

BACKGROUND

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Fannie and Freddie: What Record of Success?

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Abstract

The notion that the housing finance system in the U.S. worked until banks foreclosed on millions of homes is inaccurate. The federal government has supported the U.S. housing market through subsidies in the mortgage and secondary mortgage market for more than 80 years. Even during normal housing markets, these subsidies in the housing finance system—largely flowing to Fannie Mae and Freddie Mac—have cost the federal taxpayer billions of dollars. When the system collapses, as it has several times in the past, the cost to the federal taxpayer is substantially higher. These federal subsidies have done little to measurably increase homeownership in the U.S., yet they have cost the federal taxpayer billions of dollars, enriched politically connected financial institutions, and undermined homeowners in a profound way at points when the housing markets collapsed. After decades of experimentation, Congress should shut down Fannie Mae and Freddie Mac as soon as possible because they are a key part of a failed housing policy.

The fact that Fannie Mae has been around since the 1930s has led some to suggest the U.S. housing system functioned beautifully until the recent crisis. One policy analyst recently stated that under the system of government-sponsored enterprises (GSEs), “Mortgage credit was continuously available well into the late-1990s under terms and at prices that put sustainable homeownership within reach for most American families.”¹

This notion that the system worked until banks foreclosed on millions of homes is inaccurate. First, the millions of foreclosures

KEY POINTS

- The activities of Fannie and Freddie have harmfully distorted the housing market for far too long. Congress should shut them down permanently.
- Taxpayers have subsidized the GSEs for decades at the cost of billions of dollars, but the U.S. homeownership rate has barely moved. In 1968, the year Fannie Mae became a GSE, the rate stood at 63.9 percent. In 2013, after the implosion of the GSEs, the rate was 65 percent.
- GSE reform should include repealing the Dodd-Frank mortgage finance regulations, including the “ability to repay” requirement, so that more private capital will flow to the mortgage market.
- Congress should direct the FHFA to continue raising Fannie and Freddie’s mortgage guarantee fees (g-fees) to provide incentives for lenders and borrowers to use nongovernment agency loans.

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would not have happened if the system had worked. Just as important, the system that recently imploded began in the 1980s, not the 1930s. Fannie Mae was insolvent in the early 1980s. If it had been a fully private company, it probably would have been shut down. Instead, Fannie was allowed to continue operating, and it expanded its operations in the 1990s. The activities of the GSEs have harmfully distorted the housing market for far too long, and they should be permanently shut down.

The Early Years (1938–1968)

The typical history of Fannie Mae describes a government agency created in 1938 to purchase government-insured mortgages, thus providing lenders with much-needed cash. This gross oversimplification masks the true nature of Fannie Mae. In fact, the National Housing Act of 1934 provided for the creation of “national mortgage associations.” These associations, envisioned as private companies, were supposed to spur housing construction by purchasing government-insured mortgages.² The 1934 act was amended in 1938 to accelerate this process because no associations were formed in the intervening period. Even with government insurance, investors did not want to invest in severely depressed real estate.³

Oddly, the 1938 amendment did not explicitly authorize the creation of a *federal government* agency to purchase mortgages. The government ignored that fact and, on February 10, 1938, chartered the Federal National Mortgage Association of Washington to purchase government-insured mortgages. Two months later, Fannie Mae was born by omitting “of Washington” from the name, leaving only “Federal National Mortgage Association” (FNMA or Fannie Mae).

Although the 1934 act and its amendments prohibited Fannie Mae from making direct loans, Fannie effectively became a direct lender to mortgage companies and builders through “pre-commitments” to buy loans that did not yet exist.⁴ This practice

underscores the inherent conflicts that have always existed in Fannie Mae’s operations. First, Fannie was effectively in competition with savings and loan associations (S&Ls), the main source of mortgage funding in that era. S&Ls did not need funding from Fannie Mae, and Fannie’s operations only made life easier for S&Ls’ competitors, companies known as mortgage bankers. These mortgage companies welcomed Fannie Mae funding because they did not have access to people’s deposits to fund new loans.

Additionally, there was a basic financial contradiction between operating profitably and supporting federal housing priorities. Lending money to build homes is profitable only when the loans are paid back on schedule. This fact does not change when taxpayers guarantee loan repayments simply because politicians want to increase the number of homes built. Consequently, policymakers eventually must choose which motive—profit or politics—is more important. These issues, around since Fannie began operating, have spurred multiple attempts to privatize the agency.

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In 1954, the Eisenhower Administration tried by rechartering Fannie Mae as a “government corporation” with “mixed” ownership. The President’s advisers felt that the government was too deeply involved in housing policy to privatize Fannie immediately, so they tried to set it on a course toward privatization.⁵ Taxpayer money was used to buy stock in Fannie, but the intent of the 1954 Charter Act was clear. Eisenhower told Congress, “The Federal government should be enabled to purchase the initial stock of the reorganized association, but private

1. John Griffith, “7 Things You Need to Know About Fannie Mae and Freddie Mac,” Center for American Progress Report, September 6, 2012, <http://www.americanprogress.org/issues/housing/report/2012/09/06/36736/7-things-you-need-to-know-about-fannie-mae-and-freddie-mac/> (accessed October 4, 2013).
2. Richard W. Bartke, “Fannie Mae and the Secondary Mortgage Market,” *Northwestern University Law Review*, Vol. 66, No. 1 (March–April 1971), p. 17.
3. *Ibid.*, p. 18.
4. *Ibid.*, p. 19.
5. James R. Hagerty, *The Fateful History of Fannie Mae: New Deal Birth to Mortgage Crisis Fall* (Charleston, SC: The History Press, 2012), p. 30.

capital funds supplied by users of the facility should be built up to speed retirement of the government's investment."⁶ Getting the government completely out of Fannie's operations proved impossible, but it came closer to reality in 1968.

The New Beginning (1968–1990)

The Johnson Administration, desperate to remove debt from the federal budget, used the 1968 Housing and Urban Development Act to move Fannie's debt off the federal books. The act split Fannie up into a federally chartered "private" company, which is still named Fannie Mae, and Ginnie Mae, an entity fully owned by the government. Ginnie Mae was given Fannie's former job of purchasing only government-insured mortgages. The new Fannie was allowed to purchase mortgages that were *not* insured by federal agencies.

In May 1970, Fannie paid \$216 million to the U.S. Treasury to complete its transition to a government-sponsored entity.⁷ At this point, the federal government no longer had any ownership stake in Fannie Mae, and its common stock was publicly traded. In July 1970, Congress passed the Emergency Home Finance Act of 1970, which created the Federal Home Loan Mortgage Corporation, commonly referred to as Freddie Mac.⁸ Like Fannie Mae, Freddie Mac was not supposed to be a federal agency that continued forever. Freddie became a publicly traded company in 1989.

Although both companies had private shareholders, as of 1989 both Fannie and Freddie were government-sponsored enterprises. As GSEs, they benefited from a line of credit with the U.S. Treasury, an exemption from filing financial statements with the Securities and Exchange Commission, and an exemption from state and local income taxes. Although the securities that they issued were not

explicitly backed by the federal government, the markets (correctly) understood that the government would ultimately back the GSEs.⁹ Freddie issued its first mortgage-backed security (MBS)¹⁰ in 1971, but Fannie did not issue its first MBS until 1981. Thus, the system that officially came apart in 2008, with Fannie and Freddie both purchasing non-federally insured private mortgages and issuing MBSs, did not really begin until the 1980s.

Throughout the 1980s, Freddie Mac focused on issuing MBSs from the loans it purchased, while Fannie Mae decided both to issue MBSs and to build its own portfolio of MBSs and mortgages. This decision allowed Freddie to pass much of its risk onto outside investors, while Fannie remained directly exposed to this risk. In particular, Fannie was exposed to a large amount of interest rate risk (the risk that interest rates would rise and adversely impact the value of the company's investments).¹¹ This choice to hold mortgages caused Fannie Mae to become insolvent when interest rates rose dramatically throughout the late 1970s and early 1980s.

The U.S. General Accounting Office reported that Fannie suffered "cumulative net losses of over \$350 million in 1981, 1982, 1984, and 1985."¹² Although insolvent, Fannie was saved through "regulator forbearance" (i.e., the problem was ignored) and a special tax provision that allowed it to forgo paying federal income taxes for up to 10 years. Freddie Mac avoided financial trouble during this time mainly because of its decision against building up its own mortgage loan portfolio—a decision that was appropriate given the GSEs' intended purpose.

In a 2005 letter to *The Wall Street Journal*, Thomas Bomar, the first chief executive officer (CEO) of Freddie Mac, explained, "Accumulating a large mortgage portfolio would have been inconsistent with the intent for which Freddie Mac was

6. *Ibid.*, p. 32.

7. *Ibid.*, p. 40.

8. For a full account of these agencies' history, see Federal Housing Finance Agency, Office of Inspector General, "History of the Government Sponsored Enterprises," <http://fhfaog.gov/LearnMore/History> (accessed October 7, 2013), and "Glossary of Terms," <http://fhfaog.gov/LearnMore/Glossary> (accessed October 7, 2013).

9. The bond market certainly recognized the special nature of the GSEs. It has always called Fannie's and Freddie's bonds "agency debt," a name that reflected the (correct) belief that the federal government would save the companies if they were in financial trouble.

10. A mortgage-backed security is an investment whose value is tied to a group of mortgages.

11. Longer-term assets, such as the mortgages that Fannie was holding, are very sensitive to interest rate changes.

12. U.S. General Accounting Office, *Government-Sponsored Enterprises: The Government's Exposure to Risks*, August 1990, p. 9, <http://www.gao.gov/assets/150/149461.pdf> (accessed October 16, 2013).

created.”¹³ Regardless, at the end of 1981, Fannie held just under \$60 billion in its mortgage portfolio, and Freddie held just over \$5 billion. By the end of 1990, Fannie held a portfolio of nearly \$114 billion, while Freddie’s mortgage portfolio was just over \$21 billion.¹⁴

To fuel this growth, the GSEs used their special status to borrow money at below-market interest rates—a fact that increased the GSEs’ profitability and the taxpayers’ risk. For example, shareholders enjoyed profits when GSEs could borrow short-term funds at 4 percent to fund long-term loans that charged customers 8 percent. However, if those long-term rates quickly increased to 12 percent, Fannie would no longer be able to borrow so cheaply.

From the beginning of both Fannie Mae and HUD, affordable housing concerns have outweighed financial safety at the GSEs, allowing Fannie to hold much less capital than similar private banking institutions.

With this sort of increase in interest rates, Fannie Mae could easily become insolvent and leave taxpayers responsible for guarantees on worthless mortgages. Starting in 1968, the regulator charged with protecting the taxpayers from this risk was the Department of Housing and Urban Development (HUD). Regrettably, HUD’s mission conflicted with GSE financial safety because HUD was also charged with expanding affordable housing.

HUD’s political mission has almost always pushed the GSEs away—sometimes literally—from making sound economic decisions in favor of meeting political goals. In 1979, HUD publicly prevented Fannie Mae from adopting a less risky financing strategy so that HUD could increase “the flow of mortgage funds into older urban areas.”¹⁵ Perhaps even worse, HUD originally had “no clear statutory mandate and arguably limited statutory authority to assure the safety and soundness of the GSEs.”¹⁶ From the beginning of both Fannie Mae and HUD, affordable housing concerns have outweighed financial safety at the GSEs, allowing Fannie to hold much less capital than similar private banking institutions.

High Risk, Low Accountability

Congress first addressed Fannie’s lack of capital in the 1968 HUD Act by preventing the GSEs from taking on debt of more than 15 times its capital *unless* the HUD secretary approved a higher leverage ratio. However, by the end of 1969 the HUD secretary had already lessened the requirement twice—first to 20 times, then to 25 times.¹⁷ This trend continued, and by 1981 the provision was essentially meaningless with the ratio hovering around 50 times its capital for the rest of the 1980s.¹⁸ While large financial institutions such as commercial banks would have been required to maintain a capital ratio of more than 5 percent throughout the 1990s, Fannie and Freddie’s capital ratios were approximately 1 percent in 1990.¹⁹

In another effort to protect taxpayers, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (1992 GSE Act) placed formal capital requirements on the GSEs. The act required

13. Thomas R. Bomar, “Freddie Mac Was Meant to Succeed, Die Young,” *The Wall Street Journal*, June 13, 2005, <http://online.wsj.com/article/SB111862059910957545.html> (accessed October 7, 2013).

14. Congressional Budget Office, “Controlling the Risks of Government-Sponsored Enterprises,” April 1991, pp. 130-165, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/90xx/doc9085/04-1991-gses_rev2.pdf (accessed October 16, 2013).

15. *Ibid.*, p. 179.

16. *Ibid.*

17. Bartke, “Fannie Mae and the Secondary Mortgage Market,” p. 51.

18. These figures are computed as ratios of the total debt to equity using balance sheet data reported in Federal Housing Finance Agency, *Report to Congress 2012*, June 13, 2013, p. 81, http://www.fhfa.gov/webfiles/25320/FHFA2012_AnnualReport.pdf (accessed October 7, 2013).

19. The Congressional Budget Office reported this number as a percentage of assets and MBS. Congressional Budget Office, “Controlling the Risks of Government-Sponsored Enterprises,” p. 165. For information on bank capital ratios and the 1988 Basel Accords, see “Capital Standards for Banks: The Evolving Basel Accord,” *Federal Reserve Bulletin*, September 2003, <http://www.federalreserve.gov/pubs/bulletin/2003/0903lead.pdf> (accessed October 4, 2013).

The Affordable Housing Goals

The 1992 GSE Act called for the HUD secretary to establish three broad affordable housing goals for each of the GSEs:

1. A broad low-income and moderate-income goal,
2. A geographically targeted goal for housing located in underserved areas, and
3. A targeted income-based goal for special affordable housing.

Prior to the 1992 GSE Act, HUD only “encouraged” the GSEs to devote a fixed percentage of their mortgages to these groups. The new requirements went into effect in 1995, and the figures were updated several times. For 2001–2003, the goals were:

- **Low-income and moderate-income goal.** At least 50 percent of the dwelling units financed by each GSE’s mortgage purchases should be for families with incomes no greater than area median income (AMI), defined as median income for the metropolitan area or nonmetropolitan county. The corresponding goal was 42 percent for 1997–2000.
- **Special affordable goal.** At least 20 percent of the dwelling units financed by each GSE’s mortgage purchases should be for very low-income families (those with incomes no greater than 60 percent of AMI) or for low-income families (incomes up to 80 percent of AMI) in low-income areas. The corresponding goal was 14 percent for 1997–2000.
- **Underserved areas goal.** At least 31 percent of the dwelling units financed by each GSE’s mortgage purchases should be for units located in underserved areas. Research by HUD and others has demonstrated that low-income and high-minority census tracts have high mortgage denial rates and low mortgage origination rates, and this forms the basis for HUD’s definition of underserved areas. The corresponding goal was 24 percent for 1997–2000.

Source: U.S. Department of Housing and Urban Development, “HUD’s Affordable Lending Goals for Fannie Mae and Freddie Mac,” *Issue Brief* No. V, January 2001, <http://www.huduser.org/publications/pdf/gse.pdf> (accessed October 16, 2013).

the GSEs to hold capital worth between 0.45 percent and 2.5 percent of their assets.²⁰ The law also created the Office of Federal Housing Enterprise Oversight (OFHEO) within HUD as an independent regulator for the GSEs, but it directed HUD to require—rather than just suggest—the GSEs to meet certain affordable housing goals.

Although many legislators probably wanted this bill to rein in the GSEs, by the time the legislative

process was complete, it was easy to predict that the new GSE regulator would be ineffective at improving the GSEs’ financial soundness. The 1992 act not only required the OFHEO to gain congressional approval for any new GSE regulations, but also forced it to go through annual appropriations reviews. These features all but ensured that Congress—not the OFHEO—would be the GSEs’ de facto regulator, virtually guaranteeing that future

20. The act also included a risk-based capital requirement that required the GSEs to hold sufficient capital to withstand a severe “shock” to the economy. See Joseph E. Stiglitz, Jonathan M. Orszag, and Peter R. Orszag, “Implications of the New Fannie Mae and Freddie Mac Risk-Based Capital Standard,” *Fannie Mae Papers*, March 2002, <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.8.3820&rep=rep1&type=pdf> (accessed October 16, 2013).

decisions would be based more on politics than financial principles.

The story of how the law was shaped is a tale of a deliberate strategy by the GSEs (led by Fannie Mae) to use affordable housing goals as a weapon to secure special government privileges. This strategy—a long-standing tradition at Fannie Mae—undoubtedly allowed it to avoid stricter capital standards and full privatization for decades. As the 21st century approached, this strategy became even more important because Fannie’s critics doubled their efforts to completely privatize the GSEs.

Special Interests and Affordable Housing

In the 1980s, the Reagan Administration explored the privatization of several government enterprises, including Fannie and Freddie. In 1988, Reagan’s Commission on Privatization called for an end to “all Federal benefits and backing for Fannie and Freddie, leaving them fully ‘privatized’ after a transition period.”²¹ The Omnibus Budget Reconciliation Act of 1990 added even more political pressure. The 1990 Act required the Congressional Budget Office to prepare a study on the GSEs that included “an analysis of the financial risks each GSE assumes, ... the financial exposure of the Federal Government posed by GSEs, and the effects of GSE activities on Treasury borrowing.”²² Fannie Mae countered with its own privatization study, conducted by the investment bank Shearson Lehman Brothers.

Fannie’s 1989 study, which argued that privatization was a bad idea, was overseen by Jim Johnson, a Lehman employee.²³ Johnson was a long-time political operative whose consulting firm, Public Strategies, was purchased by Lehman in 1985. Prior to “joining” Lehman, Johnson served as the top aide to Senator (and later Vice President) Walter Mondale, ran the Kennedy Center for Performing Arts, and ran Mondale’s presidential campaign.

In 1990, Johnson was hired by Fannie Mae CEO David Maxwell to fend off those who wanted to privatize the GSEs, and he quickly became Fannie’s CEO in waiting. In 1991, when a public outcry erupted over Maxwell’s \$27 million retirement package, Johnson controlled the damage by announcing his former boss would donate \$5.5 million (his last bonus) to low-income housing projects. This strategy—deflecting criticism with affordable housing initiatives—was the backbone of Johnson’s approach.

One of Johnson’s first ventures as CEO was to launch Fannie’s Open Doors to Affordable Housing, a program that committed \$10 billion to financing low-income borrowers. Johnson then opened “partnership offices” throughout the U.S. to promote Fannie’s programs. Soon, politicians as ideologically opposed as Ted Kennedy and Newt Gingrich were participating in photo ops at their local Fannie Mae offices.²⁴ According to one former Fannie Mae executive,

The partnership offices gave us an enormous advantage when Congress was debating further regulations. We were able to call on our leaders and upon all our partners in the cities where we had these offices and say you have to weigh in. Write to Congress.²⁵

In fact, Fannie did much more than just lobby for their cause. *The New York Times* reported that Fannie (and Freddie) literally wrote much of the bill that became the Federal Housing Enterprises Financial Safety and Soundness Act of 1992.²⁶ Under Johnson’s direction, Fannie worked constantly to win the support of elected officials, homebuilders, mortgage bankers, real estate agents and developers, and even investment bankers. Fannie used grants as a tool to win support and affordable housing as a shield against the company’s critics.

21. Hagerty, *The Fateful History of Fannie Mae*, p. 71.

22. Congressional Budget Office, “Controlling the Risks of Government-Sponsored Enterprises,” p. iii.

23. Gretchen Morgenson and Joshua Rosner, *Reckless Endangerment: How Outsized Ambition, Greed, and Corruption Led to Economic Armageddon* (New York: Times Books, 2011), p. 17.

24. *Ibid.*, pp. 62–63.

25. *Ibid.*, p. 64. Eventually, HUD officially acknowledged that Fannie had misused the partnership offices as primarily lobbying offices. See Adam Selene, “HUD Review: Fannie Mae Offices Misused,” Associated Press, October 17, 2005, <http://www.freerepublic.com/focus/news/1504347/posts> (accessed October 7, 2013).

26. Stephen Labaton, “Power of the Mortgage Twins,” *The New York Times*, November 12, 1991, <http://www.nytimes.com/1991/11/12/business/power-of-the-mortgage-twins.html> (accessed October 7, 2013).

In 1994, Johnson announced Fannie Mae's Trillion Dollar Commitment, a program that earmarked \$1 trillion for affordable housing between 1994 and 2000.²⁷ Gretchen Morgenson and Joshua Rosner claim that Johnson was "the original, if not anonymous, architect of what became the disastrous homeownership strategy promulgated by William Jefferson Clinton in 1994."²⁸ Clinton's National Partners in Homeownership, a private-public cooperative, set a goal of raising the U.S. homeownership rate from 64 percent to 70 percent by 2000.

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With this onslaught of cooperation, taxpayer subsidies, and grant money, the U.S. homeownership rate increased from 64 percent in 1994 to 69 percent in 2004. However, as the financial crisis hit and more than 4 million people lost their homes, the rate fell back to 65 percent—only 1 percentage point higher than in 1968. From 1990 to 2003, Fannie and Freddie went from holding 5 percent of the nation's mortgages (\$136 billion) to more than 20 percent (\$1.6 trillion).²⁹ In 2008, the companies were deemed insolvent and put into conservatorship. Taxpayers are now responsible for payments on MBSs of more than \$4 trillion.

What Congress Should Do

Congress should:

- Permanently shut down Fannie Mae and Freddie Mac and all of their subsidiaries.
- Ensure that any legislation to close Fannie and Freddie does not create a smaller version of the GSEs under a new name. Any such entity would surely evolve and grow, just as Fannie Mae and Freddie Mac did.
- Focus on repealing the Dodd-Frank mortgage finance regulations promulgated by the Consumer Financial Protection Bureau (CFPB), including the "ability to repay" requirement, so that more private capital will flow to the mortgage market.
- Bar the CFPB and other agencies that regulate housing finance from using "disparate impact" analysis for regulatory supervision or enforcement actions.
- Not use secondary mortgage market reforms to provide regulatory relief as a reward for using a particular securitization platform.
- Direct the Federal Housing Finance Agency (FHFA) to raise Fannie and Freddie's mortgage guarantee fees (g-fees) immediately.

Conclusion

The notion that the U.S. housing system worked until banks foreclosed on millions of homes is inaccurate. Aside from the millions of foreclosures, the system did not work. For all of its failings, the system has been constantly altered, regardless of whether the costs outweighed the benefits. By 1960, after one full decade of peacetime housing policies, government-insured loans comprised 16.5 percent of the mortgage market. By 1969, this figure had decreased to just under 11 percent, even though Fannie Mae was purchasing those mortgages.

In the past four decades, millions of Americans have paid higher interest because of a government bias toward longer-term mortgages, but the U.S. homeownership rate has barely moved. In 1968, the year Fannie Mae became a GSE, the rate stood at 63.9 percent. In 1990, just prior to an expansion of Fannie's operations, the rate was 63.9 percent. The most recent data for 2013, after the implosion of the GSEs, show a homeownership rate of 65 percent. Congress should shut down Fannie Mae and Freddie Mac as soon as possible because they are a key part of a failed housing policy.

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27. See Allie Mae, "History of Fannie Mae," <http://www.alliemae.org/historyoffanniema.html> (accessed October 7, 2013).

28. Morgenson and Rosner, *Reckless Endangerment*, p. 11.

29. Hagerty, *The Fateful History of Fannie Mae*, p. 144.