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SEPTEMBER 2008: THE TAKEOVER OF FANNIE MAE AND FREDDIE MAC

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From the fall of 2007 until Fannie Mae and Freddie Mac were placed into conservatorship on September 7, 2008, government officials struggled to strike the right balance between the safety and soundness of the two government-sponsored enterprises and their mission to support the mortgage market. The task was critical because the mortgage market was quickly weakening—home prices were declining, loan delinquencies were rising, and, as a result, the values of mortgage securities were plummeting. Lenders were more willing to refinance borrowers into affordable mortgages if these government-sponsored enterprises (GSEs) would purchase the new loans. If the GSEs bought more loans, that would stabilize the market, but it would also leave the GSEs with more risk on their already-strained balance sheets.

The GSEs were highly leveraged—owning and guaranteeing $5.3 trillion of mortgages with capital of less than 2%. When interviewed by the FCIC, former Treasury Secretary Henry Paulson acknowledged that after he was briefed on the GSEs upon taking office in June 2006, he believed that they were "a disaster waiting to happen" and that one key problem was the legal definition of capital, which their regulator lacked discretion to adjust; indeed, he said that some people referred to it as "bullsh*t capital."[1] Still, the GSEs kept buying more of the riskier mortgage loans and securities, which by fall 2007 constituted multiples of their reported capital. The GSEs reported billions of dollars of net losses on these loans and securities, beginning in the third quarter of 2007.

But many in Treasury believed the country needed the GSEs to provide liquidity to the mortgage market by purchasing and guaranteeing loans and securities at a time when no one else would. Paulson told the FCIC that after the housing market dried up in the summer of 2007, the key to getting through the crisis was to limit the decline in housing, prevent foreclosures, and ensure continued mortgage funding, all of which required that the GSEs remain viable.[2] However, there were constraints on how many loans the GSEs could fund; they and their regulators had agreed to portfolio caps—limits on the loans and securities they could hold on their books—and a 30% capital surplus requirement.

So, even as each company reported billions of dollars in losses in 2007 and 2008, their regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), loosened those constraints. "From the fall of 2007, to the conservatorships, it was a tightrope with no safety net," former OFHEO Director James Lockhart testified to the FCIC.[3] Unfortunately, the balancing act ultimately failed and both companies were placed into conservatorship, costing the U.S. taxpayers $151 billion—so far.

"A GOOD TIME TO BUY"

In an August 1, 2007, letter to Lockhart, Fannie Mae CEO Daniel Mudd sought immediate relief from the portfolio caps required by the consent agreement executed in May 2006 following Fannie's accounting scandal. "We have witnessed growing evidence of turmoil in virtually all sectors of the housing finance market," Mudd wrote, and "the immediate crisis in subprime is indicative of a serious liquidity event impacting the entire credit market, not just subprime."[4] As demand for purchasing loans dried up, large lenders like Countrywide kept loans that they normally securitized, and smaller lenders went under. A number of firms told Fannie that they would stop making loans if Fannie would not buy them.

Mudd argued that a relaxed cap would let his company provide that liquidity. "A moderate, 10 percent increase in the Fannie Mae portfolio cap would provide us with flexibility . . . and send a strong signal to the market that the GSEs are able to address liquidity events before they become crises." He maintained that the consent agreement allowed OFHEO to lift the cap to address "market liquidity issues." Moreover, the company had largely corrected its accounting and internal control deficiencies—the primary condition for removing the cap. Finally, he stressed that the GSEs' charter required Fannie to provide liquidity and stability to the market. "Ultimately," Mudd concluded, "this request is about restoring market confidence that the GSEs can fulfill their stabilizing role in housing."[5]

Fannie Mae executives also saw an opportunity to make money. Because there was less competition, the GSEs could charge higher fees for guaranteeing securities and pay less for loans and securities they wanted to own, enabling them (in theory) to increase returns.[6] Tom Lund, a longtime Fannie Mae executive who led the firm's single-family business, told the FCIC that the market moved in Fannie Mae's favor after August 2007 as competitors dropped out and prices of loans and securities fell. Lund told FCIC staff that after the 2007 liquidity shock, Fannie had "more comfort that the relationship between risk and price was correct."[7] Robert Levin, the company's chief business officer, recalled, "It was a good time to buy."[8]

On August 10, OFHEO's Lockhart notified Fannie that increasing the portfolio cap would be "premature" but the regulator would keep the request under "active consideration." Lockhart wrote that he would not authorize changes, because Fannie could still guarantee mortgages even if it couldn't buy them and because Fannie remained a "significant supervisory concern." In addition, Lockhart noted that Fannie could not prudently address the problems in the subprime and Alt-A mortgage market, and the company's charter did not permit it to address problems in the market for jumbo loans (mortgages larger than the GSEs' loan limit).[9] Although there had been progress in dealing with the accounting and internal control deficiencies, he observed, much work remained. Fannie still had not filed financial statements for 2006 or 2007, "a particularly troubling issue in unsettled markets."[10]

As Lockhart testified to the FCIC, "It became clear by August 2007 that the turmoil was too big for the Enterprises [the GSEs] to solve in a safe and sound manner." He was worried that fewer controls would mean more losses. "They were fulfilling their mission," Lockhart told the FCIC, "but they had no power to do more in a safe and sound manner. If their mission is to provide stability and lessen market turmoil, there was nothing in their capital structure" that would allow them to do so.[11]

Lockhart had worried about the financial stability of the two GSEs and about OFHEO's ability to regulate the behemoths from the day he became director in May 2006, and he advocated for more regulatory powers for his largely toothless agency. Lockhart pushed for the power to increase capital requirements and to limit growth, and he sought authority over mission goals set by the Department of Housing and Urban Development, as well as litigation authority independent of the Department of Justice. His shopping list also included the authority to put Fannie and Freddie into receivership, a power held by bank regulators over banks, and to liquidate the GSEs if necessary. As it stood, OFHEO had the authority to place the GSEs in conservatorship—in effect, to force a government takeover—but because it lacked funding to operate the GSEs as conservator, that authority was impracticable. The GSEs would deteriorate even further before Lockhart secured the powers he sought.[12]

"THE ONLY GAME IN TOWN"

But Fannie and Freddie were "the only game in town" once the housing market dried up in the summer of 2007, Paulson told the FCIC. And by the spring of 2008, "[the GSEs,] more than anyone, were the engine we needed to get through the problem."[13]

Few doubted Fannie and Freddie were needed to support the struggling housing market. The question was how to do so safely.[14] Purchasing and guaranteeing risky mortgage-backed securities helped make money available for borrowers, but it could also result in further losses for the two huge companies later on. "There's a real tradeoff," Lockhart said in late 2007—a trade-off made all the more difficult by the state of the GSEs' balance sheets.[15] The value of risky loans and securities was swamping their reported capital. By the end of 2007, guaranteed and portfolio mortgages with FICO scores less than 660 exceeded reported capital at Fannie Mae by more than seven to one; Alt-A loans and securities, by more than six to one. Loans for which borrowers did not provide full documentation amounted to more than ten times reported capital.[16]

In mid-September, OFHEO relented and marginally loosened the GSEs' portfolio cap, from about $728 billion to $735 billion. It allowed Fannie to increase the amount of mortgage loans and securities it owned by 2% per year—a power that Freddie already had under its agreement with OFHEO. OFHEO ruled out more dramatic increases "because the remediation process is not yet finished, many safety and soundness issues are not yet resolved, and the criteria in the Fannie Mae consent agreement and Freddie Mac's voluntary agreement have not been met."[17]

As the year progressed, Fannie and Freddie became increasingly important to the mortgage market. By the fourth quarter of 2007, they were purchasing 75% of new mortgages, nearly twice the 2006 level. With $5 trillion in mortgages resting on razor-thin capital, the GSEs were doomed if the market did not stabilize. According to Lockhart, "a withdrawal by Freddie Mac and Fannie Mae or even a drop in confidence in the Enterprises would have created a self-fulfilling credit crisis."[18]

In early October, Senator Charles Schumer and Representative Barney Frank introduced similar bills to temporarily lift portfolio limits on the GSEs by 10 percent, or approximately $150 billion, most of which would be designated for refinancing subprime loans. The measures, which Federal Reserve Chairman Ben Bernanke called "ill advised," were not enacted.[19]

In November, Fannie and Freddie reported third-quarter losses of $1.5 billion and $2 billion, respectively. At the end of December 2007, Fannie reported that it had $44 billion of capital to absorb potential losses on $879 billion of assets and $2.2 trillion of guarantees on mortgage-backed securities; if losses exceeded 1.45%, it would be insolvent. Freddie would be insolvent if losses exceeded 1.7%. Moreover, there were serious questions about the validity of their "reported" capital.

"IT'S A TIME GAME . . . BE COOL"

In the first quarter, real gross domestic product fell 0.7% at an annual rate, reflecting in part the first decline in consumer spending since the early 1990s. The unemployment rate averaged 5% in the first three months of 2008, up from a low of 4.4% in spring of 2007. As the Fed continued to cut interest rates, the economy was sinking further into recession. In February, Congress passed the Economic Stimulus Act, which raised the limits on the size of mortgages that Fannie and Freddie could purchase, among other measures.

The push to get OFHEO to loosen requirements on the GSEs also continued. Schumer pressed OFHEO to justify or lower the 30% capital surcharge; such a stringent requirement, he wrote Lockhart on February 25, hampered Fannie's ability to provide financing to homeowners.[20]

Two days later, Fannie CEO Mudd reported losses in the fourth quarter of 2007, acknowledging that Fannie was "working through the toughest housing and mortgage markets in a generation."[21] The company had issued $7.8 billion of preferred stock, had completed all 81 requirements of the consent agreement with OFHEO, and was discussing with OFHEO the possibility of reducing the 30% capital surplus requirement. The next day, Freddie also reported losses and said the company had raised $6 billion of preferred stock.

As both companies had filed current financial statements by this time, fulfilling a condition of lifting the restrictions imposed by the consent agreements, Lockhart announced that OFHEO would remove the portfolio caps on March 1, 2008. He also said OFHEO would consider gradually lowering the 30% capital surplus requirement, because both companies had made progress in satisfying their consent agreements and had recently raised capital through preferred stock offerings. Mudd told the FCIC that he sought relief from the capital surplus requirement because he did not want to face further regulatory discipline if Fannie fell short of required capital levels.[22]

On February 28, 2008, the day after OFHEO lifted the growth limits, a New York Fed analyst noted to Treasury that the 30% capital surcharge was a constraint that prevented the GSEs from providing additional liquidity to the secondary mortgage market.[23]

Calls to ease the surcharge also came from the marketplace. Mike Farrell, the CEO of Annaly Capital Management, warned Treasury Undersecretary Robert Steel that a crisis loomed in the credit markets that only the GSEs could solve. "We believe that we are nearing a tipping point; . . . lack of transparency on pricing for virtually every asset class" and "a dearth of buyers" foreshadowed worse news, Farrell wrote. Removing the capital surcharge and passing legislation to overhaul the GSEs would make it possible for them to provide more stability, he said. Farrell recognized that the GSEs might believe their return on capital would be insufficient, but contended that "they will have to get past that and focus on fulfilling their charters," because "the big picture is that right now whatever is best for the economy and the financial security of America trumps the ROI [return on investment] for Fannie and Freddie shareholders."[24]

Days before Bear Stearns collapsed, Steel reported to Mudd that he had "encouraging" conversations with Senator Richard Shelby, the ranking member of the Senate Committee on Banking, Housing, and Urban Affairs, and Representative Frank, chairman of the House Financial Services Committee, about the possibility of GSE reform legislation and capital relief for the GSEs. He intended to speak with Senate Banking Committee Chairman Christopher Dodd. Confident that the government desperately needed the GSEs to back up the mortgage market, Mudd proposed an "easier trade." If regulators would eliminate the surcharge, Fannie Mae would agree to raise new capital.[25] In a March 7 email to Fannie chief business officer Levin, Mudd suggested that the 30% capital surplus requirement might be reduced without any trade: "It's a time game . . . whether they need us more . . . or if we hit the capital wall first. Be cool."[26]

On the next day, March 8, Treasury and White House officials received additional information about Fannie's condition. The White House economist Jason Thomas sent Steel an email enclosing an alarming analysis: it claimed that in reporting its 2007 financial results, Fannie was masking its insolvency through fraudulent accounting practices. The analysis, which resembled one offered in a March 10 *Barron's* article, stated:

> Any realistic assessment of Fannie Mae's capital position would show the company is currently insolvent. Accounting fraud has resulted in several asset categories (non-agency securities, deferred tax assets, low-income partnership investment) being overstated, while the guarantee obligation liability is understated. These accounting shenanigans add up to tens of billions of exaggerated net worth.
>
> Yet, the impact of a tsunami of mortgage defaults has yet to run through Fannie's income statement and further annihilate its capital. Such grim results are a logical consequence of Fannie's dual mandate to serve the housing market while maximizing shareholder returns. In trying to do both, Fannie has done neither well. With shareholder capital depleted, a government seizure of the company is inevitable.[27]

Given the turmoil of the Bear Stearns crisis, Paulson said he wanted to increase confidence in the mortgage market by having Fannie and Freddie raise capital. Steel told him that Treasury, OFHEO, and the Fed were preparing plans to relax the GSEs' capital surcharges in exchange for assurances that the companies would raise capital.

On March 16, 2008, Steel also reported to his Treasury colleagues that William Dudley, then executive vice president of the New York Fed, wanted to "harden" the implicit government guarantee of Freddie and Fannie. Steel wrote that Dudley "leaned on me hard" to make the guarantee explicit in conjunction with dialing back the surcharge and attempting to raise new capital, and Steel worried about how this might affect the federal government's balance sheet: "I do not like that and it has not been part of my conversation with anyone else. I view that as a very significant move, way above my pay grade to double the size of the U.S. debt in one fell swoop."[28]

"THE IDEA STRIKES ME AS PERVERSE"

Regulators at OFHEO and the Treasury huddled with GSE executives to discuss lowering capital requirements if the GSEs would raise more capital. "The entire mortgage market was at risk," Lockhart told the FCIC.[29] The pushing and tugging continued. Paulson told the FCIC that personal commitments from Mudd and Freddie Mac CEO Richard Syron to raise capital cinched the deal.[30] Just days earlier, on March 13, Syron had announced in a quarterly call to investors that his company would not raise new capital. Fannie and Freddie executives prepared a draft press release before a discussion with Lockhart and Steel. It announced a reduction in the capital surcharge from 30% to 20%. Lockhart was not pleased; the draft lacked a commitment to raise additional capital, stating instead that the GSEs planned to raise it "over time as needed."[31] It looked as if the GSEs were making the deal with their fingers crossed. In an email to Steel and the CEOs of both entities, Lockhart wrote: "The idea strikes me as perverse, and I assume it would seem perverse to the markets that a regulator would agree to allow a regulatee to increase its very high mortgage credit risk leverage (not to mention increasing interest rate risk) without any new capital." The initial negotiations had the GSEs raising $2 of capital for each $1 of reduction in the surplus. Lockhart wrote in frustration, "We seem to have gone from 2 to 1 right through 1 to 1 to now 0 to 1."[32]

Despite Lockhart's reservations, OFHEO announced the deal, unaltered in any material way, on March 19. OFHEO agreed to ease the capital restraint from 30% to 20%; Fannie and Freddie pledged to "begin the process to raise significant capital," giving no concrete commitment.[33] Paulson told the FCIC that the agreement, which included a promise to raise capital, was "a no-brainer," and that he had no memory of Lockhart ever having called it "perverse."[34]

The market analyst Joshua Rosner panned the deal. "We view any reduction [in capital] as a comment not only on the GSEs but on the burgeoning panic in Washington," he wrote. "If this action results in the destabilizing of the GSEs, OFHEO will go from being the only regulator that prevented its charges from getting into trouble, to a textbook example of why regulators should be shielded from outside political pressure."[35]

Fannie would keep its promise by raising $7.4 billion in preferred stock. Freddie reneged. Executive Vice President Donald Bisenius offered two reasons why, in hindsight, Fannie Mae did not raise additional capital. First was protecting the assets of existing shareholders. "I'm sure [Fannie's] investors are not very happy," Bisenius told the FCIC. "Part two is . . . if you actually fundamentally believe you have enough capital to withstand even a fairly significant downturn in house prices, you wouldn't raise capital."[36]

Similarly, CEO Syron spoke of the downside of raising capital on August 6, 2008: "Raising a lot more capital at these kinds of prices could be quite dilutive to our shareholders, so we have to balance the interest of our shareholders."[37] But Lockhart saw it differently; in his view, Syron's public comments put "a good face on Freddie's inability to raise capital." He speculated that Syron was masking a different concern: lawsuits. "[Syron] was getting advice from his attorneys about the high risk of raising capital before releasing [quarterly earnings] . . . and our lawyers could not disagree because we know about their accounting issues," Lockhart told the FCIC.[38]

"IT WILL INCREASE CONFIDENCE"

In May, the two companies announced further losses in the first quarter. Even as the situation deteriorated, on June 9 OFHEO rewarded Fannie Mae for raising $7.4 billion in new capital by further lowering the capital surcharge, from 20% to 15%. In June, Fannie's stock fell 28%; Freddie's, 34%. The price of protection on $10 million in Fannie's debt through credit default swaps jumped to $66,000 in June, up from

$47,700 in May; between 2004 and 2006, it had typically been about $13,000. In August, they both reported more losses for the second quarter.

Even after both Fannie and Freddie became public companies owned by shareholders, they had continued to possess an asset that is hard to quantify: the implicit full faith and credit of the U.S. government. The government worried that it could not let the $5.3 trillion GSEs fail, because they were the only source of liquidity in the mortgage market and because their failure would cause losses to owners of their debt and their guaranteed mortgage securities. Uncle Sam had rescued GSEs before. It bailed out Fannie when double-digit inflation wrecked its balance sheet in the early 1980s, and it came through in the mid-1980s for another GSE in duress, the Farm Credit System. In the mid-1990s, even a GSE-type organization, the Financing Corporation, was given a helping hand.

As the market grappled with the fundamental question of whether Fannie and Freddie would be backed by the government, the yield on the GSEs' long-term bonds rose. The difference between the rate that the GSEs paid on their debt and rates on Treasuries—a premium that reflects investors' assessment of risk—widened in 2007 to one-half a percentage point. That was low compared with the same figure for other publicly traded companies, but high for the ultra-safe GSEs. By June 2008, the spread had risen 65% over the 2007 level; by September 5, just before regulators parachuted in, the spread had nearly doubled from its 2007 level to just under 1%, making it more difficult and costly for the GSEs to fund their operations. On the other hand, the prices of Fannie Mae mortgage–backed securities actually increased slightly over this time period, while the prices of private-label mortgage–backed securities dramatically declined. For example, the price of the FNCI7 index—an index of Fannie mortgage–backed securities with an average coupon of 7%—increased from 102 in January 2007 to 103 on September 5, 2008, two days prior to the conservatorship. As another example, the price of the FNCI5 index—Fannie securities with an average coupon of 5%—increased from 95 to 96 during the same time period.

In July and August 2008, Fannie suffered a liquidity squeeze, because it was unable to borrow against its own securities to raise sufficient cash in the repo market. Its stock price dove to less than $7 a share. Fannie asked the Fed for help.[39] A senior adviser in the Federal Reserve Board's Division of Banking Supervision and Regulation gave the FCIC a bleak account of the situation at the two GSEs and noted that "liquidity was just becoming so essential, so the Federal Reserve agreed to help provide it."[40]

On July 13, the Federal Reserve Board in Washington authorized the New York Fed to extend emergency loans to the GSEs "should such lending prove necessary . . . to promote the availability of home mortgage credit during a period of stress in financial markets."[41] Fannie and Freddie would never tap the Fed for that funding.[42]

Also on July 13, Treasury laid out a three-part legislative plan to strengthen the GSEs by temporarily increasing their lines of credit with the Treasury, authorizing Treasury to inject capital into the GSEs, and replacing OFHEO with the new Federal Housing Finance Agency (FHFA), with the power to place the GSEs into receivership. Paulson told the Senate that regulators needed "a bazooka" at their disposal.

"You are not likely to take it out," Paulson told legislators. "I just say that by having something that is unspecified, it will increase confidence. And by increasing confidence it will greatly reduce the likelihood it will ever be used."[43] Fannie's Mudd and Freddie's Syron praised the plan.[44]

At the end of July, Congress passed the Housing and Economic Recovery Act (HERA) of 2008, giving Paulson his bazooka—the ability to extend secured lines of credit to the GSEs, to purchase their mortgage securities, and to inject capital. The 261-page bill also strengthened regulation of the GSEs by creating FHFA, an independent federal agency, as their primary regulator, with expanded authority over Fannie's and Freddie's portfolios, capital levels, and compensation. In addition, the bill raised the federal debt ceiling by $800 billion to $10.6 trillion, providing funds to operate the GSEs if they were placed into conservatorship.

After the Federal Reserve Board consented in mid-July to furnish emergency loans, Fed staff and representatives of the Office of the Comptroller of the Currency (OCC), along with Morgan Stanley, which acted as an adviser to Treasury, initiated a review of the GSEs. Timothy Clark, who oversaw the weeklong review for the Fed, told the FCIC that it was the first time they ever had access to information from the GSEs. He said that previously, "The GSEs [saw] the Fed as public enemy number one. . . . There was a battle between us and them." Clark added, "We would deal with OFHEO, which was also very guarded. So we did not have access to info until they wanted funding from us."[45] Although Fed and OCC personnel were at the GSEs and conferring with executives, Mudd told the FCIC that he did not know of the agencies' involvement until their enterprises were both in conservatorship.[46]

The Fed and the OCC discovered that the problems were worse than their suspicions and reports from FHFA had led them to believe. According to Clark, the Fed found that the GSEs were significantly "underreserved," with huge potential losses, and their operations were "unsafe and unsound."[47] The OCC rejected the forecasting methodologies on which Fannie and Freddie relied. Using its own metrics, it found insufficient reserves for future losses and identified significant problems in credit and risk management. Kevin Bailey, the OCC deputy comptroller for regulatory policy, told the FCIC that Fannie's loan loss forecasting was problematic, and that its loan losses therefore were understated. He added that Fannie had overvalued its deferred tax assets—because without future profits, deferred tax assets had no value.[48]

Loss projections calculated by Morgan Stanley substantiated the Fed's and OCC's findings. Morgan Stanley concluded that Fannie's loss projection methodology was flawed, and resulted in the company substantially understating losses. Nearly all of the loss projections calculated by Morgan Stanley showed that Fannie would fall below its regulatory capital requirement. Fannie's projections did not.

All told, the litany of understatements and shortfalls led the OCC's Bailey to a firm conclusion. If the GSEs were not insolvent at the time, they were "almost there," he told the FCIC.[49] Regulators also learned that Fannie was not charging off loans until they were delinquent for two years, a head-in-the-sand approach. Banks are required to charge off loans once they are 180 days delinquent. For these and numerous other errors and flawed methodologies, Fannie and Freddie earned rebukes. "Given the role of the GSEs and their market dominance," the OCC report said, "they should be industry leaders with respect to effective and proactive risk management, productive analysis, and comprehensive reporting. Instead they appear to significantly lag the industry in all respects."[50]

"CRITICAL UNSAFE AND UNSOUND PRACTICES"

Paulson told the FCIC that although he learned of the Fed and OCC findings by August 15, it took him three weeks to convince Lockhart and FHFA that there was a capital shortfall, that the GSEs were not viable, and that they should be placed under government control.[51] On August 22, FHFA informed both Mudd and Syron that their firms were "adequately capitalized" under the regulations, a judgment based on financial information that was "certified and represented as true and correct by [GSE] management." But FHFA also emphasized that it was "seriously concerned about the current level of Fannie Mae's capital" if the housing market decline continued.[52]

Fannie's prospects for increasing capital grew gloomier. Fannie informed Treasury on August 25—and repeatedly told FHFA—that raising capital was infeasible and that the company was expecting additional losses. Even Fannie's "base-case earnings forecast" pointed to substantial pressure on solvency, and a "stressed" forecast indicated that "capital resources will continue to decline."[53]

By September 4, Lockhart and FHFA agreed with Treasury that the GSEs needed to be placed into conservatorship. That day, Syron and Mudd received blistering midyear reviews from FHFA. The opening paragraph of each letter informed the CEOs that their companies had been downgraded to "critical concerns," and that "the critical unsafe and unsound practices and conditions that gave rise to the Enterprise's existing condition, the deterioration in overall asset quality and significant earnings losses experienced through June 2008, as well as forecasted future losses, likely require recapitalization of the Enterprise."[54] A bad situation was expected to worsen.

The 21-page report sent to Fannie identified sweeping concerns, including failures by the board and senior management, a significant drop in the quality of mortgages and securities owned or guaranteed by the GSE, insufficient reserves, the almost exclusive reliance on short-term funding, and the inability to raise additional capital. FHFA admonished management and the board for their "imprudent decisions" to "purchase or guarantee higher risk mortgage products." The letter faulted Fannie for purchasing high-risk loans to "increase market share, raise revenue and meet housing goals," and for attempting to increase market share by competing with Wall Street firms that purchased lower-quality securities. FHFA, noting "a conflict between prudent credit risk management and corporate business objectives," found that these purchases of higher-risk loans were predicated on the relaxing of underwriting and eligibility standards. Using models that underestimated this risk, the GSE then charged fees even lower than what its own deficient models suggested were appropriate. FHFA determined that these lower fees were charged because "focus was improperly placed on market share and competing with Wall Street and [Freddie Mac]."[55]

Even after internal reports pointed to market problems, Fannie kept buying and guaranteeing riskier loan products, FHFA said. "Despite signs in the latter half of 2006 and 2007 of emerging problems, management continued activity in risky programs, and maintained its higher eligibility program for Alt-A loans without establishing limits."[56] The company also bought private-label securities backed by Alt-A and subprime loans.[57] Losses were likely to be higher than the GSEs had estimated, FHFA found.

FHFA also noted "increasing questions and concerns" regarding Fannie's accounting. The models it used to forecast losses had not been independently validated or updated for several years. FHFA judged that in an up-to-date model, estimated losses would likely show a "material increase." In addition, Fannie had overvalued its deferred tax assets. Applying more reasonable projections of future performance, FHFA found this benefit to be significantly overstated.[58]

The 22-page report delivered to Freddie included similarly harsh assessments of that GSE's safety and soundness, but more severe criticisms of its management and board. In particular, the report noted a significant lack of market confidence, which had "eliminated the ability to raise capital." FHFA, for its part, "lost confidence in the Board of Directors and the executive management team," holding them accountable for losses stemming from "a series of ill-advised and poorly executed decisions and other serious misjudgments." According to the regulator, they therefore could not be relied on, particularly in light of their widespread failures to resolve regulatory issues and address criticisms. In addition, FHFA said that Freddie's failure to raise capital despite its assurances "invite[d]" the conclusion that the board and CEO had not negotiated "in good faith" about the capital surcharge reduction.[59]

As in its assessment of Fannie, FHFA found that Freddie's unsafe and unsound practices included the purchase and guarantee of higher-risk loan products in 2006 and 2007 in a declining market. Even after being told by the regulator in 2006 that its purchases of subprime private-label securities had outpaced its risk management abilities, Freddie bought $22 billion of subprime securities in each subsequent quarter.

FHFA also found that "aggressive" accounting cast doubt on Freddie's reported earnings and capital. Despite "clear signals" that losses on mortgage assets were likely, Freddie waited to record write-downs until the regulator threatened to issue a cease and desist order. Even then, one write-down was reversed "just prior to the issuance of the second quarter financial statements." The regulator concluded that rising delinquencies and credit losses would "result in a substantial dissipation of earnings and capital."[60]

"THEY WENT FROM ZERO TO THREE WITH NO WARNING IN BETWEEN"

Mudd told the FCIC that its regulator had never before communicated the kind of criticisms leveled in the September 4 letter. He said the regulator's "chronicling of the situation" then was "inconsistent with what you would consider better regulatory practice to be—like, first warning: fix it; second warning: fix it; third warning: you're out of here. Instead, they went from zero to three with no warning in between."[61] A review of the examination reports and other documents provided by FHFA to the FCIC largely supports Mudd's view on this specific point. While OFHEO's examination reports noted concerns about increasing credit risk and slow remediation of deficiencies required by the May 2006 consent agreement, they do not include the sweeping criticisms contained in the September 4 letter.

Two days after their two companies were designated "critical concerns," Mudd at Fannie and Syron at Freddie faced a government takeover. On September 6, FHFA Acting Deputy Director Chris Dickerson sent separate memos to Lockhart recommending that FHFA be appointed conservator for each GSE.[62]

Still, conservatorship was not a foregone conclusion. Paulson, Lockhart, and Bernanke met with Mudd, Syron, and their boards to persuade them to cede control.[63] Essentially the GSEs faced a Hobson's choice: take the horse offered or none at all. "They had to voluntarily agree to a consent agreement," Lockhart told the FCIC. The alternative, a hostile action, invited trouble and "nasty lawsuits," he noted. "So we made a . . . very strong case so the board of directors did not have a choice."[64] Paulson reminded the GSEs that he had authority to inject capital, but he would not do so unless they were in conservatorship.[65]

Mudd was "stunned and angry," according to Paulson.[66] Tom Lund, who ran Fannie Mae's single-family business, told the FCIC that conservatorship came as a surprise to everyone.[67] Levin told the FCIC that he never saw a government seizure coming. He never imagined, he said, that Fannie Mae was or might become insolvent.[68] Interviewed in 2010, Mudd told the FCIC: "I did not think in any way it was fair for the government to have been in a position of being in the chorus for the company to add capital, and then to inject itself in the capital structure."[69] The conservatorship memoranda reiterated all the damning evidence presented in the letters two days earlier. Losses at Fannie Mae for the year were estimated to be between $18 billion and $50 billion.[70] Freddie Mac's memorandum differed only in the details. Its losses, recorded at $1 billion in the first six months of 2008, were projected to end up between $11 and $32 billion by the end of the year.[71]

Although the boards had a choice, the only realistic option was assent. "We were going to agree to go in a conservatorship anyway," Syron told the FCIC. "There was a very clear message that the [September 4] letter was there as a mechanism to bring about a result."[72] Mudd agreed, observing that "the purpose of the letter was really to force conservatorship."[73] The boards of both companies voted to accept conservatorship.

Both CEOs were ousted, but the fundamental problems persisted. As promised, the Treasury was prepared to take two direct steps to support solvency. First, it would buy up to $200 billion of senior preferred stock from the GSEs and extend them short-term secured loans. In addition, it pledged to buy GSE mortgage–backed securities from Wall Street firms and others until the end of 2009. Up front, Treasury bought from each GSE $1 billion in preferred stock with a 10% dividend. Each GSE also gave Treasury warrants to purchase common stock representing 79.9% of shares outstanding. Existing common and preferred shareholders were effectively wiped out. The decline in value of the preferred stock caused losses at many banks that held these securities, contributing to the failure of 10 institutions and to the downgrading of 35 to less than "well capitalized" by their regulators.[74]

Paulson told the FCIC that he was "naive" enough to believe that the action would halt the crisis because it "would put a floor under the housing market decline, and provide confidence to the market." He realized he was wrong on the next day, when, as he told the FCIC, "Lehman started to go."[75] Former Treasury Assistant Secretary Neel Kashkari agreed. "We thought that after we stabilized Fannie and Freddie that we bought ourselves some time. Maybe a month, maybe three months. But they were such profound interventions, stabilizing such a huge part of the financial markets, that would buy us some time. We were surprised that Lehman then happened a week later, that Lehman had to be taken over or it would go into bankruptcy."[76]

The firms' failure was a huge event and increased the magnitude of the crisis, according to Fed Governor Kevin Warsh and New York Fed General Counsel Tom Baxter.[77] Warsh also told the FCIC that the events surrounding the GSE takeover led to "a massive, underreported, underappreciated jolt to the system." Then, according to Warsh, when the market grasped that it had misunderstood the risks associated with the GSEs, and that the government could have conceivably let them fail, it "caused investors to panic about the value of every asset, to reassess every portfolio."[78]

FHFA Director Lockhart described the decision to put the GSEs into conservatorship in the context of Lehman's failure. Given that the investment bank's balance sheet was about one-fifth the size of Fannie Mae's, he felt that the fallout from Lehman's bankruptcy would have paled in comparison to a GSE failure. He said, "What happened after Lehman would have been very small compared to these $5.5 trillion institutions failing."[79] Major holders of GSE securities included the Chinese and Russian central banks, which, between them, owned more than half a trillion dollars of these securities, and U.S. financial firms and investment funds had even more extensive holdings. A 2005 Fed study concluded that U.S. banks owned more than $1 trillion in GSE debt and securities—more than 150% of the banks' Tier 1 capital and 11% of their total assets at the time.[80]

Testifying before the FCIC, Mudd claimed that failure was all but inevitable. "In 2008, the companies had no refuge from the twin shocks of a housing crisis followed by a financial crisis," he said. "A monoline GSE structure asked to perform multiple tasks cannot withstand a multiyear 30% home price decline on a national scale, even without the accompanying global financial turmoil. The model allowed a balance of business and mission when home prices were rising. When prices crashed far beyond the realm of historical experience, it became 'The Pit and the Pendulum,' a choice between horrible alternatives."[81]

"THE WORST-RUN FINANCIAL INSTITUTION"

When interviewed by the FCIC, FHFA officials were very critical of Fannie's management. John Kerr, the FHFA examiner (and an OCC veteran) in charge of Fannie examinations, minced no words. He labeled Fannie "the worst-run financial institution" he had seen in his 30 years as a bank regulator. Scott Smith, who became associate director at FHFA after that agency replaced OFHEO, concurred; in his view, Fannie's forecasting capabilities were not particularly well thought out, and lacked a variety of stress scenarios. Both officials noted Fannie's weak forecasting models, which included hundreds of market simulations but scarcely any that contemplated declines in house prices. To Austin Kelly, an OFHEO examination specialist, there was no relying on Fannie's numbers, because their "processes were a bowl of spaghetti." Kerr and a colleague said that that they were struck that Fannie Mae, a multitrillion-dollar company, employed unsophisticated technology: it was less tech-savvy than the average community bank.[82]

Nonetheless, OFHEO's communications with Fannie prior to September 4 did not fully reflect these criticisms. FHFA officials conceded that they had made mistakes in their oversight of Fannie and Freddie. They paid too much attention to fixing operational problems and did not react to Fannie's increasing credit risk. Lockhart told the FCIC that more resources should have been dedicated to assessing credit risk of their mortgage assets and guarantees.[83] Current FHFA Acting Director Edward DeMarco told the FCIC that it would not pass the "reasonable person test" to deny that OFHEO took its eye off the ball by not paying sufficient attention to credit risk and instead focused on operational risk, accounting and lack of audited results.[84]

To Mudd and others, OFHEO's mistakes were not surprising. Mudd told the FCIC that the regulators' skill levels were "developing but below average."[85] Henry Cisneros, a former housing and urban development secretary, expressed a similar view. "OFHEO," Cisneros told the FCIC, "was puny compared to what Fannie Mae and Freddie Mac could muster in their intelligence, their Ivy League educations, their rocket scientists in their place, their lobbyists, their ability to work the Hill."[86]

The costs of the bailouts have been enormous and are expected to increase. From January 1, 2008, through the third quarter of 2010, the two companies lost $229 billion, wiping out $71 billion of combined capital that they had reported at the end of 2007 and the $7 billion of capital raised by Fannie in 2008. Treasury narrowed the gap with $151 billion in support. FHFA has estimated that costs through 2013 will range from $221 billion to $363 billion. The Congressional Budget Office has projected that the economic cost of the GSEs' downfall, including the total financial cost of government support as well as actual dollar outlays, could reach $389 billion by 2019.

"WASN'T DONE AT MY PAY GRADE"

Fannie's two most senior executives were asked at an FCIC hearing how their charter could have been changed to make the company more sound, and to avoid the multibillion-dollar bailout. Mudd, who made approximately $65 million from 2000 to 2008, testified that "the thing that would have made the institution more sound or have produced a different outcome would have been for it to have become over time a more normal financial institution able to diversify, able to allocate capital, able to be long or short in the market, able to operate internationally. And if the trade for that would have been, you know, a cut in the so-called implicit ties with the government, I think that would have—that would have been a better solution."[87] Chief Business Officer Levin, who received approximately $45 million from 2000 to 2008, answered only that making such decisions "wasn't done at my pay grade."[88]

COMMISSION CONCLUSIONS ON CHAPTER 17

The Commission concludes that the business model of Fannie Mae and Freddie Mac (the GSEs), as private-sector, publicly traded, profit-making companies with implicit government backing and a public mission, was fundamentally flawed. We find that the risky practices of Fannie Mae—the Commission's case study in this area—particularly from 2005 on, led to its fall: practices undertaken to meet Wall Street's expectations for growth, to regain market share, and to ensure generous compensation for its employees. Affordable housing goals imposed by the Department of Housing and Urban Development (HUD) did contribute marginally to these practices. The GSEs justified their activities, in part, on the broad and sustained public policy support for homeownership. Risky lending and securitization resulted in significant losses at Fannie Mae, which, combined with its excessive leverage permitted by law, led to the company's failure.

Corporate governance, including risk management, failed at the GSEs in part because of skewed compensation methodologies. The Office of Federal Housing Enterprise Oversight (OFHEO) lacked the authority and capacity to adequately regulate the GSEs. The GSEs exercised considerable political power and were successfully able to resist legislation and regulatory actions that would have strengthened oversight of them and restricted their risk-taking activities.

In early 2008, the decision by the federal government and the GSEs to increase the GSEs' mortgage activities and risk to support the collapsing mortgage market was made despite the unsound financial condition of the institutions. While these actions provided support to the mortgage market, they led to increased losses at the GSEs, which were ultimately borne by taxpayers, and reflected the conflicted nature of the GSEs' dual mandate.

GSE mortgage securities essentially maintained their value throughout the crisis and did not contribute to the significant financial firm losses that were central to the financial crisis.