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# Lessons from Public Administration: Recommendations for the Future of Fannie Mae and Freddie Mac and Other Aspects of Government's Response to the Financial Debacle

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# Lessons from Public Administration: Recommendations for the Future of Fannie Mae and Freddie Mac and Other Aspects of Government's Response to the Financial Debacle

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## ABSTRACT

This paper applies lessons from public administration to explore the failure of Fannie Mae and Freddie Mac, makes recommendations about their future, and suggests other improvements in government's response to the financial debacle. The two GSEs fought successfully against effective supervision and capital standards and plunged into risky mortgage investments. The two insolvent GSEs should go into receivership to be used as wholly owned government corporations to support the mortgage market without conflicting loyalties. Also, capacity of government agencies such as the Federal Housing Administration (FHA) that are supposed to play important roles in the financial recovery must be increased.

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# Lessons from Public Administration: Recommendations for the Future of Fannie Mae and Freddie Mac and Other Aspects of Government's Response to the Financial Debacle

In devising the government's response to the Great Depression, President Franklin Roosevelt turned not only to bankers, economists and lawyers, but also to scholars and practitioners in the field of public administration such as Charles Merriam and Louis Brownlow.[1] This paper seeks to build on that tradition. While other disciplines concern themselves with devising appropriate policies, public administration focuses more on trying to ensure that those policies can be effectively implemented.

This paper is based on lessons from public administration, and especially the art of organizational design, that help to understand the failure of Fannie Mae and Freddie Mac and also provide insights about government agencies that must play effective roles in responding to the financial debacle. This paper recommends both that it is time to place the two government-sponsored enterprises (GSEs) into receivership to use as wholly owned government corporations to support the mortgage market without conflicting loyalties, and also that government increase the capacity of government agencies that are supposed to play roles in the financial recovery. Public confidence could be seriously shaken by an operational failure at a major agency such as the Federal Housing Administration (FHA) that along with the GSEs is supposed to be supporting the mortgage market. Issues of organizational design can become very detailed very quickly; this paper makes two specific proposals about improving government's capacity but refrains from exploring the restructuring of financial regulatory agencies at this point, before specific regulatory agency proposals are on the table.

## I. 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.

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),[2] the two companies managed to fend off capital standards that would have reduced their excessive leverage and provided a cushion to absorb potential losses.

[1] See, e.g., Peri E. Arnold, *Making the Managerial Presidency: Comprehensive Reorganization Planning, 1905-1996*, second edition, University of Kansas Press, 1998, chapter 4, "Managing the New Deal."

[2] 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.

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.[3] As late as summer 2008 Fannie Mae continued to resist legislation that would give a federal regulator the discretion to set higher capital standards.[4]

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 increase market share by greatly increasing their purchases of risky loans.[5]

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."[6]

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.

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[3] 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.
[4] Steven Sloan, "Fannie CEO Details Issues with GSE Bill," *American Banker*, June 5, 2008.
[5] 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.
[6] Freddie Mac, *Annual Report*, 2007, p. 13.

> Many of these higher risk loans were originated in 2006 and the first half of 2007."[7]

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, compared with approximately 22% and 16% in 2006 and 2005, respectively."[8] 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.[9]

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,[10] 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.*[11] 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.

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[7] Fannie Mae, *Annual Report*, 2007, p. 24.
[8] *Ibid*, pp. 128-9.
[9] Fannie Mae, *Annual Report*, 2007, p. 93; Freddie Mac, *Annual Report*, 2007, p. 94.
[10] Thomas H. Stanton, "The Life Cycle of the Government-Sponsored Enterprise: Lessons for Design and Accountability," *Public Administration Review*, September/October 2007.
[11] This dynamic was 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.

## 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. Because the failure of Fannie Mae and Freddie Mac was systemically significant and their vulnerabilities had long been visible from the perspective of organizational design, and because the two companies have been a subject of the author's studies over the years, the two companies will be a particular focus of this paper.[12]

In making their mistakes, Fannie Mae and Freddie Mac revealed the inherent vulnerabilities of the government-sponsored enterprise (GSE) as an organizational model.[13] First, the GSE lives 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 serve public purposes. Other federal instrumentalities include most commercial banks and thrift institutions and other for-profit and nonprofit institutions.[14]

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[12] See, e.g., Thomas H. Stanton, "Government-Sponsored Enterprises: Reality Catches up to Public Administration Theory," *Public Administration Review*, in press, 2009.
[13] 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 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).
[14] 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.

In contrast to many 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 activities in the mortgage market 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."[15]

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. Because the GSEs depended on the Congress for their enabling legislation, Members of Congress 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 while 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. 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.[16]

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

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

> "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."[17]

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 who 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[18] and has invested heavily in assets that that have nothing to do with meeting public needs.[19]

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.[20]

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[17] 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

[18] 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

[19] 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*.

[20] 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

Thanks to the lobbying power of Fannie Mae and Freddie Mac, the Office of Federal Housing Enterprise Oversight 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.

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.[21]

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 urged regulatory reform, such as higher capital standards to reduce the GSEs' dangerous leverage, huge numbers of constituents could be expected to flood Capitol Hill.[22] That political power in turn entrenched the GSEs' market power.

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.

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> 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).

[21] 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.

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

## 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 by the companies, which could have further roiled the financial markets.

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 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?[23]

With shareholders still in the equation government must try to cobble unwieldy support such as using the Federal Reserve or Treasury to buy mortgage-backed securities of the two companies as a way to lower mortgage rates. The two companies and their managers appear to be caught in the strong contradiction between their obligations to serve shareholders and the needs of the housing market.[24]

If the government placed both companies into receivership, then policymakers 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. The GSEs could begin to impose essential consumer protections for borrowers, such as Alex Pollock's one-page borrower disclosure

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[23] 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.

[24] Zachary A. Goldfarb, "Government-Picked Leader Resigns as Losses Pile Up," *Washington Post*, March 3, 2009; D01 ("The government-appointed chief executive of Freddie Mac announced yesterday that he is stepping down… David M. Moffett's resignation comes amid growing losses at the McLean mortgage-finance company and unresolved questions about whether it should follow the path of a private firm trying to make its way back to profitability or that of a government agency whose overriding goal is carrying out public policy.")

form.[25] 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. As discussed below, the government also could use the GSEs to help shore up the Federal Housing Administration by providing technical and IT systems support, or by taking over some of the FHA's loan processing functions.

The Congress also would be well advised enact a sunset provision of perhaps five years in each corporation's charter. As the sunset approaches, and the troubled mortgage market has been calmed, policymakers can decide whether further governmental assistance 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, the GSE has outlived its usefulness as an organizational form. First, the GSEs 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, government can be placed at serious risk 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, because of the likelihood of regulatory capture, it is unwise for government to provide special charters to a small number of specialized institutions.

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. The enabling legislation for any surviving GSEs should contain a 10-year sunset provision so that policymakers can periodically revisit questions of their public benefits and public costs in the context of changing markets and public priorities.

*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

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

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. 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 again grow to hold a dominant position in the mortgage market. This is more than an issue of monopoly pricing. The problem facing taxpayers in today's context is one of limiting the size of GSEs and their concentration of systemic financial risks. The public utility model is not relevant to solving that problem.

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 returns, and take concomitant risks, to serve its investor owners, the cooperative GSE has an incentive to increase financial returns and risks to serve its member-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. Further Lessons From Public Administration

A branch of public administration, organizational design concerns itself with critical attributes of an organization: its capacity, flexibility, accountability and life cycle.[26] The issue of life-cycle was most important during the financial bubble in the way that regulators and financial institutions abandoned financially prudent practices and safeguards as the memory of earlier financial crises diminished in the public's mind. Now the issue of capacity is salient as government seeks to respond effectively to the current debacle.

Observing operation of our constitutional system over time, a pattern emerges: when the private sector is in ascendancy, government retreats; when the private sector stumbles, policymakers reach for government to play a more significant role. A corollary effect is that government goes through cycles of capacity and incapacity, according to the extent that there is demand for governmental action. We are now leaving a period of too much governmental incapacity and entering one where we need to improve our public institutions. This is not only true of the regulators that became lax in past years, but also of more capable institutions such as the Treasury Department that could benefit from expanded organizational capacity. One agency with considerable weakness, discussed below, is the Federal Housing Administration.

Improved performance is required not only for federal agencies that need to assist in recovering from the financial debacle, but also for the many other agencies that policymakers enlist to support the larger economic recovery. The Emergency Economic Stabilization Act (EESA) and American Recovery and Reinvestment Act (ARRA) greatly enhanced the accountability and oversight structure to help detect, report, and punish agency shortcomings and misallocation of public funds. Missing from that legislation was an effort to strengthen the capacity of the relevant agencies so that fraud and abuse might not occur in the first place.

The creation of a systemic risk regulator, which many have recommended, is fraught with organizational difficulties. For example, as a matter of organizational design, there is a difficult tradeoff between organizational independence from the political process and the amount of discretion that policymakers may be willing to give the organization to intervene preventatively in the actions of major financial institutions and their regulators. There also are other questions: from whom and from what would the regulator be independent? Suffice it to say here that, if the Federal Reserve or FDIC were to become a systemic risk regulator, one could imagine that systemically significant institutions might want to make adjustments to the range of stakeholders to whom the organization is most responsive. Another issue concerns the demonstrable need for consumer protection against unfair and deceptive lending practices. Careful organizational design is needed to ensure balanced and prudent consumer protection given the extensive participation of countervailing stakeholders in governmental processes. One answer might be to give added authority to the Federal Trade Commission to protect mortgage borrowers. Many regulatory issues, to say nothing of proposals to deal with systemic problems such as "too-big-to-fail" involve conundrums that that are best addressed in the context of specific proposals.

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[26] See, e.g., 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; and Thomas H. Stanton, "The Administration of Medicare," *Washington and Lee University Law Review*, 2003.

Given the fluidity of financial markets vis-à-vis governmental restrictions, a combination of remedies is likely to be more effective than any single prescription. Thus, for example, besides improving the capacity and expanding authority of federal regulators to wind up troubled major institutions, it would be wise to institute improved and more uniform capital requirements across multiple types of financial organization that take account of the incidence of nonquanitfiable risk,[27] require issuance of debt obligations that convert to equity in the event of insolvency, [28] strengthen consumer and investor protections and bankruptcy provisions, and prevent institutions from shopping for the most lax regulator. In addition the following are some modest suggestions, based on learnings from the field of public administration, which may contribute to improving the current state of affairs.

### A. Create a financial equivalent of the National Transportation Safety Board to monitor issues of systemic risk and propose improvements, authorized to compel information from financial regulators but without possessing its own supervisory authority.

Regardless of the form of systemic regulation that might be adopted, policymakers should create a federal oversight body with the mandate, authority, and capacity to raise issues of systemic risk and monitor risk throughout the U.S. and global financial systems. While such a new agency by itself is not enough, it makes a useful complement to a package of supervisory and regulatory improvements. [29] Especially with the current financial debacle in the public mind, it is likely that many of the new agency's reports on systemic risk and supervisory shortcomings would find an attentive audience.

Even without authority to implement its recommendations, the new agency could provide a clear voice as to emerging issues and regulatory actions needed to address them. Had it been in existence some years ago, for example, this body might have reported on the high leverage of investment banks subject to the Consolidated Supervised Entity (CSE) program of the Securities and Exchange Commission (SEC), or the high leverage of Fannie Mae and Freddie Mac, compared to other financial institutions serving the residential mortgage market, or the declining standards of the credit rating agencies in assigning credit ratings, or the potential problems of trying to apply loss mitigation to delinquent mortgages that had been securitized in private-label securities.

The organizational design relies on a simple idea: the problem of regulatory capture, which often weakens financial regulators, is less likely to impede an agency without regulatory authority. This logic resulted in creation of the National Transportation Safety Board (NTSB), which can obtain information about transportation accidents but lacks authority to compel adoption of its

[27] See, e.g., Thomas H. Stanton, "Nonquantifiable Risks and Financial Institutions: The Mercantilist Legal Framework of Banks, Thrifts and Government-Sponsored Enterprises," Volume I, Chapter 3, in *Global Risk Based Capital Regulations*, edited by Professors Charles Stone and Anne Zissu, Irwin Professional, 1994.
[28] This was recommended for the GSEs in Thomas H. Stanton, *A State of Risk: Will Government Sponsored Enterprises be the Next Financial Crisis?* HarperCollins, 1991, p. 182.
[29] A recent headline is instructive as to the limitations of this proposal: Sholnn Freeman, "Bus Safety Rules Are Long Overdue, Board Says; Panel Cites Transportation Regulators for Failing to Enact Decade-Old Suggestions," *Washington Post*, April 22, 2009.

recommendations. The NTSB supplements the Federal Aviation Administration (FAA), which is responsible for regulating and supervising airline safety, and other federal, state, and local transportation agencies. Similarly, a separate NTSB-type watchdog is needed for the financial sector.

This organization would be responsible for monitoring systemic risk throughout the U.S. and global financial systems. Among other issues, it would seek to monitor emerging financial innovations and their risk implications. While the new agency might not be able to anticipate the risk implications of each new development, it could try to do so. Perhaps most importantly, the new agency could become the source of knowledge and expertise on systemic risk and means of addressing threats to the financial system. The agency should be authorized and directed to compile and publish data relating to its systemic risk mission. Adding a mandate and authority to collect and publish data would help to provide many types of information about the financial system that were lacking as problems in the mortgage market precipitated liquidity and solvency crises and failure of major financial institutions.

The new agency might become a bureau in the Treasury Department. It would have authority to compel timely production of information from other government agencies. It would not have authority to intervene to correct weaknesses. Instead, it would be responsible for analyzing information and periodically reporting to the president and Congress, the relevant government regulatory agencies, and the general public on areas of systemic risk and supervisory vulnerability. The relevant federal regulatory agency or agencies would be required to respond to the new agency's reports promptly in writing.

The NTSB reports to the Secretary of Transportation, who is required to respond in writing within 90 days.[30] The NTSB also publishes reports on issues of transportation safety that are of national significance. While the Department of Transportation and the Congress have resisted making many improvements urged by the NTSB, they also have responded to many NTSB recommendations.

Safeguards can help ensure the ability of the new agency to speak plainly about matters that affect powerful organizations in both government and the private sector. One safeguard would be to subject the new agency to the authority and protection of a powerful committee such as the House Ways and Means Committee. Unlike authorizing committees with potentially more parochial interests, the Ways and Means Committee is responsible for both taxation and the public debt.[31] In the aftermath of the savings and loan debacle, House Ways and Means was one congressional committee that helped to drive reform of the regulatory structure of government-sponsored enterprises.[32] Ways and Means also helped to protect the integrity of the work of a small federal agency, the Administrative Conference of the United States (ACUS), which was

[30] Authority for the NTSB is found in United States Code, Title 49, Chapter 11.
[31] The Ways and Means Committee successfully asserted jurisdiction over GSE matters as a part of its public debt responsibilities. See, e.g., Title XIII of the Revenue Act of 1992, Conference Report, 102[d] session, Report 102-1084, October 5, 1992, pp. 669-671. That act passed both houses of Congress and then was vetoed at the end of the session.
[32] The role of the Ways and Means Committee is reviewed in Thomas H. Stanton, "Increasing the Accountability of Government-Sponsored Enterprises: First Steps," *Public Administration Review*, September/October 1990.

seeking to develop careful policy proposals as to the most appropriate form of safety-and-soundness regulation for the GSEs.[33] On the one hand, Ways and Means used its power to prevent the GSEs from shutting down the ACUS study; on the other hand, the ACUS study helped to inform Ways and Means about why it was important for the committee to press for improved supervision of the GSEs.

Another measure would be to govern the new agency with a board of federal officials, similar to the structure of the NTSB. Finally, to prevent pressure through the appropriations process such as Fannie Mae applied to constrain OFHEO, its regulator, some form of independence from the appropriations process would be advisable. Many policymakers fear giving such independence to the ordinary federal agency; that concern is addressed here because the NTSB-type agency would have authority to make reports, but not to act to implement its recommendations.

Some might ask whether such an independent voice on behalf of a stronger financial system can be useful. Here again, experience from the GSEs may be instructive. There are at least two cases on record where it has been suggested that the Treasury Department came under pressure to change its reported views to a position more congenial to Fannie Mae and Freddie Mac.[34] To the extent possible, it can be valuable to create and protect sources of feedback such as an NTSB for the financial system to provide accurate and unimpeded guidance to policymakers on matters as important as the risk posed by major financial institutions and the most appropriate ways to address those risks. Unlike a line agency or department of government, the financial system's NTSB would have the sole mandate to make accurate reports and recommendations. With some of the protections suggested here, it might have a chance to do so.

### B. Create a staff within the Office of Management and Budget to assess and enhance capacity of federal agencies such as FHA whose effectiveness as part of the government's response is essential and also in doubt.

The work of federal agencies, and especially federal agencies that provide loans and loan guarantees, can be helpful in coping with the financial situation. If banks are reluctant to lend into a still-declining market, some of the slack can be taken up by the Small Business Administration, Export-Import Bank of the United States, Department of Education, and federal agencies such as FHA that provide mortgage credit, for example. This work needs to be coordinated and the individual agencies need increased capacity to be able to carry out their new responsibilities and workload.

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[33] Administrative Conference of the United States, *Recommendation 91-6: Improving Supervision of the Safety and Soundness of Government Sponsored Enterprises*, 1 CFR 305.91-6, adopted June 14, 1991.

[34] On the weakening of a 1996 Treasury report on desirability and feasibility of removing government sponsorship from Fannie Mae and Freddie Mac, see, e.g., Jackie Calmes, "Federal Mortgage Firm is Facing New Assault to Privileged Status: But Fannie Has Clout to Counter the Agencies That Seek to Privatize it," *Wall Street Journal*, May 14, 1986, p. 1; Subcommittee on Capital Markets, Securities, and Government-Sponsored Enterprises, Committee on Banking and Financial Services, U.S. House of Representatives, "Oversight of the Federal National Mortgage Association [Fannie Mae] and the Federal Home Loan Mortgage Corporation [Freddie Mac]," July 24, 1996, pp. 136-141 (comments of Chairman Richard Baker). On reports of successful pressure on Treasury in 1991 to state that HUD would be an appropriate regulator of Fannie Mae and Freddie Mac, see Thomas H. Stanton, "Increasing the Accountability of Government-Sponsored Enterprises: Next Steps," *Public Administration Review*, November/December 1991, and sources cited.

The Office of Management and Budget (OMB) is ideally situated to provide this leadership. OMB should create a new Financial Stability Branch to provide management planning to support the government's response to the financial crisis. OMB is especially suitable because of its focus on government performance and effective management and implementation of critical government programs. OMB would need to add staff and establish its credibility with respect to financial issues; given the priority of financial issues in coming years, the investment would be worthwhile.

This staff could include desk-officers with responsibility for gathering information from each federal financial and credit agency and for placing that information into a set of briefings, recommendations, and options. OMB would attempt to anticipate needs of the various financial sectors, potential improvements in federal agency support for those sectors, and an assessment of the benefits and costs of each option. The staff would be particularly attuned to trying to ensure the capacity and accountability of agencies playing important roles in the government's response. The staff also would encourage federal credit agencies to share promising practices with one another. Finally, OMB could help design and support creation of new organizations (such as the financial system NTSB suggested earlier) and needed new programs.

One federal agency that needs prompt help from OMB and the Administration is the Federal Housing Administration (FHA), a part of the Department of Housing and Urban Development (HUD). HUD Secretary Steve Preston pointed out in November 2008 that the volume of FHA mortgage insurance trebled over the prior year. He was candid in his assessment that FHA is not strong enough, either in statutory authority or administratively, to carry the load of a substantial increase in volume without causing significant potential losses to taxpayers. Secretary Preston objected to Congress' refusal to allow FHA to implement modest risk-based pricing for the agency's mortgage insurance program. He also pointed to problems with FHA's patchwork of IT systems, noting that FHA's core loan processing system is still written in COBOL.[35]

The HUD Inspector General and other housing experts also worry that fraud may overtake the FHA program as subprime lenders and others move their loan production to FHA. Kenneth M. Donahue, HUD's Inspector General, warned that "It looks like an incoming tsunami."[36] FHA lacks the capacity to monitor and respond quickly to fraud. Moreover, the agency's protracted procedures do not allow for prompt removal of fraudulent or abusive lenders from the program. An interagency task force, led by the Office of Management and Budget, and consisting of representation from FHA and Ginnie Mae, and preferably also Fannie Mae and Freddie Mac (as government corporations), is needed to review FHA and Ginnie Mae and to make recommendations for improving the systems, procedures, and other aspects of capacity needed to ensure that the government can provide appropriate support for the mortgage market. Ideally, the government should arrange for Fannie Mae and Freddie Mac to provide needed systems and facilities to FHA to ensure capable implementation of the FHA single-family mortgage insurance program.

[35] HUD Secretary Steve Preston, Prepared Remarks at the National Press Club, November 19, 2008, available at http://www.hud.gov/news/speeches/2008-11-19.cfm, accessed January 2, 2009.
[36] Barry Meier, "As FHA's Role Grows, So Does the Risk of Fraud," *New York Times*, December 10, 2008.

OMB might also determine whether an alternative delivery system to FHA would be more appropriate, depending on the anticipated volume of new business. Alternatives might include giving underwriting capability to Ginnie Mae, so that it combines the function of providing mortgage insurance with its current authority to guarantee pools of MBSs, and perhaps also creating a temporary wholly owned government corporation to provide a Ginnie Mae-type guarantee for pools of conventional mortgages. Since time is short, the preferred option might be to use Fannie Mae and Freddie Mac to purchase FHA loans and apply their automated underwriting systems to the origination process. These are the kinds of issues that OMB should explore and take action to address.

In addition, the new OMB staff should analyze other organizational issues relating to the government's response. For example, a good argument can be made that the capacity of Treasury's Office of Financial Stability could be enhanced by giving the office the form of a wholly owned government corporation. The government corporation is an organizational form that permits government agencies to conduct their operations on a more businesslike basis and with potentially greater organizational capacity and flexibility than is otherwise permitted by law for most agencies. Moreover, because of government corporations maintain their books on a businesslike basis, the financial status of the organization and its activities might become easier to monitor.[37]

Two wholly owned government corporations within federal departments are Ginnie Mae, within the Department of Housing and Urban Development (HUD) and the St. Lawrence Seaway Development Corporation within the U.S. Department of Transportation. If this recommendation were deemed advisable, it would be appropriate to borrow from the experience of the Resolution Trust Corporation, a temporary wholly owned government corporation, which effectively disposed of assets from the savings and loan debacle, and to make the new organization temporary rather than permanent, with a sunset date in its charter.[38] A temporary organization can attract superior talent without undergoing the increasing life-cycle problems that sometimes beset permanent agencies of government. Use of the government corporation as an organizational platform could become especially important if Treasury continues to expand its activities under TARP and other programs. A staff at OMB with experience and ability to design government organizations could help to assess these and other ideas.

Finally, because of OMB's location in the Executive Office of the President, it can make its influence felt to ensure that new legislation, in contrast to EESA and ARRA, provides for appropriate organizational capacity, and not just added accountability measures, so that federal agencies can carry out their new responsibilities more effectively.

[37] On the special organizational attributes of government corporations, see, e.g., Thomas H. Stanton and Ronald C. Moe, "Government Corporations and Government Sponsored Enterprises," Chapter 3 in *Tools of Government: A Guide to the New Governance*, Lester M. Salamon, Editor, Oxford University Press, 2002.

[38] On the impressive way that the RTC engaged in continuous process improvement, see, e.g., Thomas H. Stanton, "Lessons Learned: Obtaining Value From Federal Asset Sales," *Public Budgeting & Finance*, vol. 23, no. 1 (Spring 2003), pp. 22-44.

## V. Conclusion: The Financial Debacle and its Consequences will be with us for Many Years; It is Time to Institutionalize the Government's Response.

This paper sounds two major themes, one concerning the government-sponsored enterprise as an organizational form and the other concerning the need to enhance government's capacity more generally to address the financial debacle.

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

Today's financial debacle developed over many years and it will take many years to address problems in the financial system and restore its strength. Once they realized the full dimensions of the problem, the Federal Reserve System and Treasury, supported by the FDIC and a few other agencies, worked tirelessly to develop and implement a remarkable array of programmatic solutions. It is time now to institutionalize the government's response and make it more systematic. This includes bringing more federal agencies into play, possibly creating new organizations and programs, and strengthening their capacity to play meaningful roles, to help provide support and address new challenges that may emerge as the financial situation evolves.