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The Political Origins of the Financial Crisis: The Domestic and International Politics of Fannie Mae and Freddie Mac

HELEN THOMPSON

AT THE epicentre of the financial crisis of 2008 were the American mortgage market, subprime-mortgage-backed securities, and the large volume of credit default swaps taken out on them as effective insurance on their risk. At the centre of the mortgage-driven boom that preceded the crisis and the capital inflows from Asia that made it possible were the government-sponsored enterprises: Fannie Mae and Freddie Mac.

Fannie was created by the American government as a federal agency in 1938 to buy mortgages in the secondary market and sell them as securities. In 1968 it was converted into a private corporation with a congressional charter. Freddie was created in 1970 to provide support for the secondary mortgage market, again as a private corporation with a congressional charter. Fannie and Freddie were fundamentally different from other companies in the American financial sector. Commercially, they operated under different rules and understandings than other players. They had access to a direct line of credit from the Treasury, they were exempt from bank regulations on security holdings, and they were exempt from state and local income tax. Crucially, the securities they issued had government agency status. Although government officials repeatedly denied that Fannie and Freddie's bonds were guaranteed by the American federal government, the widespread perception to the contrary held in the markets. This allowed Fannie and Freddie to borrow below markets rates whilst central banks became willing to buy their debt in the same way as US Treasury bonds to hold as foreign exchange reserves. Politically, they operated according to a stated policy purpose of spreading home ownership and making housing more affordable. The 1992 Federal Housing Enterprises Financial Safety and Soundness Act mandated the Department of Housing and Urban Development (HUD) to set obligatory targets for Fannie and Freddie for provision to minority and lower-income housing areas.

In the 1970s Fannie and Freddie began the securitisation of prime mortgages. From the mid-1990s they became major players in the securitisation of loans to low and mid-income earners of both prime and subprime quality. In 1995 HUD made it possible for Fannie and Freddie to meet their affordable housing target goals by buying mortgage-backed securities that include loans to low-income borrowers. In 1997 First Union Capital Markets and Bear Stearns launched the first public securitisation of loans made by banks according to their obligations under the Community Reinvestment Act. This issue was guaranteed by Freddie Mac and was assumed to have a triple A rating. In 1999 Fannie eased the requirements on loans that it would purchase from lenders and moved into subprime buying.

In the last half of the decade of subprime lending and securitisation, Fannie and Freddie moved to the centre stage of

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the market. In 2004 HUD ordered the two corporations to increase significantly their purchases of subprime and Alt-A (between prime and subprime) loans and securities, which were already considerable. Between 2004 and 2007 Fannie and Freddie were the largest buyers of subprime and Alt-A mortgage-backed securities. This further expanded the opportunity for others to engage in subprime lending and at the same time extended the market for credit default swaps on these securities. Once the credit crunch began in the summer of 2007, Fannie and Freddie's purchase of loans alone kept the mortgage market going. During the first three-quarters of 2008 they were responsible for 80 per cent of new mortgages. By the summer of 2008, Fannie and Freddie controlled 90 per cent of the American secondary mortgage market and about 50 per cent of the total mortgage market.

Fannie and Freddie's purchases of mortgage-backed securities were financed by huge borrowing. When they were taken into receivership in September 2008 they had US$5.4 trillion of such securities and debt outstanding—a sum equal to the entire official debt of the United States. Fannie and Freddie's borrowing wired the two corporations into the high politics of the international economy because by 2008 other countries' central banks held between 35 and 40 per cent of their debt issued as bonds. Most of these bonds were held by Japan and China. In 2007 China was estimated to hold US $376 billion in long-term US agency debt—most of which was issued by Fannie and Freddie. The best estimates for 2008 suggest that this figure rose significantly. The Chinese central bank was also holding the bonds Fannie and Freddie were guaranteeing as well as those they were issuing themselves. Together, China's stock of Fannie and Freddie debt amounted to at least 10 per cent of its Gross Domestic Product. Consequently, the American mortgage sector and housing bubble depended very directly on the financial support of Asian central banks. That the Asian central banks' purchase of American Treasury bonds since 2001 kept American interest rates lower than they would otherwise have been fuelled the subprime boom further.

The nature of their borrowing meant that any failure by Fannie and Freddie to meet their debt obligations was capable of igniting, what Lawrence Summers has described since he left the Treasury as, the balance of financial terror between the United States and East Asia. As Fannie and Freddie's problems mounted during the summer of 2008, Yu Yongding, a former advisor to China's central bank, explained the reality of the situation: 'If the US government allows Fannie and Freddie to fail and international investors are not compensated adequately, the consequences will be catastrophic. If it is not the end of the world, it is the end of the current international financial system.'[1]

How things went wrong at Fannie and Freddie

Whilst they constituted a significant domestic and international vulnerability, Fannie and Freddie were over the past decade extraordinarily poorly, and at times illegally, run. In 2003 Freddie Mac had to restate earnings by around US$6.9 billion. In April 2006 the Federal Election Commission fined Freddie Mac US$3.8 million for illegal campaign contributions. This was the largest fine the Commission has ever imposed. Meanwhile, Fannie did not file financial reports for 2004 and 2005 and then secured an unprecedented allowance from the Securities and Exchange Commission not to be delisted from the New York Stock Exchange. A report of special examination published by the Office of Federal Housing Enterprise Oversight (OFHEO) noted that between 1998 and 2004 Fannie overstated reported income and capital by more than US$10 billion and did so deliberately and systematically by accounting irregularities to maximise bonuses and executive compensation. As a consequence of these findings, Fannie agreed a settlement with the OFHEO and the Securities and Exchange Commission in which it was forced to pay a US$400 million fine, accept limits of growth, and promise remedial action on internal control, corporate governance, risk management and accounting.

As well as documenting these accounting and reporting abuses, the OFHEO special examination report stated that Fannie persistently ran significant interest rate risks and, as a consequence, when interest rates fell in 2002, incurred billions of dollars of losses. By the first years of this decade, it was clear that Fannie and Freddie were operating in the rapidly expanding mortgage market with significantly lower capital ratios than banks. As Alan Greenspan told the Senate Baking Committee in February 2004, Fannie and Freddie were under-capitalised and overleveraged and as such threatened the stability of the American financial system: 'These are important organizations that, because of their implicit subsidy, are expanding at a pace beyond that consistent with systematic safety.'[2] What neither Greenspan nor anyone else admitted was that financed as Fannie and Freddie's borrowing was in significant part from Asian central banks, a serious financial failure at Fannie and Freddie threatened the entire international financial order.

The failure to regulate

Given the risks that Fannie and Freddie's practices posed, regulation of the two corporations was crucial. The 1992 Federal Housing Enterprises Financial Safety and Soundness Act established OFHEO as the regulator. OFHEO was located in the Department of Housing and Urban Development and, unlike other financial regulators, its budget was subject to congressional appropriation. In the 1990s OFHEO acquired a reputation as a light-touch regulator that offered little impediment to the way Fannie and Freddie chose to pursue business.

By 2000 officials in the Treasury and some members of Congress had become worried about Fannie and Freddie's growth and the terms on which it was taking place. In first February 2000 and then April 2001, Richard Baker, a Republican Representative from Louisiana, introduced bills in the House of Representatives to create a new regulator for Fannie and Freddie. Neither made it out of committee. After it was revealed in 2003 that there were huge accounting issues at Fannie and Freddie, the Bush administration and Republicans in both houses pushed for a new regulator located in the Treasury. In June 2003, Baker introduced another bill in the House—HR 2575, the Secondary Mortgage Market Enterprises Regulatory Improvement Act. A month later, Edward Royce, a Republican from California, initiated a second house bill, and Chuck Hagel, a Republican from Nebraska introduced S 1508 into the Senate. The bill's co-sponsors were Hagel's fellow Republicans, John Sununu, Trent Lott, Elizabeth Dole and John McCain. In September of that year, the Bush administration proposed new legislation along the lines of these bills. Bush's Treasury Secretary, John Snow, told the House Financial Services Committee: 'Housing finance is so important to our national economy that we need a strong, world-class regulatory agency to oversee the prudential operations of the government-sponsored enterprises and the safety and soundness of their financial activities consistent with maintaining healthy national markets for housing finance.'[3] Whilst Republicans were to the fore on the issue, one Democrat, John Corzine, a Senator from New Jersey, introduced his own reform bill.

By the middle of 2006, however, it was clear that there was insufficient Congressional support for action, particularly in the Senate. The Senate Banking Committee passed S 1508 in April 2004 with an amendment. All the Republicans on the committee voted in favour and all but one Democrat, Zell Miller from Georgia, voted against. The Republican sponsors of the bill, however, were unable to get the bill onto the floor of the Senate. In the new Congress that began in January 2005, Senators Hagel, Sununu and Dole tried again, introducing a new bill, S 190, which would have created a new regulator and limited Fannie and Freddie's mortgage-backed security portfolios as a matter of law.

The Senate Banking Committee passed S 190 on a partisan basis in July 2005. Again, the issue became getting the bill onto the floor of the Senate. On the one side, there appears to have been no Democrat willing to support it, which left the threat of a filibuster. On the other, Fannie and Freddie began lobbying ferociously to divide Republicans over the issue. Internal documents from Freddie show that it targeted 17 Republican Senators, some of whom were members of the Banking Committee and had previously voted the bill out of committee. In May 2006 John McCain became a co-sponsor of S 190 in a last-ditch attempt by pro-reform Republicans to get the bill onto the Senate floor. McCain declared: 'If Congress does not act, American taxpayers will continue to be exposed to the enormous risk that Fannie Mae and Freddie Mac pose to the housing market, the overall financial system, and the economy as a whole.'[4] Meanwhile the House did pass a less tough bill—the Federal Housing Finance Reform Act: 331 members of the House voted in favour and 90 against with 122 Democrats voting 'yes' and 74 voting 'no'.

The pattern of political action and inaction in the 11th Congress remained much the same. In April 2007, Senators Sununu, Hagel, Dole and Mel Martinez introduced the Federal Housing Enterprise Regulatory Reform Act of 2007. A month later the House voted through, on a large majority, a weaker bill: the Federal Housing Finance Reform Act of 2007. This created a new independent regulator, but gave this regulator no authority over Fannie and Freddie's mortgage-backed-securities portfolio. The Bush administration was unhappy with this and looked to the Senate to pass something that gave the new regulator consequential authority. When the credit crunch began in the summer of 2007, Christopher Dodd, the Democrat chair of the Senate Banking Committee, and Barney Frank, the Democrat chairman of the House Financial Services Committee, attacked Bush for advocating regulatory any reform of Fannie and Freddie. Finally, in July 2008, as Fannie and Freddie reached the financial precipice, the House and Senate passed the Federal Housing Finance Regulatory Reform Act of 2008 as part of the Housing and Economic Recovery Act. It established a Federal Housing Finance Agency with the authority to set capital requirements for Fannie and Freddie and provided an unlimited line of credit from the Treasury.

The politics of weak regulation

Congress' failure to regulate Fannie and Freddie at a time and in a manner that could have helped prevent the present financial crisis was the product of both the relationships Fannie and Freddie developed on the Hill and the nature of the politics of housing in the United States. Fannie and Freddie operated a fourfold strategy in dealing with Congress. First, they offered material support to individual members, directing an estimated US$19.3 million in contributions into campaign coffers between 1990 and 2008. Second, they engaged in systematic lobbying, spending an estimated US$170 million between 1998 and 2008. Third, they created a language of political justification for their expansion around affordable housing, especially for minorities, that was tied closely to the political agenda and concerns of many in Congress, especially significant sections of the Democratic party. As the 2006 OFHEO special report noted, Fannie presented its corporate objectives as the national housing interest and used that perception to attack anyone who advocated reform.

In spring of 2000, a Clinton administration Treasury official, Gary Gensler testified to a House committee supporting the first of Richard Baker's bills that would have ended the authority of the Treasury to buy US$2.25 billion of debt from each of Fannie and Freddie. Immediately afterwards, a spokesperson for Fannie declared that Gensler's comments had just cost more than 200,000 Americans the opportunity to buy their own home because the markets now saw Fannie and Freddie as a more risky investment than hitherto. In fact, mortgage rates fell in the week following Gensler's testimony. Those who most strongly defended Fannie and Freddie's practices in Congress dismissed every report from OFHEO, including those that detailed massive abuses and irregularities, and every legislative proposal that would have created a Treasury-based regulator into an attack on affordable housing. For example, in September 2003, Barney Frank, the then ranking Democrat on the House Committee on Financial Services, rebutted the criticism of the regulator of Fannie that the company was running serious risks:

> The more people, in my judgment, exaggerate a threat of safety and soundness, the more people conjure up the possibility of serious financial losses to the Treasury, which I do not see. I think we see entities that are fundamentally sound financially and withstand some of the disastrous scenarios. And even if there were a problem, the Federal Government doesn't bail them out. But the more pressure there is there, then the less I think we see in terms of affordable housing.[5]

Making explicit his motivation, he stated at a separate committee hearing in September 2003:

> My primary interest—and I know I share this with others on this committee who care a lot about housing—is to make sure that nothing is done in this reorganization that weakens the ability, indeed the obligation, of Fannie Mae and Freddie Mac to help us with our housing problem.[6]

Whilst this kind of political language was most frequently heard from Democrats, some Republicans saw the issues in similar terms. Again in September 2003, Representative Bob Ney told the House Committee on Financial Services:

> One of the only things that held this economy together as we all know in the last two years was housing and automobiles. Right now, it is housing as an important part of the recovery. The United States mortgage and credit markets are the envy of the world. The mortgage market has singlehandedly kept the economy afloat during the recent difficult economic times, and housing has proven to be the greatest single generator of wealth in our nation. . . . The liquidity that Fannie and Freddie provide to the market should not be compromised by unnecessary government regulation.[7]

Members like Ney and Frank made this kind of argument against the Bush administration's proposals to strengthen the regulation of Fannie and Freddie despite the fact that the proposals, among other things, gave HUD new authority to enforce the department's housing goals. Later, in 2005, the department, under Bush's leadership, increased the low-income loans target set for Fannie and Freddie.

This language resonated in a politics in which the state has long acted as an agent of expanding home ownership and in which home-owners get federal tax deductions on interest payments and property taxes. In his memoirs, former

Fed chairman, Alan Greenspan, explained his judgement that it was worth running financial risks in spreading home ownership more widely:

> I was aware that that loosening of mortgage credit terms for subprime borrowers increased financial risk, and that subsided home ownership initiatives distort market outcomes. But I believed then, as now, that the benefits of broadened home ownership are worth the risk. Protection of property rights, so critical to a market economy, requires a critical mass of owners to sustain political support.[8]

Fourth, Fannie and Freddie regularly abused OFHEO. As OFHEO reported in 2006, Fannie Mae's lawyers routinely challenged the authority of OFHEO each time it acted to regulate. On one occasion, a lawyer working for Fannie suggested suing OFHEO for seeking congressional action in relation to the company. Fannie and Freddie's congressional supporters defused issues and repeatedly suggested that the problems OFHEO were presenting were inconsequential. For example, take this exchange in the House Committee on Financial Services between Barney Frank and the chief executive officers of Fannie and Freddie who were testifying on HR 2575:

> *Frank*: Let me ask [George] Gould and [Franklin] Raines on behalf of Freddie Mac and Fannie Mae, do you feel that over the past years you have been substantially underregulated? Mr. Raines?
>
> *Raines*: No, sir.
>
> *Frank*: Mr. Gould?
>
> *Gould*: No, sir . . .
>
> *Frank*: OK. Then I am not entirely sure why we are here. . . . I believe there has been more alarm raised about potential unsafety [sic] and unsoundness than, in fact, exists.[9]

In different ways the politics of race abetted the strategies pursued by Fannie and Freddie. Until it ceased operating in 2007, the Fannie Mae Foundation gave an annual donation to the Congressional Black Caucus. In part the political language of affordable housing was about minorities. In September 2003, the African-American Congresswoman Maxine Waters said to a hearing of the House Financial Services Committee on Fannie and Freddie:

> I have sat through nearly a dozen hearings where, frankly, we were trying to fix something that wasn't broke. Housing is the economic engine of our economy, and in no community does this engine need to work more than in mine. With last week's hurricane and the drain on the economy from the war in Iraq, we should do no harm to these government-sponsored enterprises.[10]

At a hearing of the House Financial Services committee in October 2004 on a preliminary report by OFHEO into the accounting abuses at Fannie, Representative Lacy Clay dismissed the regulator's inquiries and pronounced that the proceedings were nothing more than 'the political lynching of Franklin Raines'.[11] In this context, anyone who attacked Fannie and Freddie made themselves politically vulnerable.

Conclusions

Fannie and Freddie were able to operate under a loose regulatory structure in part because the legislative structure in America makes legislating difficult on most issues and provides easy opportunities for large companies to get members of Congress to act as defenders of their interests. Yet they were also protected by set of deeply embedded political interests around housing. Expanding home ownership was popular and supported by an array of home-building and housing advocacy lobbies. Just as importantly, the issue of affordable housing provided Fannie and Freddie and their defenders in Congress with an almost unassailable language of political justification. With OFHEO having no authority under the existing regulatory legislation to limit the size of Fannie and Freddie's mortgage-backed-securities portfolios, constraints on Fannie and Freddie either had to come from the market or be self-imposed. Neither came. Fannie and Freddie were able to borrow in financial markets on very easy terms, their bonds had government-agency status, and their senior executives took advantage of the opportunity that presented to them and eschewed prudence for fast expansion.

Ironically, some of Fannie and Freddie's strongest supporters in Congress were willing to attack the whole premise on which Fannie and Freddie's ability to operate commercially and to meet their housing goals depended. Barney Frank told the House Committee on Financial Services in 2003:

> I am a strong supporter of the role that Fannie Mae and Freddie Mac play in housing, but nobody who invests in them should come looking to me for a nickel—nor anybody else in the Federal Government. And if investors take some comfort and want to lend them a little money and less interest rates, because they like this set of affiliations, good, because housing will benefit. But there is no guarantee, there is no explicit guarantee, there is no implicit guarantee, there is no wink-and-nod guarantee. Invest, and you are on your own.[12]

Yet it was utterly inconceivable that the American government could not be acting as the guarantor of Fannie and Freddie's borrowing on which these corporations' actions in the mortgage market depended. It could not possibly have precipitated the kind of loss on Japan and China that would have ensued if at a moment of crisis of solvency or liquidity, it had not taken over Fannie and Freddie's debt. Understanding this to be the case, the Japanese and Chinese central banks were willing, until the summer of 2008, to lend large sums of money to Fannie and Freddie despite the reality of the two enterprises' financial position.

The large risks that Fannie and Freddie posed to the domestic and international financial system from the late 1990s onwards were hidden or minimised because the domestic political price of truth-telling was steep and international truth-telling was redundant. Those members of Congress who wanted to regulate Fannie and Freddie more tightly were easily cast as opponents of affordable housing and unsympathetic to minorities. Meanwhile, the reality that the whole housing bubble, which most politicians in Congress wished to encourage, depended on Japan and China, and that because of Japan and China's lending Fannie and Freddie had to have a federal guarantee, was too politically fraught to be articulated at all. It revealed just how far the American economy had become exposed to China and how protected Fannie and Freddie were from normal commercial considerations.

For their part Japan and China had no need to demand that the guarantee they believed existed on Fannie and Freddie's bonds be made explicit. So long as Japan and China trusted that the American government understood the rules of the game that had developed, even if some members of Congress didn't, they had no particular interest in explaining the truth about Fannie and Freddie's bonds. Japan and China could act as creditors to America's subprime housing boom without acknowledging the terms on which they were doing so because the balance of financial terror protected them. By contrast, domestically no such luxury existed. Pretending that reckless lending and an over-inflated secondary mortgage market was not a risk because it served well-intentioned political goals could not stop it from eventually precipitating the largest financial disaster for eighty years.

Notes

1 'Freddie, Fannie failure could be world "catastrophe" Yui says', *Bloomberg*, 22 August 2008.

2 Federal Reserve Board, Testimony of Chairman Alan Greenspan before the

Senate Committee on Banking, Housing and Urban Affairs, 24 February 2004. http://www.federalreserve.gov/boarddocs/testimony/2004/20040224/default.htm/.

3 Testimony of John W. Snow, Secretary of the Treasury before the Committee on Financial Services, United States House of Representatives, Washington, DC, 10 September 2003. http://financialservices.house.gov/media/pdf/091003js.pdf/.

4 Federal Housing Enterprise Regulatory Reform Act of 2005, United States Senate, 25 May 2006, Section 16. http://www.govtrack.us/congress/record.xpd?id=109-s20060525-16#sMonofilemx003Ammx002Fmmx002Fmmx002Fmhomemx002Fmgovtrackmx002Fmdatamx002Fmusmx002Fm109mx002Fmcrmx002Fms20060525-16.xmlElementm0m0m0m

5 Transcript of the hearings of the House Committee on Financial Services on the Treasury Department's views on the regulation of government-sponsored enterprises, 10 September 2003. http://commdocs.house.gov/committees/bank/hba92231.000/hba92231_0f.htm/.

6 Transcript of the hearings of the House Committee on Financial Services on HR 2575—The Secondary Mortgage Market Enterprises Regulatory Improvement Act, 25 September 2003. http://commdocs.house.gov/committees/bank/hba92628.000/hba92628_0f.htm/.

7 Transcript of the hearings of the House Committee on Financial Services on the Treasury Department's views on the regulation of government-sponsored enterprises.

8 A. Greenspan, *The Age of Turbulence: Adventures in a New World*, London, Allen Lane, 2007, p. 233.

9 Transcript of the hearings of the House Committee on Financial Services on HR 2575—The Secondary Mortgage Market Enterprises Regulatory Improvement Act.

10 Transcript of the hearings of the House Committee on Financial Services on HR 2575—The Secondary Mortgage Market Enterprises Regulatory Improvement Act.

11 Transcript of the hearings of the House Committee on Financial Services on the OFHEO Report: Allegations of Accounting and Management Failure at Fannie Mae, 6 October 2004. http://commdocs.house.gov/committees/bank/hba97754.000/hba97754_0f.htm/.

12 Transcript of the hearings of the House Committee on Financial Services on the Treasury Department's views on the regulation of government-sponsored enterprises.