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The Years 2005 to 2007

Drinking in the last chance saloon

Introduction

This chapter addresses the story of Congress's failed attempts to restrain the GSEs during the years 2005 to 2007, and its lack of awareness of the storm that was about to break. Even OFHEO's devastating final report of its examination of Fannie Mae's accounting problems did not stir enough of them to action. The case for stronger oversight was crystal clear to the Administration, to all the players in the market place, and to the wider public; it was also obvious to the Chairman of the Senate and House Committees, as both expressed their determination to act, especially in response to the accounting scandals and to revelations about the huge salaries, pensions and compensation that Franklin Raines and Brendsel received on their departure from the GSEs.

Events in 2005

The two Chairmen

At the beginning of the year, it looked as though all was set fair for legislation to restrain the GSEs. The Chairmen of the House and Senate Committees expressed their determination more than once, as part of the reaction to the accounting scandals and revelations about the huge pensions, salaries and compensation that Franklin Raines and Brendsel received on their departure from the GSEs. In two long interviews in late January, Senator Richard Shelby stated that the "climate has improved very much for regulation," but "I don't want a bill that's meaningless. I would not want to be any part of it – the administration won't either. I think the time has come for meaningful reform legislation." He added that he was "sure that there will be opposition to any meaningful legislation to reform the way GSEs work by various people, including some at the GSEs themselves," noting that in 2004, the GSEs "hired everyone in town" and "were obviously against the bill ... They say that they are 'eager for reform' but we are going to test that statement." He added that The White House and the House Financial Services Chairman "will be working

with us very strongly to bring about a strong product,” and that the GSEs “should be well-capitalized, well-regulated and well-managed.”¹

Richard Baker was reported as saying that he and Michael Oxley intended to set out their proposals for new legislation in February, which would be “the most comprehensive bill we have ever proposed, simply because the environment was so dramatically different from prior sessions when this subject was considered ... Most defenders of Fannie have re-evaluated their positions and are either going to remain quiet or, frankly, are even going to be supportive of some kind of reform.”² The new regulator would oversee Fannie Mae, Freddie Mac and the FHLBs, replacing OFHEO and the Federal Housing Board.

The Administration again asserted its support for greater regulatory oversight of Fannie Mae and Freddie Mac, when the Treasury Secretary John Snow announced, “We need a strong, credible and well-resourced regulator with a clear mandate and all the powers of other world-class financial regulators,” adding that Fannie and Freddie owned or guaranteed almost half the \$7.6 trillion mortgage market in the US, making them the second-largest debtor in the country after the federal government. He concluded his speech by saying that “whilst the GSEs have continued to grow in size, complexity and importance, the regulatory structure governing their activities has not. The new regulator should have at heart two guiding principles: promoting a sound and resilient housing finance system, and increasing home ownership for less advantaged Americans.”³ Unfortunately, this indicates a significant failure to recognize that these guiding principles contained an inherent conflict.

Democrats’ doubts led by Barney Frank

However, in a press release back in December, 2004, in response to the revelations about Fannie Mae’s false accounting, Barney Frank was careful to acknowledge that the SEC’s finding that Fannie Mae “used incorrect accounting” was “serious and disturbing.” Then he added, “While these improper decisions by Fannie Mae do not threaten the financial soundness of the operation, and *should not be used by anyone in an effort to cut back on Fannie Mae’s housing efforts*, they do reveal troubling deficiencies in its corporate governance.”⁴ This time the response in the Committee from supporters of Fannie Mae and Freddie Mac was muted.

Another bill: The Federal Housing Finance Reform Act H.R. 1461

The Congressional Committee met on April 13 to begin its considerations of yet another bill, or, as Chairman Oxley put it with an air of weariness, “We

have been working on this issue for a long time. Since the 106th Congress, this Committee has held 22 meetings and has heard from 101 witnesses on GSE-related matters.”⁵ The bill, which Richard Baker introduced as the Federal Housing Finance Reform Act, set out to establish a new regulator to replace OFHEO, which, as they had discovered in their hearings, lacked “the critical tools needed to supervise these Enterprises.” The bill was also, as Richard Baker was at pains to emphasize, “a collaborative effort, led by the Chairman, in consultation with Secretary Snow, Secretary Jackson, Chairman Greenspan and Director Falcon.” Baker also pointed out that any public company which announced that it would have a multi-billion-dollar restatement over multiple years, which could not perform its duty to report its financials in a timely manner to the market, and could not yet give a date by which that financial information would be provided, would not have received the kind of kid-glove treatment which Fannie Mae and Freddie Mac had enjoyed. He concluded that this was because of the market perception of the federal backstop. He might well have added, from his own experience, other reasons, such as the bullying tactics of the GSEs and the millions of dollars spent on lobbying.

Against that backdrop, the bill contained the following proposals:

- Abolish OFHEO and establish an independent agency to oversee the housing GSEs and the Federal Home Loan Banks;
- Enhance the safety and soundness disclosure, and enforcement tools available to the regulator; and
- Increase the budget autonomy of the new regulator by exempting its assessments for the annual appropriations process.

Baker was at pains to point out what the bill did not contain: “It does not, for example, repeal the line of credit; it does not set arbitrary limits on [their] investments portfolio; it does not make immediate or requisite changes to capital. It does create a world class regulator, with the ability to act not only in the interests of tax payers, but in the interests of home ownership. There is the authority to adjust capital, to assess risk, to approve programs and to act in the interest of home ownership.”⁶

The bill was met only with muted criticism in Committee, with concerns being expressed by Congressman Kanjorski that stronger regulation would become more “bank-like,” that an approval process for new products would be “burdensome,” and that any “radical proposals” would “fundamentally change the way in which the GSEs operate or undermine their charters,” although he did favor strong regulation.⁷ Other Congressmen such as Michael Capuano, were anxious about the impact on mortgage rates of tougher regulation. Congressman Clay feared that a substantial reduction in the size of the GSEs’ portfolios would result in higher interest rates, although the connection was not

entirely clear. Congressman Scott suggested that “if the Treasury Department had full policy control of the GSEs, the markets would perceive that control as the full backing of the GSEs by the government.”⁸

Even Barney Frank, a long-time supporter of Fannie Mae, was reluctantly prepared to support the bill in so far as it was a question of enhancing the safety and soundness of the GSEs, but he was lukewarm about it; after the discovery of their highly misleading accounting practices, he had announced in Committee that the “situation is not nearly as critical as people thought. We have found with both Fannie Mae and Freddie Mac inappropriate behavior, bad accounting – I think influenced probably by the compensation schemes of the top officials, and we have been able to step in through the regulator and correct those.”⁹ The final report by OFHEO on accounting irregularities at Fannie Mae was not completed until 2006. His primary concern was with manufactured housing and affordable housing.

The Administration’s position had remained unchanged since 2003, with the key powers being to set both minimum capital standards and risk-based capital standards; the power to assess the entities for independent funding outside the appropriations process; and the ability to place a failed GSE in receivership. The Treasury Secretary had discretion to issue debt in the amount of \$2.5bn to Fannie Mae and Freddie, and \$4bn to the FHLBs. Treasury Secretary John Snow made it clear that the line of credit was only in the event that a GSE was in significant financial distress and needed the capital to emerge successfully from a receivership process.

The Senate bill: Federal Housing Enterprise Regulatory Reform Act. S. 190

Senators Chuck Hagel, John Sununu and Elisabeth Dole reintroduced their bill on January 26, 2005. Its powers would include approval powers over the new programs and activities proposed by the GSEs, and greater authority to limit exit compensation packages or golden parachutes for executives removed for cause. The bill would also require the GSEs to report mortgage loans that they suspected to be fraudulent, even after the loans have been sold (it also removes the Presidential appointment of directors to the boards of Fannie Mae and Freddie Mac, a right which President Bush did not exercise.) The new regulator would additionally have the power to set limits to the GSEs’ secondary market activities, so that they did not participate directly or indirectly in the underwriting of a loan for an organization.

The most important provision of S.190 was to list the types of “permissible assets” that Fannie and Freddie would be allowed to purchase, bearing in mind that the GSEs pay for the mortgage assets by issuing debt securities at rates below what the mortgages and mortgage-backed bonds pay (and also rates that the benefitted from the implicit government guarantee.) The difference

between the yield on the mortgage-related assets and the GSEs' cost of funds is profit. It is for this reason that the GSEs had a strong incentive to pursue portfolio growth and also could explain why their chief executives, Richard Syron (Freddie Mac) and Daniel Mudd (Fannie Mae), opposed it. At that time, the two Enterprises had over \$1.5 trillion in portfolio assets, leading to the anxieties about concentration risk which are described fully in this chapter.

Section 109 of S.190 as reported limited the GSEs to purchasing mortgages and mortgage-backed securities for the purposes of securitization, and for certain other limited purposes. This would have the effect of radically changing the business model (or actually returning to the model of the early 1990s): the GSEs would no longer be very large investment funds, but would rather be transformed into conduits, buying mortgages from the original lenders, pooling them, packaging them into mortgage-backed securities and selling them to bond investors. This would reduce the risks of the portfolios and also reduce the cost of having to bail out either Freddie or Fannie to avoid the possibility of a systemic catastrophe in the financial markets. The opposition to such a proposal argued that there would then be fewer funds available for low- and moderate-income housing goals. In addition, S. 190 required the Director of the new regulatory authority to conduct a study of guarantee fees and to collect data regarding them. This would be the subject of an annual report to Congress in respect of the amount of such fees, and the way they are set.

Barney Frank's affordable housing fund makes its first appearance

H.R.1461, as reported, covered much the same ground. It required each Enterprise to establish an affordable housing fund to increase home ownership among very and extremely low-income families, to increase investment in housing in low-income and economically distressed areas, and to increase and to preserve the supply of rental and owner-occupied housing for very and extremely low-income families. Each Enterprise shall allocate to the fund 3.5% of its after-tax income during the first year after enactment, and 5% in the following years, unless it was less than adequately capitalized. S.190 did not contain any such provision. Finally, the bills differed in the conforming loan limits, which were not sufficiently high to cover all parts of the country, so H.R.1461 allowed an increase in the conforming loan limit up to a ceiling of 150% of the current limit in metropolitan areas where the median house price exceeds the current limit. S.190 did not contain any such provision.

The Senate Banking Committee met five times during April 2005 to consider the bill, and received testimony from 17 witnesses, including representatives of the industry; Alan Greenspan, Chairman of the Federal Reserve; David Walker, Comptroller General of the USA; Douglas Holtz-Eakin, Director, Congressional Budget Office; and Armando Falcon. The Treasury Secretary, John Snow, and

Secretary for Housing, Alphonso Jackson, gave the same testimony as they had just given to the House Financial Services Committee.

Chairman Greenspan evidence: Systemic risk and the GSEs

Of all the testimonies, Alan Greenspan's was the most important warning, and one that he had given more than once. He pointed out again that Fannie Mae and Freddie Mac were allowed by law to extend their investments in almost any direction as long as there was some link, however indirect, between these and their mission of supporting conforming mortgage markets. Because they could borrow at a subsidized rate, they were able to pay mortgage originators higher prices for their mortgages than their competitors (this was also facilitated through their guaranties, another area requiring careful oversight.)

Greenspan pointed out that the higher prices paid for mortgages were only one part of the subsidy, the other part being their return on equity, often exceeding 25%, well above the 15% annual returns survivable by other large financial institutions, and almost entirely attributable to their lower borrowing costs. Since the mid-1990s, the rapid growth of the GSEs' portfolios, reaching \$1.38 trillion or 23% of the home-mortgage market, was due to no other reason than "profit creation through exploitation of the market-granted subsidy."¹⁰ Hence the growth of their portfolios could only be curtailed by regulatory action, since clearly neither Fannie Mae nor Freddie Mac had any incentive to do so; the size and continued growth of their portfolios "concentrate interest rate risk and prepayment risk in these two institutions and makes our financial system dependent on their ability to manage these risks."¹¹

The extent of the interdependence was shown by the fact that over 4,500 banking institutions met all their Tier 1 capital requirements with GSE securities, thereby clearly increasing systemic risk. It was further intensified by the fact that the GSEs' hedging of that risk was concentrated in five or six very large financial institutions. The problem was that few members of the Congressional Financial Services Committee either understood or were ready to listen to Chairman Greenspan's warnings, despite the fact that, as Congressman Royce recognized, it was the "strongest and most stern warning I can recall coming from a Chairman of the Federal Reserve."¹²

Royce was referring to Greenspan's concern that a "stiffening of their regulation might strengthen the market's view of GSEs as extensions of government, and their debt as government debt. The result, short of a very substantial increase in equity capital, would be to expand the size of the implicit subsidy and allow GSEs to play an even larger unconstrained and potentially destabilizing role in the financial markets ... If we fail to strengthen GSE regulation, we increase the possibility of insolvency and crisis ... Almost all the concerns associated with systemic risks flow from the size of the balance

sheets of the GSEs, not from their purchase of loans from home-mortgage originators and the subsequent securitization of these mortgages.”¹³ He was wrong about the latter, as events in 2007 and 2008 would show.

More on systemic risk. Fannie Mae, Freddie Mac and OFHEO

Available to both Committees was a wealth of information about the way in which the GSEs operated, the use to which the implicit subsidies were put, the risks to which they were exposed, and the nature of the growing systemic risk. Interest rate risk for the GSEs is the potential for losses in connection with their portfolios of mortgages and MBSs. They financed these by issuing debt securities with widely varying maturities: for example, if they issued debt securities with a maturity of one year to finance a fixed-rate mortgage of 15 or 30 years, they would face the risk from the rise in market interest rates in the form of higher borrowing costs when they rolled over their maturing short-term debt; but the return on their mortgage portfolio was fixed until the mortgages are paid off. When interest rates fall, more borrowers prepay their mortgages and leave the GSEs with high-cost debt outstanding.

Retained portfolios

In 2004, the GSEs’ retained mortgage portfolios were about 40% of their outstanding debt, the remainder of which consisted of the bonds and other securities which they issued, as well as MBSs. In 2004, Fannie’s MBSs totalled \$1,403 trillion and the remainder of its debt was estimated at \$945bn. Freddie Mac’s MBSs totalled \$852bn and other debt was estimated at \$732bn.¹⁴ They issued debt of all maturities, from discount notes with maturities as short as overnight bonds to bonds with maturities as long as 30 years. To manage the interest rate risk and other market risks posed by their rapidly increasing retained mortgage portfolios, they began to issue intermediate and long-term debt securities with embedded call features.¹⁵

Credit risk

They also faced credit risk due to losses arising from mortgage delinquencies or foreclosures, but up to 2005, such losses were of the order of one to five basis points per year due to rising house prices and low interest rates, a situation which would change if interest rates rose and house prices fell. Although Fannie Mae and Freddie Mac adopted various measures to minimize losses from credit defaults, they continued to retain a substantial amount of credit risk. The extent of operational risk for Fannie Mae was still being uncovered

in 2005, but it covered false accounting, fraud, theft, mismanagement and inadequate information and recording systems.

The GSEs issue far more in debt securities than a number of the USA's largest banks combined. The law allows federally insured banks and thrifts to invest in their debt without limitation. It explicitly exempts Fannie Mae's, Freddie Mac's and other GSEs' securities from statutory limitation on commercial banks' investments in the "investment securities" of individual firms, which is generally 10% of the bank's unimpaired capital and surplus. According to the OFHEO report on systemic risk, over 30% of commercial banks with over \$1bn in assets held Fannie Mae and Freddie Mac debt equal to more than 10% of their capital, and 10% of such banks held Fannie Mae debt in excess of 50% of their capital. Smaller banks' holdings of GSE securities represented a significantly larger share of their capital; that is, those with less than \$1bn in assets.¹⁶ This alone forms part of the interdependency and hence increased systemic risk to which Alan Greenspan referred. The nature of the systemic risks set out in the OFHEO report were clearly summarized and presented in the CBO Director's report.¹⁷

Interest rate risk

In their management of interest rate risk in particular, Fannie Mae and Freddie Mac numbered amongst the largest end-users of financial derivatives, generally interest rate swaps and swaptions in combination with actual debt instruments, to create long-term debt synthetically and to obtain options to extend or shorten the maturity of their debt. They also used derivative contracts, including futures, options on futures and short sales, to hedge future purchases of mortgages and the issuance of securities against the risk of loss due to adverse interest-rate movements.

In addition, they entered into derivatives contracts (futures, options on futures and short sales) to hedge future purchases of mortgages and the issuances of securities against the risk of loss due to adverse interest-rate movements. They needed debt securities whose principal repayments match the expected repayments of their mortgage asset securities, for which they used interest rate swaps and swaptions, largely to create "synthetic" long-term debt. They bought "put" swaptions to enter into a pay fixed/receive floating swaps, so that they could lengthen their liabilities if interest rates rise and mortgage prepayments slow. According to OHFEO, all of this made it possible for the GSEs to grow their mortgage asset portfolios, hedge their growing interest rate risk and minimize their funding costs.¹⁸

OFHEO charted the growth in 1993 at \$72bn to \$1.6 trillion at year-end 2001 for Fannie Mae and Freddie Mac. That was, of course, before the accounting irregularities emerged in 2003 and 2004, so OFHEO's confidence in the figures, the ability of staff in either organisation to use swaps, swaptions

and derivatives to hedge against interest rate risk, still less account for them, had been shattered.

The report drew attention to another aspect of systemic risk: namely, that the market for derivatives at that time was highly concentrated among a small number of dealers, primarily brokerage firms and commercial banks, which were counterparties for at least one side of virtually all contracts. The largest dealers included J.P. Morgan Chase, Citigroup (including the large derivatives operation of its broker-dealer subsidiary, Salomon Smith Barney), Deutsche Bank, Goldman Sachs, Lehman Brothers, Merrill Lynch and Morgan Stanley Dean Winter. According to data compiled by the Office of the Comptroller of the Currency, at the end of 2001, seven US banks held nearly 96% of the notional OTC derivatives of the American banking system, and 25 banks held over 99% of the notional OTC derivatives outstanding of all US banks. As far as the Enterprises were concerned, five counterparties accounted for almost 60% of the total notional amount of Fannie Mae's OTC derivatives, and 58% of Freddie Mac's. The Enterprises claimed to have policies in place to limit counterparty credit risk, as all are rated single A or better.

However at the end of 2001, the credit exposure of Fannie Mae's counterparties was about \$7bn for Fannie Mae and \$2.6bn for Freddie Mac, figures which represent the sum of each Enterprise's exposure to counterparties where the netted value of the contracts favors the company. The issue that emerges from this is not only the interdependency of the various players in the market, but the fact that they were so few in number. Furthermore, in the intervening years since the collection of data for the report, both the debt issued by Fannie Mae and Freddie Mac and the derivative contracts into which they entered continued to increase.

A less obviously important part of Fannie Mae and Freddie Mac's operations is the purchase of mortgages from lenders, which are financed through the issuance of debt securities, or the creation and sale of guaranteed securities backed by pools of loans or by guaranteeing MBSs issued to lenders. Typically, Fannie Mae and Freddie Mac securitize a number of loans from a lender, which retains a portion of the monthly mortgage interest payments as compensation for servicing the loans in the pool. They pool the individual mortgages and then sell to the investors guaranteed claims (MBSs) to the contractual flows from these mortgages. For that service they charge fees, which they expect to cover the cost of defaults on mortgages and earn a return on the investment. Both lines of business have grown significantly: outstanding MBSs grew from about \$600bn in 1990 to \$2.3 trillion in 2004, while total debt grew from less than \$300bn to \$2.5 trillion over the same period (including the FHLBs).

Guarantee fees

The issue of the guarantee fees was raised by Mr Bachus in the course of the Congressional hearing on April 13, 2005. The Enterprises charge the guarantee

fees on lenders, but this has a direct effect on the costs of the mortgage for borrowers. “I understand that these G-fees are not set on how safe or sound a mortgage is, like an 80% mortgage or 90% mortgage; it is based on volume. And what they do is, they negotiate in private confidential agreements with mortgage originators, and they charge some one fee, they charge others other fees. And I understand that that can vary by as much as 15%. Obviously, the more volumes you do, the lower fee you get ... [it] obviously favors your biggest mortgage companies, and it puts your smaller mortgage companies at a disadvantage ... should not this be made public, where the public can scrutinize it?”¹⁹ Although the Treasury Secretary and the Secretary for Housing agreed, it was plainly a matter that was not going to be taken any further; such agreements and the fees charged were another important source of revenue for the GSEs. What should have caught their attention was the way in which Fannie and Freddie were buying loans, by volume, not by quality.

The bills were delayed until the summer

With bi-partisan support, the House Financial Services Committee passed H.R.1461, the Federal Housing Finance Reform Act, 2005 on a 65-5 vote. Chairman Michael Oxley had engineered the vote by adding the provisions raising the conforming loan limit, introducing the affordable housing fund, and resisting the Administration’s call for strict limits on the size of the GSEs’ portfolios.

S.190 was “marked up” on July 28, 2005 and passed by a party-line vote of 11–10, but the bill did not reach the floor of the Senate for a vote, despite the fact that the Republicans had a majority in the Senate (55 Republicans, 44 Democrats with 1 Independent aligned with the Democrats). It appears that the reason for this was the nature of the partisan vote: the bill had no Democrat sponsors. Senator Shelby was prepared to work through the summer to get bipartisan support, but he was not prepared to move the Senate bill to the floor, unless he thought that the size of the GSEs’ portfolios would be reduced.

Paul Sarbanes had introduced an amendment requiring the GSEs to set aside 5% of their profits into an affordable housing fund in the Committee stage. This was amended again by Senator Jack Reed to prevent its becoming another slush fund for the Enterprises, but the Republicans still voted it down, 11 to 9. Senator Schumer thought the affordable housing fund would not be a difficult issue to resolve, but said that, “The portfolio limits area [is] a very large sticking point for me and I think for just about every one of us [on the Democratic side] ... The bill’s portfolio restrictions would result in shifting about \$760bn in housing assets from Fannie and Freddie to other private financial institutions. By moving these assets and the risk they encompass out

of the GSEs, the bill would simply move them into the portfolios of large institutions that lack Fannie and Freddie's housing focus ... and so what we've done is, we haven't reduced the risk, but we've reduced the commitment to housing."²⁰

Once again, the domination of the "affordable housing" ideology blinded many politicians to real risks contained in the size of the GSEs' portfolios, and to the fact that their accumulation of portfolios "is a highly leveraged operation," requiring a "sophisticated hedging of interest rate risk," thus imparting a significant risk to the American financial system." This was the position Chairman Greenspan reiterated more than once, both in his testimony to the House Financial Services Committee and to the Senate Banking Committee. He might have added that, given their demonstrable and abject failure in derivatives accounting and even at the more basic level of record-keeping, there was little reason to believe that the GSEs were able to manage sophisticated hedging of interest rate risk, but the Democrats believed, or chose to believe, that all such arguments and warnings were simply designed to restrict their activities and to remove the GSEs altogether. The affordable housing fund was another canard, which had the effect of holding up or even preventing the passage of bills though the House and Senate.²¹

Further warnings about the risks in the OTC market and the GSEs

Greenspan's warnings were not lightly made, and were repeated on several occasions in 2005. In March, the Federal Reserve published a report evaluating the concerns which had been expressed not only by Federal Reserve officials, but also by foreign authorities and private analysts, about the concentration in the OTC markets for US dollar interest-rate options. There were three major concerns, which the report listed as follows:

- The potential for exit for a leading dealer to result in options market illiquidity and the potential effects of illiquidity on the housing GSEs and other hedgers of mortgages and mortgage-backed securities;
- Market risks to dealers from meeting the demands for options by mortgage hedgers, including whether data indicating the notional value of options sold by dealers significantly exceeds the notional value purchased are accurate and, if so, whether dealers are assuming significant risks; and
- Potential counterparty credit losses to market participants in the event of the failure of a leading dealer or one of the GSEs.

Concentration was relatively high by the end of 2003, when the four largest dealers accounted for 40% of the \$37.5 trillion market for US dollar interest rate swaps and forward rate agreements. The report was based on interviews with Fannie Mae, Freddie Mac, several FHLBs, a large mortgage servicer, and seven leading bank and non-bank OTC derivatives dealers. Fannie and Freddie together accounted for more than half of the options demand when measured in terms of the sensitivity of the instruments to changes in interest rate volatility (rather than notional amounts). The supply of interest rate options comprises investors in callable debt issued by the FHLBs (less important than in the past), banks and insurers, non-financial corporations and local governments, investors in structured notes, and hedge funds, which have become an important source of supply and liquidity. OTC derivatives dealers intermediate between options buyers and sellers, but there may well be mismatches between buyers and sellers, leaving them exposed to basis risk.

The GSEs assured Fed staff that even if a leading dealer left the market, they would be able to use the second tier of dealers, who would step up their activities. Furthermore, if market liquidity were temporarily impaired for some reason, the GSEs did not see themselves as dependent on continuous access to liquidity in the options market, but rather on the liquidity of the swaps market, which is less concentrated and easier to intermediate.

The conclusions of the staff report could be seen as reassuring: concentration was reasonably well-managed. The risk management strategies of Fannie and Freddie (and other mortgage hedgers) rely on continuous liquidity in the swaps markets, where there is less concentration. However, “the GSEs do assume very large net positions in the options and swaps markets. But the potential market impact of dealers’ actions to close out and replace those positions following a GSE failure are likely to be substantially offset by the effects of the increases in uncertainty and risk aversion that would be certain to accompany a GSE’s failure.”²²

The problem with this report is that it relies too heavily on the GSEs’ ability to handle risk, which, given both their abysmal failure to manage accounting for any of the processes involved, as well as the deliberate manipulation uncovered in the first OFHEO report and the lack of skilled staff or proper governance at either institution, should have given cause for doubt. The report ends by recommending that “participants in the interest-rate options markets make more of an effort to think about counterparty risk and market risk in an integrated way when evaluating counterparty credit exposures to large players.” Nevertheless, Alan Greenspan referred to the concentration risk for the GSEs in his speech to the Federal Reserve Bank of Chicago,²³ warning again that the sheer size of portfolios exposed them to the risk of market illiquidity, adding that “concerns about potential disruptions to swaps market liquidity will remain valid until the vast leveraged portfolios of mortgaged assets held by Fannie and Freddie are reduced and the associated

concentrations of market risk and risk-management responsibilities are correspondingly diminished.”²⁴

Greenspan pursued the issue of systemic risk, which he had already set out in a testimony to the Congressional Committee in 2004 and 2005, in a speech to a conference at the Federal Reserve Bank of Atlanta,²⁵ in which he stressed the issue and the difficulty of handling it through the usual means of banking regulation. In the case of the GSEs, he stated once again, these risks can only be handled by reducing the size of their portfolios. The reasons for this were set out in the speech. Regulators could not rely on market discipline to contain systemic risk in the case of the GSEs, owing to the market perception of their special relationship to the government. In addition, given their size in relation to the counterparties to their hedging transactions, the ability of the GSEs to correct any mistakes in their complex hedging strategies “becomes more difficult, especially when vast reversal transactions are required to rebalance portfolio risks.”²⁶ He continued, “a system of diversified and less-leveraged interest rate risk management, away from large, highly leveraged portfolios, would be far more resilient to the inevitable mistakes and shocks of individual risk-mitigating strategies.” Greenspan concluded that the “key activity of the GSEs – the provision of liquidity to the *primary mortgage market* – can be accomplished exclusively through the securitization of mortgages: GSEs’ portfolios of mortgage-related assets cannot [and do not] serve this function. Such empirical evidence from the history of the GSEs militates against it.”²⁷

Progress on the House and Senate bills between July and December

The key issue contained in the Senate bill S.190 is the ability to restrict the GSEs’ portfolio limits. It directs the new regulatory authority to establish criteria regarding the assets which the Enterprises can hold, and to consider safety and soundness as well as “systemic risk” posed by the size and composition of those investments. In other words, it allows for portfolio limits, which the Congressional bill, H.R.1461, did not. The new regulatory authority should have the powers, in Treasury Secretary John Snow’s view, “to allow the GSEs to only hold as much as is necessary to carry out their mission with an appropriate level of safety.” Exactly what the principles should be, and whether it should be up to Congress to set out the general framework or for Congress to stipulate, if not the exact ratio, at least the principles that should apply in order to come to conclusions about the portfolio, was left as an open question.

This was the legislative approach which Alan Greenspan recommended to the Senate and Congressional Committees, perhaps in the interests of getting some legislation in place which would include both some limits on portfolio

growth, and appropriate receivership arrangements. His view was that the GSEs should “hold only the minimum level of assets needed to accomplish their primary mission mandated by their Charter.” In the face of political suspicion, Greenspan may have felt that this was the right approach, but it ran the risk of making the mistakes of the past again: the Charters set out a minimum capital ratio, but one that turned out to be lower than banks were required to provide under Basel I. They also required the regulator, OFHEO, to produce a risk-based capital model, which it then took ten years to develop. But both the House and the Senate were determined to press ahead with their own bills. In the case of the House, this was despite the warnings issued by the Administration and the Federal Reserve.

The result of the legislative process in the Senate and the House was that lawmakers faced a difficult problem in reaching agreement, with two substantially different bills before them. Congressman Richard Baker and Chairman Richard Shelby hoped to reach a consensus, but although Senator Shelby wanted a good bill, he could not accept the affordable housing fund or abandon the question of portfolio limits. The Minority Leader, Senator Harry Reid had made his position clear: he regarded any limitation on the size of the portfolios of the Enterprises as “measures that could cripple the ability to carry out their mission of expanding home ownership ... we cannot pass legislation that could limit Americans from owning homes and potentially harm our economy in the process.”²⁸ Given these opposing views, there was little likelihood that a compromise could be reached, although discussions continued behind the scenes.

The Administration rejects H.R.1461

In September and October, both Chairman Greenspan and the Administration made their positions entirely clear with regard to H.R.1461. In a letter to Senator Robert Bennett,²⁹ Chairman Greenspan spelt out in more extensive detail, the risks inherent in the strategies for managing the risks involved in the GSEs’ portfolios. The interest rate and prepayment risks inherent in mortgages with refinancing options cannot be eliminated, but what can be markedly reduced is the systemic risks involved in such large holdings.

But he added, “Today, the US financial system is highly dependent on the risk-managers at Fannie and Freddie to do everything right, rather than depending on a market-based system supported by the risk assessments and management capabilities of many market participants, who have different views and different strategies for hedging risk.” In the case of the Enterprises, there are “no meaningful limits to the expansion of their portfolios,” so they must either have the “ability ... to quickly correct the inevitable misjudgments inherent in their complex hedging strategies ... [in a situation which] requires that the ultimate counterparties to the GSEs’ transactions provide sufficient

liquidity to finance an interest-rate-risk transfer that counters the risk ... or rely on passive hedging.” The cost and quantity of derivatives required for the latter approach made this a very expensive way of managing prepayment risks, and again involved “Fannie and Freddie avoiding large errors.”

Chairman Greenspan then explained that the reduction in the GSEs’ portfolios would have no effect on the availability of home mortgage credit, and that reducing the portfolios would not be difficult, since there were many potential purchasers amongst other financial institutions in the US, including many central banks, which had long purchased agency debt and also hold MBSs in ever-increasing quantities. His final warning at the end of the letter stated, “in the case of GSEs, excessive caution in reducing their portfolios could prove to be destabilizing to our financial system as a whole and in the end could seriously diminish the availability of home mortgage funds;” words which would prove all-too prescient.

The same warning was reiterated in a Statement of Administration Policy, issued on October 26, 2005, which noted that the outstanding debt of the housing GSEs was \$2.5 trillion, and that they provided credit guarantees on another \$2.4 trillion. By comparison, the privately held debt of the Federal Government was currently \$4.1 trillion. Given the size and importance of the GSEs, the Administration noted that Congress must ensure their large mortgage portfolios did not place the US financial system at risk; H.R.1461 “fails to provide critical policy guidance in this area.” This statement was issued on the same day that the House was due to vote on the bill on the floor of the House.

The House passes H.R.1461

Despite the Administration’s statement, the House of Representatives passed the GSE regulatory reform bill, establishing the Federal Housing Finance Agency, financed through assessments on the GSEs on October 26, 2005 by a bipartisan vote of 331-90. The affordable housing fund was part of the bill, but Democrats and a wide range of 600 faith-based groups opposed a provision which barred organizations involved in voter registration, lobbying activities, and the get-the-vote-out efforts from participating in the fund. They failed to remove these restrictions, but only narrowly. Having failed in this effort, Barney Frank and some other Democrats voted against the final bill. After the vote in the House, Chairman Shelby indicated that there would be no Senate vote on the legislation for GSE regulatory reform in 2005, and that he still wanted to see a reform bill which included the main elements of S.190; they would continue to press for that in 2006.

H.R.1461 was received in the Senate and read twice, and then referred to the Senate Committee on Banking, Housing and Urban Affairs on October 25, 2005. The bill was ordered to be reported favorably, with an amendment in the nature of a substitute, on July 28, 2005. The Administration did not get

the bill it wanted and needed; Congress had once again failed to restrain the GSEs. Lawmakers should have paid more attention to OHFEO's report on accounting issues at Fannie Mae, which identified the GSE's failure to follow generally accepted accounting practices, in particular amortization of discounts, premiums and guarantee fees; accounting for financial derivatives contracts and structural problems in accounting operations and review. That report had been released in September 2004, followed by Fannie Mae's announcement in November that it was unable to file a third-quarter earnings statement because its auditor, KPMG, refused to sign off its accounting results. In December, the SEC, after finding serious inadequacies in Fannie's accounting methods, ordered the Enterprise to restate its accounting results from 2001: that had been followed by the departure of Franklin Raines and Timothy Howard. These events ought to have been fresh in the minds of *all* of the members of the House and Senate Committees, and should have required decisive legislative action.

Events in 2006

The Rudman report

The first report had been commissioned by the special Congressional Financial Services Committee, where it was welcomed by Congressman Frank, who commended the Board for its good sense in engaging the former Senator Rudman.³⁰ He added, "those of us who know him ... have such confidence in his integrity that we benefit from a report that's not being challenged ... I think we should make it very clear ... that we are talking about a betrayal by some of those at Fannie Mae of their high mission ... but this is not something that ought to be used to undo the housing mission."³¹ It was more than a few individuals; OFHEO's final report makes it clear that it was a question of the way in which the whole operation was run, and perhaps went even deeper than that. A number of issues were discussed at the hearing, but none of any great moment; the 2,600 pages or so revealed little more than was contained in OFHEO's preliminary audit. It concluded, as OFHEO had done, that "management's accounting practices in virtually all areas that we reviewed were not consistent with GAAP."³² Perhaps not surprisingly, and in contrast with OFHEO's Special Examination, published some four months later, it concluded: "Overall, we find that Fannie Mae's Board sought in good faith to respond to evolving legal and other standards in the area of corporate governance, that it sought appropriate internal and external support and advice in meeting these standards; and that its aim was to establish governance policies and practices at least in line with those of leading US corporations and peer institutions. The Corporate Governance Benchmarking Project,

conducted with the assistance of an outside law firm, reflects the Board's intent that the Board remain up-to-date in the area of governance, consistent with its obligations and responsibilities."³³

Furthermore, although the report describes all the accounting errors and manipulations in painstaking detail, it does not seek to estimate what Fannie Mae's actual earnings were, nor its true financial condition, and how these differed from its public financial reports. The company ceased to file financial reports from late 2004; it assessed its unrecognized losses as being in the range of \$9bn, and later increased that to about \$12bn, but there is no indication as to whether or not the estimates still applied, or indeed how Fannie Mae could know, given not only the extent of the accounting errors but also the complete inadequacy of its accounting systems. This led to further questions about the extent to which Fannie's risk management procedures, including especially its hedging activities, were distorted in order to achieve certain earnings goals, thus creating unnecessary exposures in order to reduce the cost associated with its hedging strategies. Fannie Mae and some members of the House Financial Services Committee had hoped that the Rudman report would undermine OFHEO, and that the charges against Fannie Mae would appear much weaker. However, the Rudman report did not quite give Fannie what it wanted, and was overshadowed by that of OFHEO.

OFHEO: Report of the Special Examination of Fannie Mae

The final report was finally published in May 2006, having taken over two years to complete, which was not surprising given the vast number of documents reviewed and the numerous interviews conducted with current and former employees of Fannie Mae, its Board, and KPMG.³⁴

The report was precise and to the point, detailing the manifold failings at every level: the GSE's deliberate and improper earnings management, its determination and success in having the "rules written that worked for us," and its arrogance. All of this underlies what Christopher Cox, Chairman of the SEC, had no hesitation in calling the "extensive financial fraud" at Fannie Mae.³⁵ It is worth setting out just the summary of the report, which is indeed the severest possible indictment of a company, every aspect of which was either fraudulently or incompetently managed but which still managed to present itself to the world as one of the lowest-risk financial institutions and as "best in class" in terms of risk management, financial reporting, internal controls, and corporate governance. This was a "façade" which was unremittingly presented by an army of lobbyists to those who were taken in by or chose to believe it, or who may not have believed it but believed that whatever happened, the government would have to bail them out. The latter proved true in the end. Fannie Mae of course was always ready to use its "housing mission" and its commitment to providing affordable housing for low- and moderate-income

families to gild its image. The use of the image also made it much more difficult for the media, politicians and others to criticize the Enterprises.

In their summary, OFHEO states that:

- During the period covered by this report, 1998 to mid-2004, Fannie Mae reported extremely smooth profits growth and hit announced targets for earnings per share precisely in each quarter. Those achievements were illusions deliberately and systematically created by the Enterprise's senior management with the aid of inappropriate accounting and improper earnings management.
- A large number of Fannie Mae's accounting policies and practices did not comply with GAAP. The Enterprise also had serious problems of internal control, financial reporting, and corporate governance. Those errors resulted in Fannie Mae's overstating reported income by some \$10.6bn.
- By deliberately and intentionally manipulating accounting to hit earnings targets, senior management maximized the bonuses and other executive compensation they received, at the expense of shareholders. Earnings management made significant contribution to the compensation of Fannie Mae Chairman and CEO Franklin Raines, which totaled over \$90m from 1998 through 2003. Of that total, over \$52m was directly tied to achieving earnings per share targets.
- Fannie Mae consistently took a significant amount of interest rate risk and, when interest rates fell in 2002, incurred billions of dollars in economic losses. The Enterprise also had large operational and reputational risk exposures.
- Fannie Mae's Board of Directors contributed to those problems by failing to be sufficiently informed and to act independently of its Chairman, Franklin Raines, and other senior executives; by failing to exercise the requisite oversight over the Enterprise's operations; and by failing to discover or ensure the correction of a wide variety of unsafe and unsound practices.
- The Board's failures continued in the wake of revelations of accounting problems and improper earnings management at Freddie Mac and other high-profile firms, the initiation of OFHEO's special examination, and credible allegations of improper earnings management made by an employee of the Enterprise's Office of the Controller.
- Senior management did not make investments in accounting systems, computer systems, other infrastructure, and staffing needed to support a sound internal control system, proper accounting, and GAAP-consistent

financial reporting. Those failures came at a time when Fannie Mae faced many operational challenges related to its rapid growth and changing accounting and legal requirements.

These are the main issues set out in the OFHEO report, well attested by all the evidence from the sources outlined above. The arrogance of Fannie Mae was summed up in the words of Mr Daniel Mudd, former Chief Operating Officer (from February 2000), who became Chief Executive of Fannie Mae (in December 2004) after the departure of Mr Raines, in a memo to the latter in November 2004. "The old political reality was that we always won, we took no prisoners, and we faced little organized political opposition ... we used to, by virtue of our peculiarity, be able to write, or have written rules that worked for us."³⁶

The SEC required Fannie Mae to restate its financial results for 2002 through to mid-2004, and incurred expenses for the restatement process, regulatory examinations, investigations and litigation, which according to Fannie Mae's estimates would exceed \$1.3bn in 2003 and 2006 alone. That was in addition to the billions in losses incurred by the company through its corporate failings.

Congressional hearings on the report

There were two hearings on the OFHEO report, one before the Congressional Committee on June 6 and the other before the Senate Banking Committee on June 15. In the Congressional hearing, the report was well-received and the need acknowledged for new legislation to strengthen the hand of the regulator, with a clearer recognition on the part of most members of the Committee of the extent of the risks as evidenced by Congressman Hensarling: "What we have is the second largest borrower in the world, second only to Uncle Sam himself, an institution holding a Federal Charter, an asset portfolio worth over a trillion dollars, and they can't produce a reliable financial statement. That is troubling to say the least."³⁷

Congressman Garrett noted the irony of the fact that the hearing was taking place on the same day as Ken Lay received his guilty verdict in the wake of the Enron scandal, yet the Fannie Mae debacle, which the Chairman of the SEC, Christopher Cox, described as "one of the largest restatements in American corporate history" at an "\$11bn reduction in previously reported net income"³⁸ had not resulted in imprisonment for either Franklin Raines or Timothy Howard.

Mr Garrett quoted Armando Falcon's comment that "Fannie Mae is the Enron of government on government steroids" and pointed out that it was due to the government benefits that "their house of cards remains standing." This was in response to Congressman Barney Frank's statement that "what

is heartening to me here is that the underlying structure of Fannie Mae and Freddie Mac, the strength of the housing market, the strength of that model, allowed them to withstand being misrun.”³⁹ He failed to understand the value of the implicit government guarantee and the subsidy, or the implications of the OFHEO report, which portrayed an institution which was rotten to the core, or grasp the devastating nature of the comments. The conclusion of the hearing was the need for Senate to act on its bill, since it would only be then that the House and Senate would be able to work together on a conference committee to send the President the GSE bill in this Congress.

The Senate Banking Committee took evidence from Christopher Cox, James Lockhart III, who took over the directorship of OFHEO from Armando Falcon, Daniel Mudd, CEO of Fannie Mae, and Stephen Ashley, the newly appointed Chairman of the Board. Fannie Mae had finally agreed to separate the roles of Chairman and Chief Executive. Apart from his written testimony, Chairman Cox was at pains to stress the enormity of the corporate failings at Fannie Mae, both in terms of the size of the restatement and the fact that the company’s internal controls were “wholly inadequate for size, complexity and sophistication of Fannie Mae’s business.”⁴⁰ He explained that, going back to at least 1992, the SEC had continually urged that the GSEs should comply with the disclosure requirements of Federal Securities laws. In July 2002, Fannie Mae entered into a voluntary agreement to comply and register its common stock, and began filing periodic reports with the SEC on March 31, 2003; however, after that date reports became increasingly sporadic and Fannie did not file its annual report for 2004 or 2005, nor did it file its quarterly report (Form 10-Q) for any of the preceding seven quarters. Cox emphasized the point that the \$11bn not only falsely enriched its senior managers, but investors (mutual funds, pension funds, local governments and others) paid for \$11bn in earnings which were not there. “A company with \$47.5bn in market capitalization chartered by Congress, a private company with a public mission, as it calls itself, was for a period of several years raising capital on the basis of financial statements that were the result of fraud ... The harm to investors is both direct and measurable. The stock price of Fannie Mae fell from over \$75 to very recently under \$49.”⁴¹

Some of the Senators, such as Senator Jack Reed, pressed Mr Lockhart to reassure them that whatever had happened, the company was going in the right direction in terms of risk management, systemic risk, and the retained portfolio. He got short shrift from Mr Lockhart: “They have not handled operational risk yet ... I do not think ... that they actually have a good operational risk capital model ... and they are certainly not complying with Sarbanes-Oxley ... There is no doubt in my mind that these companies are more highly leveraged, potentially, than any other financial institution in this country. They have \$1.5 trillion of debt outstanding, and they have used that debt to buy \$1.4 trillion of assets. To hedge those assets, they have \$1.3 trillion of derivatives, and on top

of that, they have \$2.6 trillion of guarantees. And that is built on a combined capital of only \$75 billion.”

Senator Reed then tried to downplay the risk by claiming that their retained portfolio only accounted for 14%, but Lockhart reminded him that the two companies represented 40% of the market, 15% on mortgages owned and 26% on the guarantees, a very large exposure.⁴²

The other issues raised concerned the role of Daniel Mudd, appointed as CEO, and corporate governance. It emerged from the Senate Committee hearing that Mudd’s earnings over the period in question were \$26m, of which \$15m was triggered by the accounting irregularities and the total mismanagement of the company. He claimed that, even though he was Chief Operating Officer during that period, his job was focussed on customers and technology systems. That seems to be somewhat of an understatement of the role of COO, who is usually responsible for all the day-to-day operations of the company and reports to the CEO. He added, “I was not responsible for financial accounting. I was not responsible for the mortgage portfolio. I was not responsible for internal audit and I was as shocked as anyone in the company or anyone in Congress or anyone in the market when these issues were uncovered and came to light.”⁴³ He remained as CEO until September 2008.

Senator Hagel questioned Stephen Ashley, the Chairman of the Board. It emerged that he had been a Board member since May 1995, and became Chairman after Franklin Raines’ resignation in December 2004, when the decision was taken to separate the roles of chairman and chief executive. He had 40 years of experience in the mortgage business and had served as director or president of a number of businesses.⁴⁴ Senator Hagel put it to him that as a member of the Board he had a “fiduciary responsibility,” but that according to the reports, “it is pretty clear that you failed ... you did not know anything about what happened, what was developing, the lobbying, the money, the compensation ... was it strange to you at all that was going on, no questions asked?” To which Mr Ashley replied, “I cannot express the deep disappointment and anger that I, as a member of the Board, and I know this is shared by my colleagues on the Board, feel at this moment in time when a company and a management and people that we put our trust in was broken, and not just broken, but shattered ... However, I think it is reasonable for any Board to be able to trust their management.”⁴⁵ This is an interesting reply, as it refers to trusting the management rather than to any oversight responsibilities. Stephen Ashley remained as Chairman of the Board until September 2008.

Most of the members of the Committee realized the serious nature of the charges against Fannie Mae and the extent of the systemic risks. It has to be said that the Democrat Senators were rather more concerned to play down the extent of the potential damage. A somewhat more extreme version of that position was expressed by Senator Schumer: “I have some real concerns here. Obviously, there have been some misdeeds at Fannie and Freddie. I think a

lot of people are being opportunistic, taking those and then throwing out the baby with the bathwater, saying let us dramatically restructure Fannie Mae and Freddie Mac when that is not what is called for as a result of what has happened here. First I want to ask you, Mr Lockhart, the new administration at Fannie and Freddie have taken some real reforms ... do you think what they have done is adequate?" To which Mr Lockhart replied that it would take "several years for them to be SEC compliant" and that work on internal controls, risk management, accounting systems and the whole series of actions set out in OFHEO's agreement was taking place slowly.⁴⁶

But still no bill in 2006

Radical action might have been expected after a report of that nature and considering the testimony, but although Chairman Shelby would have preferred another hearing and had hoped to bring the bill forward to a floor vote, no further action was taken on the bill that year. No further hearings on the OFHEO report took place. But as the weeks wore on and the November elections approached, the gap between the two parties on the legislation remained as wide as ever. The nine Democrats on the Senate Banking Committee issued a report, stating that limiting the assets which Fannie Mae and Freddie Mac could hold would limit access to affordable housing, and that "forcing the GSEs both to withdraw from the market and sell off existing bonds would raise the costs of this source of mortgage capital." They reiterated the demand for an "affordable housing fund" financed by a percentage of the GSEs' profits, which was not part of S.190. They concluded that the Committee Bill does not "strengthen the existing affordable housing goals," and "if passed in its current form, could actually weaken affordable housing obligations of the Enterprises by allowing the regulator the authority to 'modify or rescind' existing housing goals."⁴⁷

Senator Bob Bennett pointed out that "if you have a bill reported out of committee on a party line vote in an atmosphere as politically charged as we have with floor time at a great premium going into an election, my guess would be that the leader would say, 'I can't afford floor time to fight over this.' I do not see any indication that there would be an accommodation between the Democratic position and the Republican position on the committee bill."⁴⁸

Michael Oxley, House Financial Services Committee Chairman, wrote to Treasury Secretary, Henry Paulson urging him to redouble his efforts to clear the way for a bill to regulate the GSEs. "Our goal should be to enact robust GSE legislation and send it to President Bush this year," since the "number of legislative working days in the Senate is dwindling quickly." The bill passed in the House in 2005, which would in part establish a new regulator for the GSEs, is the "strongest reform legislation that will ever pass in the House, absent a conference report ... As each day passes without news of progress on the other

side of the Capitol that will allow the full Senate to act, the likelihood increases that the Congress could close without addressing the serious inadequacies of the current regulatory system and without protecting tax payers, investors and markets.”⁴⁹

Voices calling for reform were ignored

These and many other voices called for regulatory reform up to and even after the election in the “lame duck” session. The new Federal Reserve Chairman, Ben Bernanke, in the course of delivering the report on monetary policy to the Senate Banking Committee, was asked by Senator Dole for his views on whether the GSEs’ regulator should have the authority to allow the Enterprises to increase their portfolios when there is a downturn in the market. The assumption is that they would thus be able to increase liquidity in the market when there is a downturn.

Chairman Bernanke replied that the Federal Reserve’s research indicated that increasing the portfolios had very little effect, and that at any rate liquidity would not be increased by holding MBSs rather than treasuries. However, he continued, “for the purposes of trying to come to an agreement on GSEs’ legislation, we could perhaps discuss or consider the possibility that the director might provide some emergency ability to the GSEs to make extra purchases during times in which the director judged the housing market to be in distress for some reason, but then to get rid of that extra portfolio, get rid of the extra MBSs over a period of time when the emergency was eliminated.”

In answer to a question from Senator Carper, which was mainly about the affordable housing fund, but also covered the need for regulation before the end of the year, Bernanke stressed the importance of coming to a decision. “The Federal Reserve was drawn to this issue initially because ... we felt that the large portfolios exceeded what was needed for the housing purpose and indeed posed a threat to the stability of the financial system ... The reports we have seen recently on GSE accounting by the OFHEO, which cast into doubt the underlying accounting and internal controls of these agencies, I think just heightens my concern that those large portfolios at some point might create serious problems in the financial markets.”⁵⁰

The Administration made its views known once again in pressing for reform, reiterating that the retained portfolios “concentrate rather than distribute the prepayment risk and interest rate risk associated with mortgages and mortgage backed securities held by them, and concentrate them in entities that as a result of the lower levels of capital which they are required to hold are substantially more leveraged than other financial institutions ... hence it is critical that both a strengthened regulator and a mandate to address portfolio size, be included in any final legislation from Congress.” This does not mean a “hard” cap expressed in terms of dollars, but the portfolio cap would be a

“clear direction” to the new regulator as to the type of assets which could be included in the GSEs’ portfolios. The key element for the Administration was not so much the size of the cap but relating this to their mission, which many agreed would result in a substantial reduction in the portfolios. All this would be done through regulation. The legislation would also allow the regulator to increase the cap in times of emergency, temporary disruptions in the mortgage market.

The Treasury Undersecretary for Domestic Finance, Randal Quarles, added an important point. “Secretary Paulson has made it clear to me that he believes that there is systemic risk associated with the GSEs’ retained portfolios. While he shares the view that a legislative outcome is preferable, he has instructed us to ensure that the mechanics of our debt approval process are robust enough to give the Treasury the practical options of limiting the GSEs’ debt issuance in accordance with our statutory authority should that become necessary. If a legislative solution is not achieved, Treasury will have no choice but to consider additional action.”⁵¹

The first signs of trouble in the mortgage market

In the event, although talks continued up to the eve of the election and even in the lame duck session, a compromise was not reached. The issues which remained unresolved included the creation of an affordable housing fund, changes to the way in which conforming loan limits are set, and the appointment of public interest directors to the FHLBs. Whilst the debates took place about the form legislation should take, members of neither committee had noticed the changes taking place around them. It was left to two subcommittees of the Senate Banking Committee to consider the “Housing Bubble and its Implications for the Economy.”⁵² They took evidence from the Chief Economists of OFHEO, the Federal Deposit Insurance Corporation, the National Association of Home Builders and the National Association of Realtors. The OFHEO house price index showed that the general level of house prices rose by 56% from the spring of 2001 to the spring of 2006 (inflation-adjusted, a rise of 38%), partly due to lower long-term mortgage interest rates (8% in mid-2000 to less than 6% from early 2003 to mid-2005), building supply constraints, an ageing population and speculation. But pace of increases in house prices had moderated, especially in the most superheated markets. One important indicator was the swelling inventory of unsold houses on the market, up from 3m to 4.5m over 18 months.

The National Association of Realtors reported that existing home sales in July fell by 11.2% from the previous July, and that new home sales were down 22% from 2005. The Association noted that there were wide variations. It is fair to say that neither the witnesses nor the members of the Committee saw any of this as indicating more than a temporary slowdown, or even as Chairman

Bernanke called it, a “substantial correction.” Not even UBS’s statement that the rate of subprime 60-day delinquencies had already risen from 4.5% to 8% from the previous year, and that such loans were going into foreclosure more quickly than before, made an impact. No doubt with elections looming and the focus on legislation, lawmakers were distracted from such considerations.

The elections were held on November 7, with the Democrats gaining control of the House of Representatives with a majority of 31; each party had 49 seats in the Senate but the two Independents joined the Democrat caucus. Barney Frank became Chairman of the House Financial Services Committee and Senator Christopher Dodd became Chairman of the Senate Banking Committee.

Events in 2007

The whole process of legislation began again in the House under Barney Frank’s Chairmanship.

Federal Housing Enterprises Regulatory Reform Act, S.1100

Senators Hagel, John Sununu, Elizabeth Dole and Mel Martinez introduced GSE regulatory reform legislation, S.1100, which was simply a revision of S.190. Their aim was to create an independent regulator to oversee the safety and soundness of the housing GSEs, to focus on the GSEs’ combined \$1.4 trillion investment portfolio on their housing mission of promoting affordable housing. Amongst the other provisions, the most important was to provide the new regulator with the authority to close down a failing GSE and protect against a taxpayer bailout, but it did not provide for an affordable housing fund. The bill was referred twice in Committee and then referred to the Senate Committee on Banking, Housing and Urban Affairs.

The Committee did not consider any legislation in 2007, although the Chairman stated: “In my view, there is broad agreement that we should create a new regulator to oversee Fannie Mae, Freddie Mac and the FHLBs. This new regulator must have a number of core powers in order to do its job effectively, and to be considered credible in the eyes of the public. These powers include the ability to set both minimum and risk-based capital levels for the Enterprises, enhanced enforcement and prompt corrective action powers, including the authority to set and enforce prudential management and internal control standards; the ability to put a GSE into receivership; and authority over both safety and soundness and mission. The goal in giving the new regulator this broad responsibility is to ensure a more coherent regulatory framework, better enforcement, and a more consistent, deeper and more aggressive effort on affordable housing at all the GSEs. In addition, I believe

that the new regulator must be politically independent and funded outside of the appropriations process. It is my hope that this shared consensus can be the basis for moving strong and effective legislation forward.”⁵³ Fine words, expressing a hope which had often been expressed before, to no avail. And again, nothing happened.

Federal Housing Finance Reform Act, H.R.1427

Meanwhile, Chairman Barney Frank introduced H.R.1472 on March 8, 2007. The first hearing was held on March 12 and the second on March 19. In the course of his opening remarks at the second hearing, referring to the debates on the previous bill, he said, “We did disagree that they [the regulators] should be empowered to deal with something called ‘systemic risk’ over and above safety and soundness. I will continue to be very sceptical that you can have entities that cause risks to the system when they themselves have no problems.”⁵⁴ The second statement is hard to believe after OFHEO’s Special Examination of Fannie Mae. As for the first, unfortunately, he would soon find out what systemic risk meant.

The bill covered much the same ground as the one in the previous session, in that it established the Federal Housing Finance Agency to regulate Fannie Mae, Freddie Mac and the FHLBs and to replace OFHEO. The new independent agency would be headed by a director appointed by the President, confirmed by the Senate for a period of five years, plus three deputy directors. The duties of the director required him to ensure that regulated entities operate in a “safe and sound manner,” to maintain adequate capital and internal controls, and contribute to the “liquid, efficient, competitive and resilient national housing finance markets.” To achieve these objectives, the regulator would be obliged to issue regulations, setting out the standards for every aspect of the GSEs’ operations, such as the independence and adequacy of internal audit systems and the management of interest rate and market risk.

The FHFA would be funded by the annual assessments collected from the GSEs, and would not be subject to the appropriations process, ensuring greater independence. This would allow the regulator to adjust the risk-based capital requirements and provide for minimum capital levels to ensure the safety and soundness of the GSEs. The Director could by order increase the minimum capital levels on a temporary basis, if, for example, an unsafe or unsound condition were to exist. The bill required the Director to conduct a periodic review of the assets and liabilities of each GSE, and, if necessary, to require by order the disposal or acquisition of an asset or a liability. It also allowed for prior approval of new business activities or new programs, and grandfathers any current ones. The Government Accountability Office was required to study the guarantee fees, including the factors determining their amount, and the total revenue from such fees. Each GSE would have to register at least one

class of its capital stock with the SEC, and comply with requirements for proxy reporting and transaction disclosure requirements for directors, officers and principal stockholders.

Finally the bill contained Chairman Frank's crowning achievement, the affordable housing fund, funded by the GSEs. This would provide formula grants to increase home ownership for extremely and very low-income families; increase investment in housing in low-income and chronically distressed areas; increase and preserve the supply of rental housing for such groups; increase investment in public infrastructure development related to this housing; and leverage investments from other sources in affordable housing and in public infrastructure development.

This time the Administration did not oppose the bill. The President issued a statement, supporting those elements in the bill which are "essential for proper regulatory oversight of the housing GSEs and for protecting the safety and soundness of the housing finance system and the broader financial system."

The Administration did, however, "oppose provisions that would increase the conforming loan limit, thus diluting the housing GSEs' commitment to low-income buyers," and to the affordable housing fund. It also rejected the Federal Government appointment of directors to the boards of the GSEs, because this would be inconsistent with current corporate governance standards and reinforces the misperception of a government guarantee. The Administration believed that the Board of the FHFA should be composed only of the FHFA Director and the Secretary to the Treasury and the Secretary for Housing. Despite these reservations, the Administration was looking forward to working with Congress on the bill to bring about the much-needed reforms.⁵⁵

The bill was passed in Committee by a vote of 45-19 on March 29. It was the product of careful negotiations between Barney Frank and Treasury officials, and as a result very few changes were made. The Federal Housing Finance Reform Act was passed in the House of Representatives on May 29 by partisan vote of 313 to 104, but, although it was referred to the Senate Banking Committee, it never became law, partly due to deep divisions about how to regulate the Enterprises, and partly because Christopher Dodd had announced his intention to run for President.

By April 2007, attention had shifted away from the GSEs to the subprime mortgage crisis, which began to dominate the headlines. "Who to blame and what to do" became the key issues for both Congress and Senate. Chairman Dodd called for a summit of regulators, lenders and consumer advocates to help identify and reduce the damage from foreclosures rising at an alarming rate, triggered but not caused by the Federal Reserve's string of 17 interest rate rises in the summer of 2005. The next chapter will focus on the causes of the subprime crisis and why no one expected it to happen.