stanton, "The Life Cycle of the Government-Sponsored Enterprise: Lessons for Design and Accountability," *Public Administration Review*, September/October 2007.

[15] Three sets of documents are available at the committee website, http://oversight.house.gov/story.asp?ID=2252, accessed February 7, 2009.

[16] Kevin G. Hall, "Greenspan takes some blame for financial meltdown," McClatchy Newspapers, October 23, 2008, http://www.mcclatchydc.com/staff/kevin_hall/v-print/story/54712.html, accessed 12-06-2008

There are huge governance implications of this statement, coming as it does from a firm believer in the efficiency of market forces. Not only GSEs, but other financial institutions sought ways to increase their leverage and reduce the quality of their supervision by government. But there was a difference. As they served the perceived interests of their shareholders, banks and other investors were filled with the irrational exuberance of the market bubble; in addition, the GSEs faced, and failed to manage, stakeholder pressure to engage in activities that they probably knew, and their risk officers did know, could inflict serious harm on the companies.

The GSE combines private ownership with government backing in a way that creates a political force that can dominate virtually any safety-and-soundness framework. The statutory framework of GSEs also creates special financial vulnerability because of the incentives that GSEs have to appoint CEOs and senior management that are politically adept and who may not necessarily be experienced at managing a major financial institution.

A GSE lives or dies according to the terms of its enabling legislation. Especially GSEs such as Fannie Mae and Freddie Mac that are directly chartered by Congress, but also GSEs such as the Federal Home Loan Bank System that are chartered by their regulator, have tended (albeit not invariably) to select CEOs and other top managers because of their ability to manage political risk rather than the risks that derive from their financial activities. This was seen in the newest GSE, Farmer Mac, which returned to the Congress several times since its original authorization in 1987 to obtain adjustments to its charter powers to allow it to offer increasingly profitable financial services. Farmer Mac has never been a strong success in public policy terms[17] and has invested heavily in assets that that have nothing to do with meeting public needs.[18]

Fannie Mae and Freddie Mac made a practice of mastering political risk, both by providing blandishments to favored members of the political establishment and other stakeholders, and by applying pressure to contain threats to what the companies considered their franchise value.[19]

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[17] U.S. General Accounting Office, Farmer Mac: Revised Charter Enhances Secondary Market Activity, But Growth Depends on Various Factors, GAO/GGD-99-85, May 1999

[18] Among other investments having nothing to do with its public purpose, in September 2008 Farmer Mac held in its investment portfolio $50.0 million of Fannie Mae floating rate preferred stock and $60.0 million of Lehman Brothers senior debt securities. After taking losses on these investments the GSE was recapitalized on September 30, 2008 by issuing new stock to institutions of the Farm Credit System, another GSE, and thereby averted insolvency. See Farmer Mac, *Form 10-Q Quarterly Report for the Period Ended September 30, 2008*.

[19] This has been a long-standing policy. In 1991 Representative Jim Leach (R-IA) stated:

> "[I]t is not surprising that Fannie and Freddie are beginning to exhibit that arrogant characteristic of a duopoly, controlling 90% of the market. Such market dominance allows for heavy-handed approaches to competitors, to financial intermediaries, and to consumers. Competitors such as community based savings and loan associations and commercial banks are also users of GSE services. They are understandably apprehensive about expressing reservations about their practices in fear of retaliation. Likewise, would-be competitors such as securities firms run well known market risks if they object or attempt to compete with Fannie and Freddie. The two GSEs distribute billions of dollars of business on Wall Street and have a reputation of not cottoning to challengers of the status quo."

U.S. House of Representatives, "Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991," Report of the Committee on Banking, Finance and Urban Affairs, H.Rpt. No. 102-206, to accompany H.R. 2900, September 17, 1991, at p. 122 (Dissenting Views of Representative Jim Leach).

The GSEs are active participants in the process of influencing policymakers, and especially those who are in positions to affect their charter legislation. On April 19, 2006, Freddie Mac paid a record fine to the Federal Election Commission to settle charges that the company violated federal law by using company resources to hold some $ 1.7 million in fundraisers, many involving the then-Chairman of the House Financial Services Committee. That committee is responsible for the legislation that created both Fannie Mae and Freddie Mac and that periodically considered legislation to address shortcomings in their supervision.

Thanks to the lobbying power of Fannie Mae and Freddie Mac, the Office of Federal Housing Enterprise Oversight (OFHEO) had been created as an institution that lacked the capacity needed to do its job. OFHEO was limited by the appropriations process and had a budget that was much smaller, compared to its responsibilities, than the budgets of federal bank regulators.

Whenever OFHEO tried to do its job well, as in the 2004 Special Examination Report on Fannie Mae, it felt political pressure. Fannie Mae lobbyists generated a congressional request for the Inspector General (IG) of the Department of Housing and Urban Development (HUD) to investigate OFHEO's conduct of the special examination. Between October 2002 and June 2004, there had been three other congressional requests for IG investigations of OFHEO. Fannie Mae lobbyists also tried to use the appropriations process to force a change in the leadership of OFHEO. They convinced the relevant Senate Appropriations Subcommittee to try to withhold $10 million from OFHEO's appropriation until a new OFHEO director would be appointed.

The enactment of a stronger supervisory framework in 2008 meant that the new regulator, the Federal Housing Finance Agency (FHFA) no longer was subject to the appropriations process. However, the political strength of the GSEs was reflected in the fact that the new legislation, improving as it did on the old law, continued to deny the regulator the mandate, discretion, or authority to regulate safety and soundness that federal bank regulators have long possessed.[20]

The new law, the Housing and Economic Recovery Act of 2008 (HERA) became law less than two months before Fannie Mae and Freddie Mac failed. Ultimately the two GSEs were not well served by their tradition of selecting politically capable CEOs who could fend off the kind of supervision that a more capable regulator might have been able to provide.

Because of their government backing and low capital requirements in their charters, Fannie Mae and Freddie Mac gained immense market power. They doubled in size every five years or so until in 2008 the two companies funded over $ 5 trillion of mortgages, over 40 percent of the mortgage market.

Their market power gave them political power. Whenever someone would urge regulatory reform, such as higher capital standards to reduce the GSEs' dangerous leverage, huge numbers of constituents could be expected to flood Capitol Hill.[21] That political power in turn entrenched the GSEs' market power.

[20] To give but one example, the new law required the new regulator to conduct an estimated 25-30 rulemakings, often with short deadlines, to implement key provisions of the act. The bank regulators have discretion in many of the areas where HERA sought to impose inflexibility upon the FHFA through required rulemakings.

[21] Observers have long noted this pattern. "Builders, real estate brokers and bankers across the country rely so heavily on Fannie Mae for mortgage funds that they live in fear of offending the firm and routinely defend it in

The experience of Fannie Mae and Freddie Mac as privately owned institutions with extensive government backing shows the shortcomings of the government-sponsored enterprise as an organizational model. However sound the accountability structure may be when the organization begins, the incentive to satisfy private owners will lead a GSE to try to weaken safety and soundness oversight and lower capital standards. Both Fannie Mae and Freddie Mac arguably had more effective accountability structures when they were chartered as GSEs than when they were supervised by OFHEO. Between 1968 and 1992, when OFHEO was established, both companies had successfully removed government controls that they considered unacceptable.

In short, the drive to satisfy shareholders is intense and easily can overwhelm considerations of what might be best for the financial system, the housing system, or American taxpayers.

III. What Should be Done With the GSEs Now?

This question must be separated into two parts, first how the government should use the two failed GSEs to support today's troubled mortgage market, and second, what should happen with the GSEs in, say five years, after the housing market has begun to recover.

A. The government should place Fannie Mae and Freddie Mac into receivership and allow them to function as wholly owned government corporations to support the mortgage market.

The government placed Fannie Mae and Freddie Mac into conservatorship rather than receivership. Unlike receivership, the voluntary acceptance of conservatorship by Fannie Mae or Freddie Mac was not subject to litigation, which could have further roiled the financial markets. Placing a failed financial institution directly into conservatorship violates the customary practice of the federal bank and thrift regulators who first place an institution into receivership, then separate the assets into a "good-bank/bad-bank" structure and send the good bank, cleaned out of troubled assets, into conservatorship or bridge-bank status. Placing an institution into receivership removes the shareholders of the defunct institution. Thus, when IndyMac failed, it was placed into receivership. The receiver then transferred the deposits and most of the assets to a newly chartered thrift, IndyMac Federal Bank. The FDIC then placed itself as conservator of the new IndyMac Federal Bank.

As past losses materialize and are recognized by Fannie Mae and Freddie Mac it has become clear that both institutions have lost their entire net worth. It is time to place both companies into receivership. Placing both companies into receivership will help to remove an inherent conflict in the government's position. Technically, conservatorship means that the government is working to restore the companies to financial health. The government has preserved the shareholders in the two companies and allowed their stock to trade freely. This is inconsistent in key aspects with the government's need to use the two companies, now that the value of shareholder

Washington." David A. Vise, "The Money Machine: How Fannie Mae Wields Power," *Washington Post*, January 16, 1995, p. A14.

holdings in the companies is zero, to support the mortgage market. Until shareholders are removed from the equation, officers and directors of the two companies will face conflict as to their fiduciary responsibilities. Do they price mortgage purchases low to support the market or do they price higher to replenish the companies' shareholder value?[22]

With shareholders still in the equation government must try to cobble unwieldy support such as using the Federal Reserve to buy mortgage-backed securities of the two companies as a way to lower mortgage rates.

If the government placed both companies into receivership, then we could use Fannie Mae and Freddie Mac as agents of reform for the mortgage market. They could fund mortgages in a manner targeted to meet pressing public purposes. They could begin to impose essential consumer protections for borrowers, such as Alex Pollock's one-page borrower disclosure form.[23] They also could begin to devise and impose requirements that primary lenders and other participants in the mortgage process have appropriate financial strength and capability and accountability before they are allowed to do business with the two companies. In short, the government could turn the collapse of Fannie Mae and Freddie Mac into an opportunity to begin to fashion important rules of conduct for those types of participants in the housing market that have served American consumers and taxpayers so poorly. The government also could use the GSEs to help shore up the Federal Housing Administration by providing technical and IT systems support.[24]

The Congress also would be well advised to place a sunset provision of perhaps five years into each company charter. As the sunset approaches, and the mortgage debacle hopefully is behind us, policymakers can decide whether further support for the mortgage market is required, and the organizational form that is most suitable.

B. Fannie Mae and Freddie Mac should not again become privately owned organizations that operate with federal backing.

For many reasons, it is important now to end the GSE status of Fannie Mae and Freddie Mac. First, the GSEs have now squandered a policy tool that government had used for decades: the perception of an implicit rather than explicit federal guarantee of their debt obligations. That means that government would need to provide some form of express guarantee if the GSEs were to be restored. Second, as has was seen in the savings and loan debacle and now with the GSEs, the government risks far too much trying to insure the liabilities of a specialized financial institution. If policymakers were to seek to support the mortgage market they should authorize government guarantees of mortgage assets or, at most, mortgage-backed securities. Third, the government should not provide special charters to a limited number of specialized institutions.

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[22] The two companies themselves complain of the conflict in their roles in conservatorship. Fannie Mae Form 10Q filing for the quarterly period ended September 30, 2008, p. 7; Freddie Mac Form 10Q filing for the quarterly period ended September 30, 2008, p.5.

[23] Alex Pollock's one page mortgage form can be found at http://www.aei.org/scholars/scholarID.88/scholar.asp. It is attached below.

[24] FHA's need for enhanced capacity is discussed, e.g., in Thomas H. Stanton, "Strengthening Government's Ability to deal with the Financial Crisis," IBM Center for the Business of Government, March 2009, found at http://www.businessofgovernment.org/pdfs/StantonFinancial.pdf.

As the GSEs have shown, it is virtually impossible to protect the regulator of a few institutions from being dominated. This is especially true if the regulated institutions operate under a law such as HERA, that provides for different rules, especially for capital, but also for other aspects of safety and soundness, than apply to other institutions in the same lines of business. Fourth, proposals to craft special rules such as trying to regulate the GSEs as public utilities or by limiting them to cooperative ownership will not overcome the vulnerabilities of the GSE as an institutional form that is based on political dominance. Consider each of these issues in turn.

The implicit government guarantee of GSE obligations is no longer available as a policy tool.

In earlier years, government was careful to preserve the option that it would decline to bail out holders of GSE obligations and GSE-guaranteed mortgage-backed securities. Treasury regularly counseled that the government's involvement should be characterized as merely the "perception of an implicit guarantee" rather than as an actual implicit guarantee. These niceties began to erode with the financial rescue of the failed Farm Credit System in the mid-1980s and the government's rush to support obligations of the Funding Corporation (FICO) in 1996. With the financial rescue of Fannie Mae and Freddie Mac debtholders and MBS-holders in 2008, the perception of implicit government backing of GSEs has become an anachronism. If the Federal Home Loan Bank System continues on its current financial trajectory, that institution may add to the market's expectations that a GSE is backed by an explicit rather than implicit government guarantee.

One consequence of the destruction of the implicit guarantee is that government in the future either will be required to provide an express guarantee, backed by the full-faith and credit of the United States, or none at all. Another consequence is that, unlike the former implicit federal guarantee, explicit government guarantees are subject to scoring on the federal budget comparable to the treatment of Ginnie Mae's financial guarantees by the Office of Management and Budget. The days of the GSE as a source of an off-budget government subsidy for housing finance are coming to an end.

The government risks far too much trying to insure the liabilities of a specialized financial institution.

As periodic failures of federal guarantee programs have shown,[25] the government can and sometimes does lose the capacity to supervise use of its financial guarantee. The Federal Housing Administration's single-family mortgage insurance program currently would seem to be especially at risk, for example.[26] However, a guarantee of assets rather than liabilities has several advantages for the government and taxpayers. First, asset guarantees are subject to oversight through the federal budget and the application of credit budgeting. This allows the Office of Management and Budget to monitor the risks involved in extending the guarantee and to provide

[25] See, e.g, Leonard Downie, Jr., *Mortgage on America*, Praeger Publishers, 1974, for a discussion of the failure of HUD single-family and multifamily programs in the early 1970s.
[26]See, e.g., HUD Secretary Steve Preston, Prepared Remarks at the National Press Club, November 19, 2008; and Barry Meier, "As FHA's Role Grows, So Does the Risk of Fraud," *New York Times*, December 10, 2008., available at http://www.hud.gov/news/speeches/2008-11-19.cfm, accessed January 2, 2009.

feedback to the agency and program through the annual process of reestimating the budgetary costs. As can be seen with programs such as federal deposit insurance and guarantees of the Pension Benefit Guaranty Corporation (PBGC),[27] for example, this form of supervision and discipline is sorely lacking for federal programs that guarantee liabilities rather than financial assets.

Second, it is less difficult to monitor the risks inherent in a guarantee of assets than in a guarantee of liabilities. For a guarantee of assets, the government must monitor the quality of origination, servicing, and collections, and the credit quality of the assets themselves. By contrast, monitoring a guarantee of liabilities of a financial institution involves trying to assess the quality of the institution's management, its capitalization, its accounting practices, and many other potential sources of risk besides the quality of its assets.

Third, as was seen most clearly in the savings and loan debacle, a federal guarantee of an institution's liabilities creates a form of moral hazard that can greatly multiply the government's risk exposure, compared to the actual volume of liabilities that government believes that it is guaranteeing. By contrast, when government guarantees financial assets or even pools of financial assets, it can provide for risk sharing that, at least in principle, can reduce the government's potential losses.

For all of these reasons, if government can avoid guaranteeing the liabilities of a private institution, it should do so. In the case of providing support for the residential mortgage market, this conclusion is bolstered by the fact that federal mortgage insurance, or perhaps a federal guarantee of pools of mortgages, with appropriate risk-sharing with the loan originator, can provide needed support for the mortgage market without incurring the risks involved in trying to guarantee the liabilities of a GSE. It seems prudent that the future structure of housing finance must take account of the difficulty that both public and private sector managers can have in trying to manage a large volume of assets and mortgage-backed securities.

The government should not provide special charters to a limited number of specialized institutions.

Regulatory capture is a major problem for federal regulators of all types.[28] The problem is especially acute for a regulator of only a few institutions. Such a regulator can be expected to assume a parochial point of view compared to a regulator with responsibility for supervising a plethora of institutions with varying interests and perspectives.[29] The problem becomes

[27] The law states that liabilities of the PBGC are not backed by the United States. As with the backing of GSE obligations that the GSEs disavow in their loan documentation, no one believes this.
[28] See, e.g., Marver Bernstein, *Regulating Business by Independent Commission*, Princeton University Press, 1955.
[29] The GAO has made similar observations and earlier recommended that all of the GSEs be supervised by a single high-level regulator:

> "Because of its important responsibility to supervise the safety and soundness of all the enterprises, the members of the independent regulator's board need to have sufficient status, respect in government and business, and financial expertise. GAO proposes a three-member board composed of a full-time chairperson who acts as the chief executive officer of the regulatory staff, the Secretary of the Treasury, and the Chairman of the Federal Reserve System."

U.S. General Accounting Office, *Government-Sponsored Enterprises: a Framework for Limiting the Government's Exposure to Risks*, GAO/GGD-91-90, May 1991, p. 8. This recommendation failed to be adopted, in part because it especially acute for institutions such as GSEs that fall into a hybrid category between other organizational types. Take, for example, the issue of appropriate capital standards: should GSE capital standards be set according to bank-type standards or according to the standards that state regulators apply to private mortgage-backed securities conduits? A regulator with responsibility for supervising only the housing GSEs is likely to move towards the lower capital standards. This opens the door to regulatory arbitrage and the likelihood that the GSEs once again would resume their excessive growth, based on their regulatory advantages rather than on whether it makes sense to concentrate so much risk in a few specialized financial institutions.

The inability of the Congress to set bank-type capital standards for Fannie Mae and Freddie Mac or to create for them a supervisory framework that was at least as strong as the supervisory framework for banks stands as a warning of the political dynamics that are at play here. As specialized institutions, GSEs tend to be the province of parochial committees or subcommittees of the Congress that are attuned to the benefits of GSEs for the stakeholders whom they serve and are relatively insensitive to the need to protect ordinary taxpayers from having to pay for an expensive rescue.

The prospect of differential capital and other supervisory requirements that permit regulatory arbitrage relates to the problem of GSEs becoming not only “too big to fail,” but also “too big to succeed.” Along with other financial institutions, Fannie Mae and Freddie Mac have shown, at great cost to the residential mortgage market and larger financial system, that the GSEs and their politically oriented managers lack the ability to manage such large institutions. The failure of internal controls at both GSEs occurred in 2003-4, when they were smaller than they were when they failed completely several years later.

Again, if government guarantees assets rather than liabilities, support can be provided to the residential mortgage market without incurring the political and financial risks that a GSE entails.

III. Evaluating the GSE as an Organizational Form

The Government Sponsored Enterprise tends to have greater capacity and flexibility than the government agency, but is much less accountable and exhibits life cycle vulnerabilities.

Four criteria are helpful in evaluating the quality of agencies and instrumentalities of government that carry out public purposes:[30]

> *Capacity*: What is the capacity of the organization, in terms of people, administrative budget, systems, and organization, to carry out its public purposes?

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could have placed congressional jurisdiction over the regulator into a broad-based committee such as the House Ways and Means Committee rather than in the hands of the GSE authorizing committees.

[30] See, e.g., Thomas H. Stanton, “The Administration of Medicare,” *Washington and Lee University Law Review*, 2003; and, Thomas H. Stanton, “Moving Toward More Capable Government: A Guide to Organizational Design,” Chapter 1 in Thomas H. Stanton, ed., *Meeting the Challenge of 9/11: Blueprints for Effective Government*, M.E. Sharpe Publishers, 2006.

> *Flexibility*: What flexibility does the organization have, under the law and in practice, to carry out its public purposes?
>
> *Accountability*: How well is the organization held accountable for (1) carrying out its public purposes, and (2) its stewardship of public resources?
>
> *Life Cycle*: As the organization matures, what strengths and shortcomings manifest themselves?

For different organizations different measures will become more critical than others in understanding strengths and weaknesses. As a general rule, to the extent that weaknesses appear, government departments may have difficulty with the measures of capacity and flexibility, while privately owned instrumentalities may have difficulty with accountability. Numerous organizations of all types have difficulty with life-cycle, and the ability to remain active, focused and useful over many years.

Government sponsored enterprises are privately owned institutions free from the budgetary and other constraints imposed on government agencies. As such they tend to develop significant capacity and flexibility compared to government agencies that serve the same economic sector. A comparison of mortgage operations of Fannie Mae and Freddie Mac on the one hand and the Federal Housing Administration (FHA), on the other, displays this pattern.

On the other hand, the issue of accountability is salient for GSEs, and Fannie Mae and Freddie Mac in particular. As private companies operating with substantial government subsidies, GSEs often grow to dominate their markets. Market power leads to political power which in turn leads to favorable changes to the GSE's charter to help expand its market power and reduce the effectiveness of any accountability framework government may seek to apply to the GSEs.

The issue of life cycle is also important for the GSEs. The rapid growth of GSEs, combined with their dominance of accountability measures such as government oversight and capital requirements can lead to flawed business decisions.[31] The current crisis in the mortgage market raises issues of GSE accountability and life cycle with special force.

Proposals to craft special rules such as trying to regulate the GSEs as public utilities or by limiting them to cooperative ownership will not overcome the vulnerabilities of the GSE as an institutional form that is based on political dominance.

Proposals to create a different accountability framework or governance structure for Fannie Mae and Freddie Mac do not change the assessment of the GSE, even with those changes, as an organizational form. Most importantly, the issue of political dominance of the GSEs over their regulators and GSE influence over their congressional authorizing committees will not go away.

Some have suggested that Fannie Mae and Freddie Mac can be regulated as public utilities. This suggestion has several defects. The first issue relates to the purpose of utility regulation.

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[31] See, e.g., Thomas H. Stanton, "The Life Cycle of the Government-Sponsored Enterprise: Lessons for Design and Accountability," *Public Administration Review,* September/October 2007.

Regulation is called for when public utilities benefit from scale economies that may give them characteristics of monopolies; price regulation by a public utility commission seeks to prevent a public utility from imposing monopoly pricing on its customers.

In other words, rather than limiting the size of a public utility, government accepts a utility's dominant market position and seeks to limit the high prices that could result. But taxpayers are far too much at risk if the GSEs grow to hold a dominant position in the mortgage market, regardless of price regulation. Given that the problem facing taxpayers in today's context is one of limiting the size of GSEs and their financial risks rather than controlling monopoly pricing, the public utility model is not relevant.

Secondly, regulated companies too often capture their regulators. Many a political scientist has written, for example, about the dominance of the Interstate Commerce Commission by the railroads that the ICC was supposed to regulate. The GSEs would simply shift the application of their political power from domination of their past regulators to the new public utility regulator.

Third, the creation of a separate utility-type regulator for the GSEs, rather than merging supervision with the responsibilities of a regulator that supervises banks and thrifts as well as GSEs, again would encourage the preferential capital and supervisory requirements that lie at the core of GSE financial vulnerability.

In short, application of a public utility model to Fannie Mae and Freddie Mac would perpetuate many of the vulnerabilities and large-scale risks of the GSE model that lie at the root of their failure in 2008.

A cooperative governance structure also fails to add quality to the GSE model. This has been seen among the GSEs in the financial failure of the Farm Credit System in the mid-1980s and the precarious financial condition of the Federal Home Loan Banks today. While the investor-owned GSE seeks to increase risk to serve its investor owners, the cooperative GSE has an incentive to increase risk to serve its owners that use its services. That was seen in the efforts of the Farm Credit System to provide credit to its cooperative borrowers below the GSE's own cost of funds. That approach could not be sustained and led to the system declaring insolvency in the mid-1980s.

IV. To Help Stabilize the Mortgage Market the Government Should Provide Support to the Residential Mortgage Market Through One or Two Wholly Owned Government Corporations. Thereafter the Government Should Largely Withdraw From Supporting the Secondary Market

As has been recommended above, the government should promptly end Fannie Mae and Freddie Mac as investor-owned companies with perceived federal backing and turn today's Fannie Mae and Freddie Mac into separate wholly owned government corporations. At some specified time, say five years from now, when the mortgage market stabilizes once again the government would wind up those corporations.

This approach deals both with the capacity and the life-cycle disadvantages that otherwise can accompany the creation of wholly owned government corporations. Having a five year sunset period would allow the wholly owned government corporations to provide support for the mortgage market at a critical time. The experience of the Resolution Trust Corporation (RTC) indicates how a temporary government corporation can develop the capacity to deal with complex financial issues. It does this by attracting high-quality talent who might not contemplate a longer term career in government. The RTC was impressive in the way that it evolved constant improvements in its approach to its mission.[32]

Even though the Congress could allow one or both of the government corporations to sunset at the end of their charter terms, this is not a foregone conclusion. The continuation of a government corporation could appeal to some policymakers because of the ability to use revenues from mortgage operations to support affordable housing, which the congressional housing subcommittees strongly favor.

Some argue that government support is needed to ensure access to the 30-year fixed-rate mortgage at all times during the credit cycle. The presence of the GSEs, with their massive federal subsidies, has distorted the market so that we have no clear idea what the private market will be able to fund by itself. One possibility would be to use a government corporation to provide government support for a 30-year fixed-rate mortgage only for selected borrowers such as first-time homebuyers.

Just as one must question whether a GSE or other private institution is properly manageable once it funds, say, a trillion dollars of mortgages, one must also question whether managers of wholly owned government corporations will be up to the task. As a matter of protecting taxpayers from excessive financial risk there should be limits on the size of both public and private institutions that provide financial support to the mortgage market. One clear lesson of the current debacle is that it is too risky to maintain immense financial institutions of any kind over the long term. This logic may lead policymakers to sunset the government corporations that have been proposed here to assist during the current period of instability. If so, the model of the wholly owned government corporation would remain available when needed to provide government support for the mortgage market in the event of any future crisis.

V. Conclusion

The government sponsored enterprise has outlived its usefulness as an instrument of government policy. While other financial institutions have also shown vulnerability, the GSE appears to be especially prone to dominating any reasonable accountability structure. GSEs are simply too powerful for their own good. Fannie Mae and Freddie Mac, now demonstrably insolvent, should be placed into receivership and turned into wholly owned government corporations that sunset after perhaps five years. As such they could support the mortgage market, not only through their access to government funding, but also by imposing rules for consumer and investor protection,

[32] See, e.g., Thomas H. Stanton, "Lessons Learned: Obtaining Value From Federal Asset Sales," *Public Budgeting & Finance*, Spring 2003.

capital requirements on mortgage market participants, and other protective measures that policymakers could apply to the rest of the housing finance system.

About the Author

Thomas H. Stanton is a Fellow of the Center for the Study of American Government at Johns Hopkins University. He is a member of the board of directors of the National Academy of Public Administration and a former member of the federal Senior Executive Service. His publications include two books on government-sponsored enterprises (GSEs) and two edited books on federal organization and management. Concerns expressed in A *State of Risk: Will Government Sponsored Enterprises be the next Financial Crisis?* (HarperCollins, 1991) helped lead to enactment of several pieces of legislation and the creation of a new GSE regulator. Mr. Stanton's B.A. degree is from the University of California at Davis, M.A. from Yale University, and J.D. from the Harvard Law School.