CORPORATE WELFARE FOR THE POLITICALLY CONNECTED

THE STORY OF FANNIE MAE AND FREDDIE MAC

Introduction

Just a few decades ago, companies gave gold watches to their executives when they retired. With this generous gift, a company could thank an employee for years and years of service. Today, the gold watch seems quaint compared with the golden parachute -a large compensation package given to a departing executive – and golden handcuffs – high-value stock options that vest if an employee stays with a company for a few years.

Now our friends in Washington, D.C. have come up with a gold-plated perk of their own, one that makes corporate America look downright stingy. Washington's most connected operators are leaving government service and putting themselves out to pasture, but the pastures where these people graze are not green. They are solid gold.

Washington insiders are taking jobs at government-sponsored enterprises (GSEs) like the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). These semi-private corporations have charters from Congress that put them light years ahead of their competitors. The advantages given them by federal law send their profits into the billions, while their executives reap salaries in the multimillions. These same executives use their influence in Congress to protect their companies' precious exemptions from laws that everyone else in their industry – the secondary mortgage market – must obey. In addition, Fannie Mae and Freddie Mac have a relatively low-key regulator who either doesn't have or doesn't exercise the authority to keep the GSEs from expanding into lines of business to which they have only the most tenuous connections.

All that's gold does not glitter, at least to the American taxpayer. Fannie Mae and Freddie Mac are supported by government subsidies that the Congressional Budget Office (CBO) pegged at $6.5 billion in 1995. Expansion into new markets and increasingly risky investments could stifle competition and send taxpayers' liabilities into the hundreds of billions of dollars, repeating the all-too-recent savings and loan (S&L) debacle.

Before Fannie Mae and Freddie Mac go any farther, Congress should take a hard look at where these GSEs are going and whether they should be subject to the same consumer-protection regulations as their private-sector competitors. If they retain any government sponsorship at all, Fannie Mae and Freddie Mac should stick to the broad public policy purpose for which they were created: to pump as much private money as possible into the housing market, so that interest rates on home mortgages for low and moderately priced housing are within reach of the ordinary home buyer. And members of Congress should ignore their influential friends and former employees who are on the Fannie and Freddie payroll. The GSEs' lobbying teams may be heavyweight and brassy, but they are not good-as-gold for the U.S. economy and the American taxpayer.

What are Fannie Mae and Freddie Mac?

Fannie Mae and Freddie Mac are semi-private corporations that receive special benefits under charters granted by the federal government. Congress created Fannie Mae in 1938, "privatized" it in 1968, and created Freddie Mac two years later. The companies exist to create liquidity in the secondary market for mortgages. Fannie and Freddie buy mortgages from original commercial mortgage lenders, who take that money and make new loans. Fannie and Freddie then bundle up the mortgages they have bought and issue mortgage-backed securities (MBS), which are sold to ordinary investors. Originally, only Fannie and Freddie did this. But as the financial markets have broadened, and as individual and institutional investors have become more sophisticated, the market for MBS has matured, and many financial institutions now sell these securities.

But their government charters continue to be a gold mine for Fannie and Freddie, providing them with advantages that private-sector companies can never have. Fannie and Freddie do not have to register their securities with the Securities and Exchange Commission (SEC), for example. This frees them from regulatory burdens that their private-sector competitors carry. According to Treasury Under-Secretary Gary Gensler, this exemption was worth $280 million to Fannie and Freddie last year. They are also exempt from paying state and local income taxes, an advantage that any small business would love to have. In 1999, that exemption saved Fannie and Freddie $690 million.

These perks would be enough, one would think, in an industry where competition should be making profit margins slim. But there are more. Fannie and Freddie do not have to meet the same capital requirements that are imposed on banks and thrifts. In other words, they do not have to keep as much money on hand to cover losses if people default on the mortgages Fannie and Freddie have bought. Their private-sector competitors have to hold more capital, which reduces profitability. However, it is not just profitability at issue here. By not protecting themselves like banks and thrifts do, Fannie and Freddie leave their stockholders open to increased risk.

The government giveaway does not stop there. Fannie Mae and Freddie Mac each have a $2.25 billion line of credit from the U.S. Treasury Department, a blockbuster of a break that no private-sector company could ever get. The goodie that tops them all, though, is the appearance that Fannie Mae and Freddie Mac are too big to fail. The financial markets believe that the U.S. government would bail these companies out if they went belly up, just like the government bailed the S&Ls out in the 1990s.

Fannie Mae and Freddie Mac are also using their legal exemptions to expand their shared mortgage monopoly. And in recent years, they have moved aggressively to expand their profits, causing them to take on more and greater financial risk. If either Fannie or Freddie, the biggest players in the mortgage lending industry, were to go under, it would have seismic consequences for the U.S. economy. The federal government would have to step in, and taxpayers would be handed a massive bill, just like when the S&L crisis hit. That's why risky behavior at Fannie Mae and Freddie Mac threatens taxpayers, not just Fannie and Freddie's stockholders.

Fannie and Freddie's Political Connections

Because Fannie Mae and Freddie Mac were created by Congress, it should be no surprise that they have close ties to the politically connected. Five of Fannie Mae's eighteen directors are appointed by the President of the United States. But their advantages only start there.

Fannie Mae has become a veritable Millionaire Acres for people leaving government service. Franklin Raines, the former director of the Office of Management and Budget in the Clinton Administration, is the current CEO. His compensation package is reported to top $8 million a year. Freddie's Chairman and CEO, Leland Brendsel, makes nearly $7 million annually. Fannie Mae Vice Chair Jamie Gorelick was a deputy attorney general under President Clinton. In June 1999 testimony before the House Budget Committee, Ralph Nader noted that Ms. Gorelick made nearly $2 million in her first eight months on the job, though she had no previous experience in housing finance. And former Fannie Mae Chairman James Johnson, a close adviser to former Vice President Walter Mondale, made $9.5 million in 1998.

Former Clinton Administration officials and Democrats are not the only ones munching clover in Fannie Mae's golden pasture. Senior Vice President John Buckley was press secretary for Congressman Jack Kemp (R-N.Y.) and he worked on the Republican presidential campaigns of 1984 and 1996. Fannie Mae Vice President Duane Duncan was staff director for Congressman Richard Baker, the Louisiana Republican who currently chairs the House subcommittee that oversees Fannie and Freddie.

Government officials occasionally return from Fannie Mae to recharge their political connections, too. Clinton Administration Commerce Secretary William Daley was a director and the current director of the Congressional Budget Office, Dan Crippen, is a former Fannie Mae lobbyist.

All of these political connections should be enough, but Fannie Mae takes even greater pains to protect its substantial interests. Writer Owen Pullman, in a 1999 article in The International Economy entitled "Crony Capitalism: American Style," noted that Fannie Mae has nearly 20 top-drawer law firms on retainer to help run its $4 million a year lobbying operation. In 1996, House Banking Committee Chairman Jim Leach (R-Iowa) merely floated the idea of reducing some of Fannie's perks. It took less than a day for Fannie and friends to "blow the idea out of the water."

A Corporate Welfare Credit Card

Why do Fannie Mae and Freddie Mac cultivate their Washington connections so carefully? Because their bread and butter are the advantages they have been given in federal law. The CBO found in 1996 that about 40 percent of the earnings of Fannie Mae and Freddie Mac could be traced to their government-sponsored status. Some of the perks that go to Fannie and Freddie are more obvious than others, but each one is nothing more than corporate welfare. Fannie and Freddie sometimes even help members of

Congress deliver pork to their districts. But, more than anything, the two companies are a heaping plate of ham served right up to the politically connected in Washington, D.C.

The exemption from state and local tax is an obvious subsidy. It gives Fannie and Freddie a leg up on their competition at the expense of the schools, roads, and police and fire protection that are usually paid for with state and local taxes. The exemption from SEC registration allows Fannie and Freddie to issue MBS more cheaply and at greater profit than any competitor. And Fannie Mae's $2.25 billion line of credit is like taxpayers' money in the Fannie Mae bank.

The lower capital requirements enjoyed by Fannie and Freddie increase their profits while increasing their risk. This is a nicely hidden perk; its "stealth" corporate welfare. By lowering the amount of money Fannie and Freddie must keep on hand to cover defaults, Congress is letting them fly a little higher, taking greater risks than those private mortgage lenders can take.

The risks do not vanish, however. There is an understanding that Congress and the American taxpayers are shouldering that burden. The U.S. government is the insurance carrier for Fannie and Freddie if they fall on hard times.

This has made Fannie and Freddie one of the best credit risks in the country, nearly as good as the U.S. Treasury. And they are not afraid to tout that status. In an August 1998 report to investors, Fannie Mae cited its federal "agency" status and suggested that Fannie Mae debt is "on a par with obligations of the United States." Their government-backed credit rating allows the GSEs to borrow at rates almost as low as the Treasury itself. Cheaper money for Fannie and Freddie means that they can loan money more cheaply or make more money on the same loans than their private-sector counterparts. That message has been received loud and clear on Wall Street. A May 12, 2000 Moody's press release ascribed the GSEs' high bond rating to their "good financial fundamentals, the strong implied government support of the enterprises, and the competitive advantages they enjoy as a result of their special status." More subtle than a corporate welfare check, this golden goodie is a corporate welfare credit card.

Fannie Mae and Freddie Mac are leveraging their corporate welfare credit to the max. In a September 1999 speech, Fannie Mae CEO Franklin Raines noted that the previous year had been Fannie Mae's 12th consecutive year of double-digit growth in operating earnings per share. He predicted that, over the next five years, Fannie Mae would continue to deliver that level of growth. "[W]e have set as a goal to double our earnings per share in five years," Raines said. That growth will come from pushing into new markets and increasing their government subsidies, or from increasingly risky investments – buying mortgages that have a greater risk of defaulting than the ones Fannie and Freddie have bought up to now.

Cracks in Fannie and Freddie's Political Defense

Despite the aggressive profit motive that Fannie Mae CEO Franklin Raines exhibits in his speeches to shareholders, Fannie Mae seeks to protect itself politically by wearing the mantle of public service. It has rolled out a $4 million a year public image campaign

touting itself as the leader in affordable lending for minorities and people at the low end of the economic scale. At a press conference on March 2, 2000, for example, Raines called Fannie Mae the "market leader" in breaking down home-ownership barriers created by wealth, income, credit, information, and discrimination.

But a *Washington Post* article published the very day Raines made his statement about minority lending told a dramatically different story. The *Post* reported that the shares of Fannie Mae and Freddie Mac mortgages going to minorities *trail* the national average for mortgage lending by 1.3 percent and 2.1 percent, respectively. This disparity is more pronounced with African Americans and Hispanics. Fannie and Freddie buy, respectively, 3.2 percent and 3.0 percent of loans made to African-Americans. But, nationally, African Americans take out about 5 percent of the loans. This means that Fannie Mae and Freddie Mac, for all their federal subsidies, are *less* aggressive with mortgages of non-white Americans than their private-sector competitors, who also pay the state and local taxes that support local schools and educate poor and minority children.

Although Fannie and Freddie purchased 39 percent of all mortgages for owner and rental housing units in 1997, their share of low- and moderate-income housing mortgages was only 30 percent. Their share of mortgages issued to very low- and low-income families was only 24 percent. This means that, despite their claims to be bringing home ownership to low-income families, Fannie Mae and Freddie Mac are purchasing fewer of the loans made to such borrowers than the market as a whole. Fannie and Freddie are buying mortgages issued to the middle and upper classes, borrowers whose mortgages are willingly bought by any secondary market investors.

These statistics about low-income mortgage support come from the Department of Housing and Urban Development (HUD). William Apgar, federal housing commissioner at HUD, told the *Washington Post*, "The absence of active involvement by Fannie Mae and Freddie Mac in these markets limits the opportunities for African American families to get conventional mortgages." HUD has proposed regulations that would require Fannie and Freddie to increase their public service commitment, in light of all the public benefits they receive.

After the *Post* revealed Fannie Mae's poor lending record, Chairman Franklin Raines wrote a livid op-ed accusing the *Post* of "journalistic malpractice." Fannie Mae's friends and lobbyists fanned out on Capitol Hill to reconstruct Fannie Mae's public service image. However, a big chunk of the benefits Fannie Mae and Freddie Mac collect from the government go directly to their executives and stockholders, not to the public. In 1996, the CBO called Fannie Mae and Freddie Mac a "spongy conduit." Of the more than $6.5 billion they received in subsidies in 1995, only two thirds were passed on as a benefit to home buyers. One dollar out of every three goes to shareholders and executives, but this ongoing windfall may not be enough for Fannie and Freddie.

Aggressive Growth, Increasing Risk and Conflicting Regulations

Fannie Mae and Freddie Mac plan aggressive growth in order to feed shareholder expectations and executive compensation. Regulators at HUD are pushing them to

support lending to consumers who have a greater risk of default. Thus, they are likely to try to expand in two directions: new services and riskier investments.

Fannie and Freddie have already exhibited a penchant for growth into businesses that are not expressly authorized by their charters. Freddie Mac, for example, attempted to enter the mortgage insurance market and briefly received a change in its charter to allow this. Fannie Mae has considered providing life insurance for its borrowers. Both Fannie and Freddie have invested in providing automated underwriting services to lenders, and even directly to borrowers. This could put them in the business of originating loans, which would eviscerate a functioning and diverse private market for consumer home loans. In 1996, CBO found that the nation's mortgage markets were fully served by private firms. The CBO report even questioned whether Fannie and Freddie are still needed to perform their original function – providing liquidity in the secondary mortgage market.

Because of their government-sponsored advantages, Fannie and Freddie can offer new financial services at prices below the actual cost of providing them. But the benefit to consumers of lower prices, which are subsidized by taxpayers anyway, might only last a short time. Once Fannie and Freddie had captured a big chunk of the business, they could raise prices again. This legal monopoly would destroy diversity and innovation in the markets for financial services; no private company could do this without drawing the attention of the Justice Department. Most importantly, the risks of business failure would fall on the U.S. government and taxpayers. Growth into new markets would inflate the value of Fannie and Freddie's subsidies to dramatic new heights.

Pushed by HUD regulators, Fannie and Freddie have begun to advertise their intention to begin purchasing a larger number of mortgages that have a higher risk of default. However, Armando Falcone, the director of the Office of Federal Housing Enterprise Oversight (OFHEO) – an office within HUD that oversees Fannie and Freddie – has said that OFHEO will limit Fannie and Freddie to purchasing only suitably qualified mortgages, as required by law. He has also said that OFHEO will require Fannie and Freddie to hold more capital. This means that while some HUD officials are pushing Fannie and Freddie to take on more risk, Fannie and Freddie's financial regulators are making that difficult to achieve. In this contradictory tug of war, it will be difficult for OFHEO to work against its parent agency.

S&L regulators had the same kinds of responsibilities that OFHEO has for overseeing Fannie Mae and Freddie Mac. Instead of reining them in, the S&L regulators exercised "regulatory forbearance," which allowed the S&L crisis to fester. OFHEO may be no more effective than were the S&Ls' regulators.

Furthermore, OFHEO is subject to attack by Fannie and Freddie in the congressional appropriations process. In 1999, a Senate committee capped OFHEO's funding at $16 million despite the Clinton Administration's request for a 20 percent increase in its budget, because Fannie and Freddie lobbyists had worked to kill the increase in funds. The funding ultimately was increased partly because the private sector urged legislators not to hamstring OFHEO's already limited independence, but the episode showed the willingness of Fannie Mae and Freddie Mac to use the appropriations process to try to neutralize their chief regulator.

Ultimately, Fannie and Freddie will end up with a larger portfolio of riskier investments combined with insufficient capital. Their portfolios will become highly sensitive to economic shifts. It is at this point that the futures of Fannie Mae and Freddie Mac begin to follow the path of the S&L crisis.

An S&L Crisis for the New Millennium?

Though recent experience has lulled many into thinking that the economy will grow in perpetuity and interest rates will remain stable forever, they will not. Economic shocks from a number of quarters may push rates up or down quickly. The larger Fannie and Freddie get and the riskier their behavior becomes, the more sensitive their bottom lines will be to movements in the economy and interest rates. A general downturn in economic conditions could send Fannie and Freddie into insolvency. This, along with the fact that the U.S. government essentially insures Fannie and Freddie, means that they may be on the same path that the S&Ls took before going bust in the 1980s.

Even if the economy weakens gradually, there are a number of ways Fannie or Freddie could become insolvent. In a recession, slumping housing prices and rising unemployment would cause a high number of mortgage defaults. With their anemic capital stores, it is questionable whether Fannie and Freddie would have the cash necessary to guarantee the mortgages they have purchased and re-sold as MBS.

Like the S&Ls did, Fannie and Freddie use short-term debt to buy long-term mortgages. Usually, money can be borrowed more cheaply in the short term. However, if the cost of short-term borrowing rises above long-term, as happened with the S&Ls, Fannie and Freddie will hemorrhage funds. The mortgages that they have paid for with short-term, high-interest debt will offer relatively low returns.

Alternatively, if interest rates were to drop, many mortgages that Fannie and Freddie hold and guarantee would be refinanced. Fannie and Freddie would have to cover the difference between the long-term funding they have issued and the new, lower price of borrowing. This, too, would cost them large amounts of money very quickly.

The implied existence of a government guarantee, however, would protect Fannie and Freddie from being pushed into bankruptcy or shut down by regulators like private-sector lenders. On the strength of that implied guarantee, in fact, investors continued to lend money to Fannie Mae when it was financially shaky in the early 1980s. Nothing in the way the marketplace has responded to Fannie and Freddie investments in ensuing years indicates that the outcome would be any different in another economic downturn. Investors believe that the federal government will always step in to protect Fannie Mae and Freddie Mac.

This is exactly what happened in the S&L crisis of the 1980s. S&Ls went into the red because of extremely high interest rates, but they were kept afloat by federal deposit insurance, which guaranteed that depositors would get their money back even if S&Ls were to lose all of their stockholders' money. Rather than shutting down, the S&Ls took riskier and riskier gambles in order to increase stockholders' returns, using depositors'

money. As a 1990 report by the Congressional Research Service stated, "[D]eposit insurance meant that depositors had nothing to lose as a consequence of risky lending by thrifts….S&L owners had nothing else to lose as a result of risky lending either. This left the Federal Government as the only party involved that had anything to lose as a consequence of risky lending by the thrifts." As we all know, the S&Ls' gambles did not pay off, and taxpayers ended up with the bill.

With federal deficits in decline, the U.S. Treasury is reducing its borrowing, and Fannie Mae and Freddie Mac are becoming the largest issuers of debt in the country. In just a few years, they are likely to be issuing more long-term debt than the entire U.S. government. Yet they are heading down the road that the S&Ls took in the 1980s. Their financial portfolios make them more susceptible to insolvency with each passing day. They issue bonds to buy back their own MBS, which means that they hold a double risk: the underlying credit risk associated with the mortgages they bought originally, and the interest rate risk associated with the earnings on the MBS. In addition, they owe money to the bondholders. This is the very same house of cards the S&Ls erected.

These high-flying lenders could be jolted by interest rate changes and economic shocks at any time. Their government cushion permits Fannie and Freddie to be more careless with investments, not more cautious, a perverse incentive that could lead to losses. The end result will be a government bailout that costs taxpayers hundreds of billions of dollars.

Summary

Because so many of the corporate chieftans at Fannie Mae and Freddie Mac are former political leaders, and because the companies have such a large and expensive lobbying team, reform will not come easily. The GSEs will spend a lot of their gold to protect their exemptions. The payoff makes it more than worthwhile for them, with profits in the billions and executive salaries in the multimillions.

However, with the revelation that Fannie and Freddie's lending practices are not particularly helpful to their target populations – minorities and people at the lower end of the economic spectrum who have difficulty securing mortgages – their gilded image has begun to wear thin. More importantly, the heightened scrutiny is revealing that Fannie and Freddie are even greater threats to the public treasury than the S&Ls were in the 1980s. Fannie and Freddie are poised to expand risky investments and abuse their unique government endorsement in exactly the way the S&Ls did.

Despite the political connections of the executives at Fannie Mae and Freddie Mac, and despite the high-powered lobbying team, Congress must take steps to tighten oversight and demand accountability of the GSEs and safeguard their long-term solvency. If Congress does not do so, American taxpayers could ultimately bear the brunt of another crippling bailout.