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The Dominance of the GSEs

As has been discussed in previous chapters, there are several reasons for the dominance of the GSEs in the mortgage market, including the advantages of the hybrid structure, the subsidies, and the inability of HUD or Congress to restrain their freedom in building up their portfolios, in spite of the risks to the financial system for which the US is paying bitterly, will be examined. These include the GSEs' use of their automated underwriting system to dominate the market, and the refusal to allow Congress to impede their progress by making higher capital demands or removing any other benefits.

The GSEs' automated underwriting (AU) systems

Fannie and Freddie: First in the market

It may seem odd to describe the introduction of automated underwriting as a reason for the GSEs' domination of the market, but so it was. This was partly because they were early introducers, and used that pole position to hold sway over lenders. James Johnson, then Chairman and CEO of Fannie Mae, invested some \$7bn in technology and in underwriting experiments between 1994 and 1997; the automated system was introduced in 1995, and was continually refined and updated thereafter.

The GSEs were able to make use of statistical credit scoring models which had been developed in the 1970s and 1980s, making it possible to price disparate credit risks. Fair Isaac acknowledged that the information they received from credit repositories was deficient in some respects and called for better reporting. Since then their models have been adapted to handle conflicting and duplicate information, and to avoid relying on data they know to be unreliable;¹ despite data inaccuracies and incomplete reporting, credit scores are highly predictive of loan performance. The models were incorporated into the GSEs' automated systems. Then, with the introduction of statistical modeling techniques and automated underwriting, analysts concluded that these new techniques would enable them to be able to assess the risk of lending with far greater accuracy than manual underwriting.

Developing and using the automated underwriting systems

Freddie Mac describes automated underwriting as a technology-based tool that combines historical loan performance, statistical models and mortgage lending factors to determine whether a loan can be sold into the secondary market. Mortgage originators use the system to determine the terms on which the loan could be sold into the secondary market; evaluate the credit, collateral and capacity of borrowers to make their monthly mortgage payments; and identify the appropriate type of loan for the borrower. Freddie's website emphasizes the importance of the three Cs; it also provides specific examples of families who have been helped by automated underwriting, dispelling the myth that low-income families cannot get a conventional loan; that borrowers need almost perfect credit to qualify for a loan; and that a down payment of 20% is required to buy a home. Freddie Mac's system was known as Loan Protector (LP) and Fannie Mae's as Desktop Underwriter (DU).²

The system evaluates the likelihood that the borrower will repay the loan, based on data summarizing how borrowers with similar loan, property and credit characteristics have repaid their loans in the past, using statistically based predictive models that correlate the underwriting data to credit performance. These models assign a loan to a risk category based on an estimate of the borrower's likelihood of default. The loan risk categories and the appraisal produced by the AU system form the basis for the lender's underwriting decision. The main three categories are:

- An Accept (LP) or Approve (DU) designation denotes the lowest level of risk and indicates that the GSE in question is willing to purchase the loan with minimal documentation.
- A Refer (LP and DU) designation indicates that the loan application needs to be referred to one of the lender's underwriters for review. Based on additional information, the loan may still be acceptable to the agencies. This category was removed from LP in November 1998.
- A Caution (LP) or Refer with Caution (DU) designation indicates that the application represents substantial risk and extenuating circumstances would have to be present for the loan to be acceptable for the agencies.
- For certain loans, the statistical property appraisal generated by the AU systems can be used in conjunction with an exterior property inspection in lieu of a full appraisal. This streamlined approval process can save from 50–70% of the costs associated with a standard appraisal.

The growth in the use of the GSEs' system was very rapid even in the early years; for example, as at the end of 1997, 51% of all lenders closing loans

used it, and amongst lenders originating more than \$1bn, 41% used LP and 32% used DU. Quite apart from increasing usage of the system by lenders, it was also expanded by the GSEs, when they released Internet versions of the automated systems in 2001. Freddie Mac estimated that over 10,000 brokers and 300 wholesalers had access to their system alone; by 2003 Freddie Mac was processing 40,000 loan applications a day and expected to reach 10 million by the end of the year. Fannie was much more reticent about the number of loans, but the total value of loans purchased reached over \$1.3bn in the same year.³ Freddie Mac was probably anxious to publicize the number of loans it processed, since it continually competed with Fannie, the much larger Enterprise.

Flexible standards

Right from the start, the underwriting criteria used in the automated system were flexible. In 1999, Franklin Raines announced a pilot project involving 24 banks in 15 markets to encourage banks to extend home mortgages to individuals whose credit was generally not good enough to qualify for conventional loans. This would be rolled-out nationwide in 2000. "Fannie Mae has expanded home ownership for millions of families in the 1990s by reducing down-payment requirements. Yet there remain too many borrowers whose credit is just a notch below what our underwriting has required who have been relegated to paying significantly higher mortgage rates in the so-called subprime market."⁴

Fannie and Freddie certainly offered 100% mortgages (Flex100 Home Purchase Loan, and Flex 97, which required a 3% down payment). Freddie Mac offered similar products, such as Homes Possible 100 and Homes Possible Neighborhood Solutions. My Community Mortgage offered relaxed credit and debt-to-income ratios, provided that the borrower came up with \$500 to pay certain costs, e.g. towards the closing costs. In 2000, Franklin Raines urged the housing industry to work together to advocate a Mortgage Consumer Bill of Rights. "The housing industry during the 1990s ... broke down the toughest barriers to equality in home ownership, including income, finance, credit, information and even discrimination." Fannie's strategy is to offer mortgage products that allow lenders to qualify more home buyers for low-cost conventional financing. In 1999, it rolled out its Timely Payments Rewards Mortgage, which allows families with slightly impaired credit to qualify for a mortgage that was about 2% below the subprime rate; after 24 months of consecutive payments on time, the rate drops another 1%.⁵ There were frequent announcements on new products throughout the years up to 2008, showing that the underwriting standards were certainly not meeting the usual demands of the three Cs. In June 2006, HUD published its review of underwriting guidelines to identify potential barriers to Hispanic home ownership: often large, poor families, including undocumented illegals, unlikely to be in regular employment. The report is interesting in that, perhaps inadvertently, it shows

the weakness of underwriting requirements. The only barriers it could still find were the lack of acceptability of cash income; the requirement that borrowers be legal residents of the USA; and the requirement for homebuyer education and counseling, which might be difficult if there were insufficient Spanish courses available.⁶

Automated underwriting was often praised by those whose major interest in the late 1990s and early 2000s lay in the extension of lending to minorities and low- to moderate-income borrowers. Improved risk assessments, in their view, reduced the variance in the default equation, allowing managers to accept a higher level of risk. Underserved populations, in particular, benefitted from Loan Prospector's increased ability to distinguish between a wide range of credit risks, and "increased accuracy has led to the development of new mortgage products which would have been deemed too risky even just a few years ago. Freddie Mac now uses Loan Prospector to approve higher-risk mortgages, such as zero-money-down loans, Alt A loans, which tend to have non-traditional documentation, and A-minus loans, which pose a significantly higher risk of default. Accurate risk measurement is working in borrowers' favor, not against."⁷ It was widely accepted that the flexibility of AU facilitated a growing diversity of mortgage products, those featuring low or no down-payment requirements, higher debt-to-income ratio, reduced cash reserve requirements, flexible employment standards and reduced mortgage insurance. According to Harvard's Joint Center, the development of loan products such as these have enabled the more cash-strapped borrowers at the margin to qualify for mortgage loans."⁸

Given the advantages of such systems, the GSEs used their early entrance to secure certain benefits. Even by 2005, most of the loans purchased by the GSEs used the LP or DU systems, not because other major lenders had not developed their own or were not in a position to do so, but because it was not in anyone's interests to develop another independent system. The GSEs provided various incentives to encourage the use of their systems, such as better guarantee fees (and higher fees for those who did not use DU or LP), and greater legal waivers to prevent possible loan buy-back requirements against the lender. In the last analysis, the GSEs did not approve any other automated underwriting system. Despite claims about reduction in costs, there were costs involved in using the system, such as user training, costs of supporting the interface between a lender's own computer systems and DU and LP, and, for third-party vendors, the fees paid to the GSEs for delivering their products through the systems.

The sale of third-party products through the system was introduced by the GSEs with Fannie Mae's announcement in 2001 that access to its DU system would only be possible through MornetPlus 2000, a proprietary Fannie Mae on-line system that links lenders, realtors and others with providers of services such as appraisals, credit reports and title insurance.

The AU systems are proprietary systems, so that it is not possible to know what the underwriting criteria are; nor is it possible therefore for a lender to

know whether or not a loan was going to be accepted (for purchase by the GSEs) until the fee was paid and the loan had been put through the system. The GSEs do not reject all the mortgages which have not been approved by their systems, but they then place more stringent requirements on the lender, who is obliged as a result to carry a greater part of the risk. In certain circumstances, the lender may have to repurchase the loan from the GSEs if the borrower defaults and the loan was not put through their system.

Using automated underwriting as an inducement

However, as Peter Wallison notes, the “strongest inducement to use the GSEs’ AU systems is that fact that it is the most effective way of ensuring that a mortgage loan will be purchased by one of the GSEs, thus reducing the lender’s cost or risk of carrying the loan ... and, since the GSEs are ... the sole economically feasible purchasers of most of the vast majority of all residential loans made in the United States, lenders that use the GSEs’ AU systems gain considerable cost advantages over lenders that do not.”⁹ By February 1999, the GSEs’ combined market share in the use of LP and DU by lenders was 95%. Wallison argued that in comparison with the Court of Appeals decision concerning Microsoft as an attempt to monopolising a trade, so a case could be made that Fannie and Freddie were monopolising the automated underwriting market under anti-trust legislation. Many disagreed with Peter Wallison’s analysis, and a case was never brought to the courts.

The GSEs extended and confirmed the use of their automated systems by engaging with various lenders. These partnership deals varied considerably between banks and in the aims and objectives, and were most frequent in the late 1990s and early years of the following decade. A range of examples follows, which, if nothing else, show that Fannie Mae and Freddie Mac searched for every possible opportunity to expand the business.

- (1) Fannie Mae teamed up with the Union Bank of California and the Consumer Credit Counseling Service in Santa Clara County and Los Angeles to offer \$6.5m in loans to consumers with impaired credit histories, but only to those who had actively participated in the local debt-management and counseling programs and had “graduated” from them within the past year. The funds were issued by Union Bank and underwritten by Fannie Mae. Similar schemes were established in 13 other cities.
- (2) In February 1998 both Fannie Mae and Freddie Mac were seeking to make their underwriting systems available directly to consumers. Fannie Mae teamed up with Finet Holdings Corp., a multi-lender website where consumers could send a loan application which was then processed by Fannie Mae’s DU, before the consumer selected

a lender from a panel of about 40 lenders chosen by Finet and participating in their program. The lenders paid the cost of running the application through the DU system, and Finet absorbs the cost if the loan is not finalized. The system puts in a merged credit report and a borrower pays a \$39 fee online for up to three attempts. Freddie Mac was in the process of a somewhat similar project, using LP and linking borrowers up with its Goldworks subscribers, its lenders' network.

- (3) In May 1998, Fannie Mae announced a new low down-payment product called the Flexible 97 Mortgage, offering a conventional fixed-rate 30-year mortgage with a 3% down payment, where the latter could come from a gift, an unsecured loan from the family, a grant from an employer, a non-profit or a government agency. Other features included the ability to pay the future mortgage on the basis of income received but no minimum credit score. The new product was sold through the network of 500 lenders using DU together with two mortgage insurance companies (Mortgage Guaranty Insurance and Commonwealth Mortgage Insurance).
- (4) In July 1998, the *Milwaukee Business Journal* reported that lenders were increasing their use of the automated underwriting systems, partly because of efficiency and also because of the fee reductions on offer once they entered into a deal. These included St Francis Capital Core and several other similar banks, as the DU told them whether or not the GSE would buy the loan: as the Journal reported, "this in effect tells the bank whether to approve the loan." The costs were reduced from \$60–70 for every loan processed to an undisclosed sum, but less than \$60. Another bank, M&I Mortgage Corp., decided to use Freddie Mac's LP system which meshed with their own software.¹⁰
- (5) Freddie Mac announced a partnership with Wendover Financial Services in February 2001, which allowed its licensed real estate brokers to offer customers mortgage applications, customized pricing and loan approvals using LP. At the same time, LoanTrader.com, which was a transactional marketplace for subprime lenders and brokers, was integrated with LP on the Internet, thus enabling automated underwriting decisions for LoanTrader's brokers and lenders. Fannie Mae simultaneously announced a partnership agreement with America's Community Bankers.
- (6) Perhaps one of the most important deals Fannie Mae ever made was with Countrywide, given the size and importance of its operations in the mortgage market. Although Countrywide was acquired by the Bank of America in January 2008, at the time this would have appeared to be an excellent partnership, giving access as it did

to Countrywide's mortgages to brokers on Fannie and Freddie's automated systems. Countrywide mortgages became available on Fannie Mae's Desktop Originator on the Web and Freddie Mac's Loan Prospector on the Internet.¹¹

This is just a small sample of the various partnerships, relationships and often complex deals that both Fannie Mae and Freddie Mac entered into over the years, especially up to 2003 and 2004, when the accounting problems came to light. The deals helped to ensure that there was little criticism of the GSEs' dominance in the marketplace, but did not succeed in silencing all the critics: for example, John Taylor, President and CEO of the National Community of Reinvestment Coalitions, stated that the GSEs' regulators "should encourage a wide diversity of credit scoring systems, competing with each other in developing sound and flexible underwriting criteria. This will open more doors to home ownership for minorities and low- to moderate-income borrowers. In addition, the regulatory oversight agency should continue conducting fair lending testing of the GSE underwriting systems, as HUD has just started doing."¹²

With a rather different emphasis, the former Treasury Under-Secretary Gary Geinster stated, "To the extent that the GSEs now finance a significant portion of their sector of the mortgage market, the willingness of the GSEs to purchase a mortgage has become a far more significant factor in deciding whether to originate that mortgage. The GSEs automated underwriting systems are increasingly becoming the means by which originators decide to lend. This technology will make the process more efficient. In the long run, however, this trend may result in less diversity in credit decisions and less price competition."¹³ Geinster's conjectures were probably correct, but with so many deals and the near-certainty of selling-on the loans to the GSEs, to many, the lack of competition no doubt seemed less important as time went on. The concern which did linger was that the AU systems discriminated against minorities, primarily due to the credit scoring codes, though it appears that other AU systems in use at the time did not lead to quite as high a rejection rate as other automated systems in 1999. These and other complaints led HUD to conduct a fair lending review, which took over two years to complete. In those early days of the use of such systems, and in the context of the prevailing view that it was vital to extend home ownership to minorities, the emphasis was on fair lending rather than the quality of the mortgages.

Automated underwriting fails to measure default risk

This emphasis on fair lending meant that the data issues, which would turn out to be just as significant for minorities with mortgages as for all others, were overlooked. In February 2001, Fannie Mae revealed the contents of the "black box," that is, the range of factors taken into account when giving loan approval. Much as expected, these were borrower characteristics, including, for example,

equity, taking appraisal or sales value into account; credit history (FICO scores); debt-to-income ratio; and the borrower's work status (salaried or self-employed). To these factors was added information about the type of loan and the type of property, and information about any previous defaults or foreclosures.

These are all entirely reasonable factors, but what is missing here are any historical data concerning what would happen to mortgages of a particular type in an economic downturn or in a period of falling house prices. Where such data are incorporated into a computerized model, they tend to be of short duration. The model does not take account of any other external risks, such as changes in interest rates, unemployment or lack of stability in employment even where the work status is salaried. Nor is the basis of borrower default predictions explained in this revelation.

All of this depends on the assumption that the full contents of the "black box" have been revealed, and that it is clear what importance was given to each of the factors over time. For example, the acceptability of the source of the down payment changed over time, and automated appraisals of the value of the property were introduced, based on local house-price data, with some kind of external evaluation of the property that allowed what were called "drive by" appraisals rather than a true inspection. Such appraisals may only have verified the existence of the property at the purported address, and perhaps, say, the presence of a roof, but did little to prevent inflated appraisals, which was another contributory factor to the collapse of the mortgage market. The down payment was considered to be merely an impediment to lending, rather than providing some kind of reassurance that the borrower intended to pay the mortgage. Debt-to-income ratio is correctly included, but the means of verifying income cannot be carried out through this kind of system.

Over time (as can be seen from some of the above partnerships and deals), LP and DU allowed for the shift of the underwriting decision from the GSEs to the lenders, and then to the brokers and finally to the borrower. The GSEs would, of course, claim that this was not the case, because use of the system determined the acceptance or rejection of the loan application. But the whole development and use of the AU reduced human input and control and, as time went on, allowed others to "game the system."

The use of DU and LP and the elements in the model apparently led the GSEs and the regulators to believe that loan acceptance depended on the assessments provided by the system, whereas in fact the quality and accuracy of the data submitted was the key. This is not necessarily to imply that the data was submitted fraudulently; only that those using it needed to ensure that all the data given was properly validated or understood instead of being based on a cursory review of documents provided. Under the system, lenders could assess a borrower's creditworthiness based on "a verbal verification of employment" which was "the only required income verification for borrowers with low-risk profiles." Fannie Mae insisted that, "We've researched this very carefully, and

we know that people who have certain risk profiles ... in a very high percentage of the time, simply do not take on financial obligations that they cannot handle.”¹⁴ Reliable third-party data bases should have been used, rather than depending on borrower-supplied data: two years’ of tax returns, paychecks and a written verification of earnings from the borrower’s employer were the typical requirements. Other problems in the data were set aside, such as proper appraisals (difficult to find, admittedly, in the US in the 1990s and until the rules were changed in 2008). In addition to data issues, the GSEs frequently changed the significance and weight to be attached to the various factors listed above: for example, accepting loan applications with low and borrowed down payments. Fannie and Freddie frequently changed the system as they sought to develop “new” products in their quest for ever-greater market dominance.

“Fannie Mae had constructed a vast network of computer programs and mathematical formulae that analysed millions of daily transactions and ranked borrowers according to their risk. Those computer programs seemingly turned Fannie into a divining rod, capable of separating pools of similar-seeming borrowers into safe and risky bets. The riskier the loan, the more Fannie charged to handle it. In theory, those high fees would offset any losses.” DP did not and probably could not achieve that, but it is not possible to tell, as the details of the models were never revealed and the extent to which programs were modified and adapted to meet specific requirements, perhaps of partners such as Countrywide, were never disclosed. One take on the system was provided by Marc Gott, a former director in Fannie’s Loan Servicing Department, who said, “We really did not know what we were buying. This system was designed for plain vanilla loans, and we were trying to push chocolate sundaes through the gears.”¹⁵

HUD’s demand for full loan level data

Once again, issues regarding data are vitally important. Checking the automated underwriting applications against the original files would clearly be a major undertaking. Even carrying out meaningful spot checks, given the annual volume of applications (running into millions) would be demanding in terms of human and financial resources, even if the GSEs were seriously prepared to provide them. As indicated in Chapter 5, as part of its proposals for new housing goals for Fannie Mae and Freddie Mac HUD included a Notice of Proposed Information Collection for the GSEs, which covered both the Public Use Data Base and Public Information (which was shelved) together with changes in data reporting, designed to assist with the prevention of predatory loans, defined as high-cost loans. The combined report from HUD and the Treasury contained a recommendation that Fannie Mae and Freddie Mac should provide data about the loans accepted through DU and LP: the APR and the cost of credit, together with the borrower’s debt-to-income ratio. The recommendation was resisted both by the GSEs and by the industry, on the grounds that the detailed requirements

had not been spelt out (apart from the possible rules which would be drawn up by the Federal Reserve and would apply to HMDA data as well). The comment period ended on January 8, 2001 and the joint letter from the trade associations was published on January 5, asking for HUD to withdraw the Notice. The American Bankers Association, America's Community Bankers, the Independent Community Bankers of America and the Mortgage Bankers' Association all wanted HUD to withdraw it, as "interested parties because Fannie Mae and Freddie Mac will look to their customers, primary market lenders, to supply them with additional data necessary to meet their reporting requirements." They added that "Due process and fundamental fairness require that those who will bear the burden be notified specifically of what that burden will be and be given a reasonable opportunity to assess the implications of the proposal and comment on its reasonableness, particularly in the light of the potential burden of dual reporting regimes for a single objective ... We [therefore] strongly urge that, at a minimum, the proposal be withdrawn at this time and published in the *Federal Register* with a list of all the data elements to be collected."¹⁶ The then Assistant Secretary, William Apgar, stated that HUD was aware of the extra burdens to be taken into account if new loan data elements were to be included in the reporting requirements, and if they could not be handled by existing systems then HUD would build in a transition period for them. In the event, the whole issue was postponed.

The issue is an interesting one. Reporting requirements do, of course, impose costs on companies and may require transitional periods for systems adjustments. But the resistance on the part of the industry does raise questions about their own control of mortgage credit. In order to assess the credit risks they had taken on in granting mortgages, assuming it was their policy to grant loans where, for example, the borrower's debt-to-income ratio and other features of the loan carried higher risks, then the banks would surely have such data available. There may, of course, be less concern about carrying credit risk, since the agreements to use DU and LP carried with them the near-certainty that the loans would be purchased by Fannie Mae and Freddie Mac. They create mortgage backed securities, the holders of which get the (passed-through) interest and principal payments of the mortgage borrowers, less a "guarantee fee" charged by the GSEs. The guarantees of the GSEs protect the MBS holders against losses due to "credit risk" (the possibility of default). The mortgage originators can sell their swapped MBSs into the secondary market for these securities, or hold them as relatively liquid assets in their portfolios.

Clearly Fannie Mae and Freddie Mac charged different levels of guarantee fees according to the degree of risk involved. To take one such example, Fannie Mae announced new "eligibility standards" for "refinance mortgages" on September 23, 2002, with the aim of aligning their eligibility and pricing policies more closely with the risk profile of the particular mortgage transaction. Their research indicated that "cash-out refinance mortgages default at a higher rate

than other refinance transactions, adjusting for other risk factors ... We also confirmed that the default rate increases as the new mortgage amount increases beyond the unpaid principal balance of the mortgage that was refinanced.”

Fannie Mae distinguished between limited cash-out mortgages and refinance mortgages, and defined the latter as referring to refinance mortgages that involve the refinance of subordinate liens that were not used in whole to purchase the subject property. “Lenders must obtain written confirmation (and maintain such confirmation in the loan file) that all the proceeds of the existing subordinate lien were used to fund part of the purchase price of the subject property, in order to treat the transaction as a “limited cash-out” refinance. Other relevant documents, such as the contract of sale, should be obtained and retained for this purpose. Then the lender was responsible for ensuring that any application for such a loan (after February 1, 2003, and allowing time for systems adjustments) should be entered into the DU as the appropriate refinance type. The guidance also requires lenders to ensure that the valuation appraisals are carefully scrutinized, as these are more likely to be inaccurate in cash-out refinance transactions. Lenders were warned that cash-out refinance loans would be carefully categorized according to the LTV levels; a table of increased loan level charges was also included.

With reference to the alleged difficulties of providing information, it is interesting to note two important points. Fannie Mae and Freddie Mac’s systems had become increasingly sophisticated as they introduced new products or accepted the new types of mortgage which the lenders introduced to meet demand, or to meet the requirements for more lending to low- and moderate-income borrowers or those in underserved areas. From the above example, it is quite clear that Fannie and Freddie could (in theory at least) identify the loans they accepted through the automated system, and that they required files to be kept of the relevant information. Since all the parties involved needed to know how many and what types of loans they accepted, agreed or bought in order to assess the credit risk involved, and, in the GSEs’ case, with the important element of charging differential fees, then it is difficult to see why providing HUD with the data should present such difficulties. Fannie and Freddie were nonetheless reluctant to provide such information: they did not want the riskiness of the loans they were acquiring to become known. Franklin Raines, in particular, always referred to “meeting our standards,” as though these were the highest standards of lending.

“We also set conservative underwriting standards for loans we finance to ensure the homebuyers can afford their houses over the long term. We sought to bring the standards we apply to the prime space to the subprime market with our industry partners primarily to expand our services to underserved families. Unfortunately, Fannie Mae-quality, safe loans in the subprime market did not become the standard, and the lending market moved away from us. Borrowers were offered a range of loans that layered teaser rates, interest-only, negative

amortization and payment options and low-documentation requirements on top of floating-rate loans.”¹⁷ They set out to offer “high-quality, low-cost, non-predatory loans” to borrowers with blemished history. It is hard to reconcile this statement with the loans which Fannie Mae knowingly bought over the years, and from lenders such as Countrywide.

Fannie Mae, Freddie Mac and Congress

Making sure the 1992 Act did not impose unwelcome restrictions on the GSEs

The Federal Housing Enterprises Financial Safety and Soundness Act, 1992 took shape over three years, during which time the GSEs worked with the Administration to develop the original proposal, and then with Congressional staff to shape the final outcome. That is to say, James Johnson, then Chief Executive of Fannie Mae, used his powerful lobbying position to shape the GSEs as he wished. “Protecting the Charter had become management’s pre-eminent concern.”¹⁸ The Act, as a result of a series of compromises, mostly to the benefit of Fannie Mae, resulted in the creation of the Office of Federal Housing Enterprise Oversight (OFHEO), as an office within HUD, but a little separate from the department in that the Director was appointed by the President for a five-year term. According to the statute, “The Director is authorized, without the review or approval of the Secretary, to make such determinations, take such actions, and perform such functions as the Director determines are necessary” to set capital standards, issue and enforce regulations, and examine Fannie Mae and Freddie Mac.¹⁹ It was thought that this would sufficiently separate the OFHEO from political influence.

On the other hand, the Secretary for Housing under the legislation retains the right of approval over any OFHEO actions not directly required by the legislation. OFHEO is required under the legislation to submit appropriations requests for Congressional approval, and must clear drafts of proposed regulations through the Office of Management and Budget. OFHEO’s function was to ensure the safety and soundness of the GSEs; from the start, Fannie Mae was determined to ensure that it had some protection against regulatory limitations on its activities. The Act therefore included the requirement that OFHEO put all proposed regulations before Congressional oversight committees, and that funding for OFHEO had to go through an annual appropriations review. Some critics recognized at the time that this would give the GSEs “a chance to exercise influence over the regulator by lobbying the Appropriations Committees.”²⁰

Preserving benefits: Treasury line of credit

This issue arose during a hearing held by Richard Baker, Chairman of the Capital Markets Subcommittee on March 22, 2000.²¹ It was the first of a

series of bills that he and others introduced for better regulation of the GSEs. Testimony was given by Gary Gensler, Treasury Under Secretary at the time, in the course of which he supported the removal of the Treasury's line of credit from the GSEs. This was first authorized at its current level (it was authorized to purchase up to \$2.25bn of Fannie and Freddie's obligations) in 1957. Mr Gensler was at pains to point out that the amount was irrelevant anyway, given the size of the GSEs at the end of 1999: they had grown in size to \$1.4 trillion, and either owned or guaranteed about 63% of all outstanding conforming, conventional mortgages, of which the retained portfolio represented 26%. GSE share of the US debt markets was increasing; at \$1.4 trillion, it was the same size as the US's entire municipal debt, and over half of the \$2.7 trillion privately held marketable Treasury debt. The GSEs also then held \$1.2 trillion in GSE MBSs, which Gensler also recommended should be curtailed. As will be seen, it was not possible for the Administration or the Federal Reserve to change any of that without Congressional approval, which is where Fannie and Freddie were able to exercise their powers.

After the hearing, Gensler said in press interviews that debt issued by Fannie and Freddie was not guaranteed by the US government, which was hardly news, although many investors interpreted the line of credit and other ties to the government as an implicit backing by US taxpayers. Gensler's testimony not only upset the markets, but created a veritable storm. It upset the bond markets the following day, but as John Lonski, Chief Economist at Moody's Investor Services, pointed out, "Some credit market participants were lulled into thinking that agency papers and Treasury debt were virtually indistinguishable. We've warned investors about it for a long time. If the market is overreacting, then it may have more to do with its own nervous state than with Mr Gensler's remarks."²²

The markets calmed down pretty quickly, while volatility remained with Freddie and Fannie, who launched their attacks in the press with CFO Timothy Howard calling Gensler "irresponsible" and "inept." Freddie's spokeswoman Sharon McHale said that he had "showed utter contempt for the nation's housing and mortgage markets," and Fannie's spokesman, David Jeffers, said that the "bond market's reaction raised costs to consumers," adding "frankly we see no reason why Treasury would want to give up a tool that supplies emergency credit at a time of crisis."²³

Fannie and Freddie both apologized, but then followed this with further attacks. David Jeffers said that "it is unfortunate and regrettable when statements made by the Treasury have such an immediate and profound effect on American consumers ... [those] attempting to purchase homes today will pay about a quarter point more in mortgage rates as a result of the Under Secretary's comments, and that means that they will pay an extra \$5,800 over the life of an average Fannie Mae 30-year loan. The rise in mortgage costs caused by the Treasury's remarks means that about 206,000 families will be

disqualified for home loans.”²⁴ This again was retracted the next day, but by then the damage had been done.

Through extensive advertising, Fannie was seen as a mortgage provider throughout the country (although, of course, it did not lend anyone any money). As Congress considered one bill after another in the years to come, Fannie and Freddie’s tactics were always the same: any change would increase the cost of mortgages. Then they would arrange for various associations, such as the Association of Independent Community Bankers, to write to the Congressional committees and organize constituents to write to their Representatives or Senators with the same message. Their message would also be conveyed to the House Financial Services Committee. The Subcommittee’s Ranking Democrat, Paul Kanjorski, hoped the bill (Housing Finance Regulatory Improvement Act, H.R. 3703) was not on a “fast track,” but then he thought that they “should not rush into judgment” almost until the end. Congresswoman Maxine Waters was concerned, as ever, that any changes should not hinder the ability of African-American homebuyers to qualify for mortgages. She wanted Freddie Mac and Fannie Mae to expand and provide more mortgages to poor people, which remained her position until the GSEs collapsed. As for removing the Treasury line of credit? Nothing was done until 2008, when Fannie and Freddie needed far more than \$2.25bn.

Fending off higher capital requirements

According to the 1992 Act, OFHEO had to develop a risk-based capital stress test to ensure the GSEs held enough capital to cover credit and interest rate risks, plus 30% for management and operational risks. The 1992 Safety and Soundness Act set out a number of factors which OFHEO was expected to take into account; the single assumption was that there would be ten years in which interest rates fell by 6%, while at the same time house prices would fall throughout the country at a rate observed in an area with at least 5% of the population with the highest default rates and credit losses for the GSEs for at least two years. During that time, the test assumed that the GSEs would not conduct any new business for at least two years. It was odd to set out such details in legislation, and even odder to regard its development as essential during a period in which modeling for various risks was being developed.

Work on the test was supposed to be completed by December 1994, but it was not finished until October 1998, when it was sent to the Office of Management and Budget, which did not complete its review until March 1999, when it was sent to Congress for a 15-day review, followed by a four-month period for public comment. OFHEO hoped it would be finalized by the autumn, but that was far too optimistic; the final rule was not published until July 19, 2001 for public comment, and after that, it was published in the Federal Register on September 13, over 100 pages of it including OFHEO’s responses to comments.²⁵

A brief summary

The housing GSEs are required to hold capital equal to the minimum requirement or the risk-based capital requirement, whichever is the larger. The former is defined as 2.5% of a GSE's assets plus 0.45% of the outstanding MBSs that it guarantees. As at the end of 2002, with the then volume of outstanding MBSs, the minimum capital requirement was about 3% of assets for both Fannie and Freddie.

The risk-based capital requirement (RBC) is defined as the level of capital necessary for a GSE to absorb all losses and survive a ten-year stress period that begins with a sharp upward or downward movement in interest rates and the onset of a sustained decline in house prices. To estimate the GSEs' losses during that period, OFHEO used a computer model, or stress test. OFHEO then had to estimate the effects of upward and downward movements in interest rates to determine which is worse for the GSEs, and to use that shock in the stress test. In addition, house prices are assumed to decline by 11% during the stress period and then to recover to the initial level of the previous five years. Then, OFHEO estimated how those changes in interest rates and increases in credit losses, because of defaults, would affect the GSEs' earnings, in order to calculate the risk-based capital requirement. The amount of capital was then raised by 30% to account for unmeasured management and operations risk. "The test incorporates no new Enterprise business and no asset sales to raise cash. It simply runs off their existing assets, liabilities and off-balance sheet activities under the stress conditions. This no-new-business requirement is explicitly mandated in the 1992 Act."²⁶

"No new business" meant that the GSEs could not create or purchase new MBSs, nor actively reset their derivatives portfolios, although it was not entirely clear whether this would hurt the Enterprises or help them survive the test. A dynamic true hedging would help the GSEs, but the wrong strategy might compound losses. If that was the intent in raising the issue, it was scuppered by the Congressional Budget Office and the Government Accountability Office in June 2002, when the latter published its assessment, in its Report to the Congressional Committees entitled "Incorporating New Business is not Advisable", a matter which was still under consideration in 2003. In a letter to the then Chairman of the Senate Committee on Banking, Housing and Urban Affairs, Paul Sarbanes, the Congressional Budget Office summarized the issues raised by the GAO, which it stated might be useful for the Director of OFHEO when considering risk-based capital:

- The current assumption of no new business does not appear to understate the capital required by the GSEs to survive the stress period. Changing the new business assumptions could reduce the ability of the stress test to measure required capital for the GSEs' current stock of business.

- The primary effect of new business on the required level of capital depends on whether the new business is assumed to be voluntary (and thus largely profitable) or compulsory and unprofitable; if the former, it would reduce the capital requirement, and if the latter, it would increase it.
- Assuming that new business would be profitable, following a time lag for the GSEs to adjust to the new level of interest rates and higher credit losses in a stress period, is probably more realistic than assuming that new business would result in continuing losses. The reason is that both the GSEs' management and federal regulators have incentives to ensure the survival of those Enterprises.

Inadequacies of the test

The stress test itself was inadequate in other respects. First of all, under the then Basel I requirements, mortgage loans had a risk weight of 20%, so that the capital requirement for a mortgage loan would be 4%. If Basel II had been applied, then banks would have had to maintain higher levels of capital against mortgage loans than the GSEs, but the Federal Reserve did not approve the final rules implementing the Basel II risk-based requirements until November 2, 2007. Only large, internationally active banks were obliged to apply the rules over the following three years, although other banks could elect to comply with them, leaving smaller banks with a simpler framework.

The stress test was subject to criticism, partly because it assumed uniformly severe economic conditions throughout the USA, whereas economic capital should depend on the degree of geographical diversification of the mortgage portfolio.²⁷ The GSEs purchased loans from lenders throughout the USA, and the house price collapse occurred first and more extensively in the so-called "sand states" (Arizona, California, Florida and Nevada). It was therefore a limitation of the test that it only envisaged one scenario, whereas stress tests, properly conducted, postulate a range of scenarios, and estimate the capital requirements for each. Because of these and other innovations in handling risk, the test turned out to be less stringent than the minimum standards, and largely irrelevant.

Secondly, the stress test did not distinguish sufficiently between the likelihood of losses from subprime loans and prime loans. According to an OFHEO working paper by Pennington-Cross, an analysis of a synthetic portfolio of Fannie Mae and Freddie Mac mortgages randomly sampled from 30-year fixed rate mortgages and subprime mortgages shows that the expected or mean simulated losses from subprime mortgages are five or six times higher than for prime loans. The paper also argued that the use of simple risk-sharing arrangements could greatly mitigate expected losses and reduce their variation.²⁸ Such analyses indicate that the single stress test set out, even if applied rigorously throughout,

would not have led OFHEO to understand all the risks to which the GSEs were exposed.

Fannie Mae and the stress test

Freddie Mac welcomed the introduction of the stress test and was constructive in its approach. Fannie, on the other hand, was as obstructive as possible. Shortly before the details of the test were sent to OMB, Fannie objected to any OFHEO reference to a specific capital amount or percentage amount of capital, because this would create a false perception of capital inadequacy. Then the GSE claimed that OFHEO had never talked to its own officials in order to understand their business. Although OFHEO could not legally consult Fannie until the proposed rule was issued, the acting Director, Mark Kinsey, stated that his officials had talked to theirs, as well as to mortgage insurers, large banks and thrifts, and other private market institutions about how they handle risk. In fact they had held many meetings with Fannie Mae officials to understand how they measure and model risk.

That move having failed, Fannie Mae then returned to its usual attack: the proposed rule would limit its ability to serve low- and moderate-income borrowers. They did not get very far with that, so the last try was to suggest that the rule might lead to higher guaranty fees for lenders. In 1999 the Executive Summary of the proposed rule pointed out that the ability of Fannie and Freddie to meet the proposed standard while continuing to meet their affordable housing responsibilities was demonstrated by Freddie's risk-based capital surpluses in 1996 and 1997. OFHEO pointed out that Fannie's capital deficits were not caused by the credit risk of affordable loans, but by unhedged rate risk. "The risk-based standard is unlikely to cause any changes in mortgage rates and will not give the Enterprises incentives to raise their credit guarantee fees. Because the rule will help ensure the continued health of Freddie Mac and Fannie Mae, borrowers will, in fact, benefit from the rule."

For once, Raines recognized that he was not going to prevent the introduction of the test, so by April 1999, Fannie was advising equity analysts that even if the OFHEO proposal was carried out, it would not affect their company's performance. Their Chief Finance Officer, Timothy Howard, claimed that Fannie could reallocate its hedging dollars and subordinated debt to meet the requirements: "Even if the regulation does not change at all, Fannie Mae will be able to adapt to it with no measurable impact on earnings per share growth."²⁹

By the time the stress test was developed and carried out, Raines was not too concerned about its impact. In fact, he saw that its successful application could be used to his advantage. The OFHEO stress test depended on "data that characterize, at a point in time, an Enterprise's assets, liabilities, and off-balance sheet obligations, as well as data on economic conditions, such as interest rates and house prices [from public sources] ... The Enterprises are required

to submit data to the OFHEO at least quarterly for all on-and-off balance sheet instruments in a specified format ... This data submission is called the Risk-Based Capital Report and serves as the financial 'starting position' of an Enterprise for the data for which the stress test is run."³⁰

The Fannie Mae Papers and the risk-based capital test

The Fannie Mae Papers, produced by housing and other economists, also bolstered Raines' position.³¹ One in particular was extremely important, produced by Joseph Stiglitz, Nobel Prize winner, Jonathon Orszag, Managing Director of Compass Lexecon, and Peter Orszag, former Director of the Congressional Budget Office during the Bush Administration and more recently, Director of the Office of Management and Budget in the Obama Administration until 2010. Their much-publicized conclusion (no doubt regretted now) was:

This paper concludes that the probability of default by the GSEs is extremely small. Given this, the expected monetary costs of exposure to GSE insolvency are relatively small – even given the very large levels of outstanding GSE debt and even assuming that the government would bear the cost of all GSE debt in the case of insolvency. For example, if the probability of the stress test conditions occurring is less than one in 500,000, and if the GSEs hold sufficient capital to withstand the stress test, the implication is that the expected cost to the government of providing an explicit government guarantee on \$1 trillion in GSE debt is less than \$2m. To be sure, it is difficult to analyse extremely low probability events, such as the one embodied in this stress test (a severe national economic shock that is assumed to last for ten years). Even if the analysis is off by an order of magnitude, however, the expected cost to the government is still very modest.³²

Deflecting SEC registration

The role of Congressional and Senate Committees has been illustrated in the oversight of the GSEs, HUD and the OFHEO, the necessity of Congressional approval of major rule changes and the long saga of establishing risk-based capital requirements. The bill proposed by Congressman Richard Baker in 2001 would have removed the GSEs' exemption from SEC registration and reporting requirements, and would, amongst other things, have required Fannie and Freddie to publicly disclose at least annually, financial, business and other information that the Fed determines is in the public interest. That bill had been successfully defeated; it never left committee. Then Congressmen Chris Shays and Edward Markey introduced a bill in April 2002 (H.R. 4071) which would repeal Fannie and Freddie's exemption from Securities and Exchange Commission registration requirements, and drew attention to the fact that they were the only two Fortune 500 companies not subject to disclosure and registration rules. Chris Shays issued a press release in support of the bill on March 21, stating that, "This disclosure is paramount to maintaining transparent markets and providing investors

with the accurate and timely information they need to make informed financial decisions. The exemption of Fannie Mae and Freddie Mac from federal securities laws flies in the face of good corporate practice. Our legislation simply brings Fannie and Freddie in line with other firms, and gives investors access to vital information ... there is no excuse for private investor-owned corporations to be exempted out of these important investor protection requirements.”³³ They may have been emboldened in the forthright nature of this statement by the response of the SEC Chairman, Harvey Pitt, during the hearing on H.R. 3763, the Corporate and Auditing Accountability, Responsibility and Transparency Act:

MR SHAYS: “In 1992, the SEC, the Treasury and the Federal Reserve in a joint report recommended legislation to repeal the GSEs’ exemption from the Federal securities law. As you know, Fannie Mae and Freddie Mac are the only two publicly traded firms that aren’t. Does the SEC still adhere to the Commission’s 1992 report?”

MR PITT: “We have not changed our general position, but we have focused on it again. I will say that in this day and age I believe transparency has to be the order of the day. To the extent that exemptions permit anything less than transparency, which I believe is the case, I believe at least that portion has to be removed. Frankly, I could care less whether the GSEs pay registration fees or things of that nature. But I do believe that disclosure is critical for the GSEs as well as for other public companies.” When Mr Shays then asked if he could use the statement that Federal securities regulation is premised on a full and fair disclosure (of accurate, complete and timely disclosure of financial information) of this information, “as a strong support in some cases of such disclosure,” the Chairman replied in the affirmative.³⁴

Franklin Raines had been present at the hearing, giving testimony on behalf of the Business Forum, an association of CEOs recognized as an “authoritative voice on matters affecting American business corporations and as such has a keen interest in corporate governance.” He was quick to note Chairman Pitt’s replies and, obviously in response to questions Raines had briefed the media to ask, the SEC quickly issued a “clarification” stating that “neither Chairman Pitt nor the Commission is advocating any change in the legal status of the GSEs.” Such a statement was characteristic of Harvey Pitt’s approach during his brief period as Chairman.³⁵

No doubt fearing that unwelcome requirements would be imposed on them, especially in the post-Enron era, Fannie Mae and Freddie Mac agreed to make certain voluntary disclosures whilst still opposing the bill to make them subject to SEC requirements. This took the form of website disclosure of the purchases and

sales by their own senior executives as allowed immediately after the publication of their quarterly earnings. Both GSEs claimed that such information was always made available to investors who contacted the company. These efforts were not enough to stave off further moves to ensure that they conformed to SEC requirements. On May 29, 2002, the Office of Management and Budget issued a “prompt” letter to OFHEO, urging the regulator to strengthen corporate governance at Fannie Mae and Freddie Mac and to require the GSEs to make certain public disclosures.³⁶ The letter stated: “In September, 2001, OFHEO published a proposed rule to codify the corporate governance requirements for Fannie Mae and Freddie Mac that currently exist in OFHEO’s guidance to the Enterprises. We request a further rule-making that would include additional requirements to strengthen the corporate governance of Fannie Mae and Freddie Mac ... We [also] request that OFHEO consider a rule-making to require each Enterprise to disclose publicly the information that is required of publicly traded companies by the SEC, including any additional requirements SEC requires in the future. While the Enterprises now voluntarily comply with many of these disclosures, they are not required to do so. Such voluntary compliance might be abandoned at a time when it is most needed.” Such moves, the letter added, would advance the goals the President set out in his Ten-Point Plan for Corporate Responsibility and Protecting America’s Shareholders.

In his reply of June 28, Armando Falcon stated that OFHEO was considering a rule which would include the following:

1. Periodic reports both quarterly and annually, supplemented by a special report filing for material developments outside the timetable. These filings would be as comprehensive as the current SEC requirements.
2. Registration of Fannie Mae and Freddie Mac’s offerings of stock and debt. Here the OFHEO is developing an approach that would facilitate registration in a way which does not impede their ability to meet their financing needs.
3. Supplemental disclosures, additional information above and beyond current SEC requirements, such as interest rate risk, derivatives and mortgage backed securities.

In response to OMB’s press release, Fannie Mae and Freddie Mac stated that they wholeheartedly embrace the goals outlined in the President’s 10-point plan. Freddie Mac stated that it was already working with OFHEO on its disclosure project; they welcomed the opportunity to continue working with OFHEO and OMB because they were confident that both would recognize that their disclosures already met or exceeded those required by the SEC. Fannie Mae also stated that it already disclosed more information to investors than any other large financial institution.³⁷

The outcome was less than the OFHEO's proposals in its letter of June 28. Just two weeks later, the regulator abandoned its plan to issue a rule-making requiring the GSEs to register their debt. On July 12, in a joint press conference with the SEC and OFHEO, Fannie Mae and Freddie Mac announced that they would voluntarily register their common stock with the SEC, but not their debt or MBSs.

In his statement at the press conference, the SEC Chairman said, "Although Fannie Mae and Freddie Mac's decision to subject themselves to the full panoply of the Securities and Exchange Act disclosure is voluntary, it is now irrevocable without SEC approval. This addresses the concern that, however complete their disclosures were, it was a matter of choice, not a requirement of law. Fannie and Freddie will file, for example, complete audited 10-K annual reports, 10-Q quarterly reports, and 8-Ks regarding current events affecting them ... And, of course, we will have our full complement of enforcement authority over these periodic disclosures. Similarly, the companies' officers and directors will file reports on their purchase or sale of company stock, and the companies' proxy statements will be subject to SEC staff review, as is true of other public companies."

Chairman Pitt also announced a study of the disclosure requirements applicable to mortgage-backed securities. "The goal is to ensure that the same standards of disclosure apply to all engaged in the distribution of these securities. But this agreement does **not** subject the companies' securities to Securities Act registration requirements applicable to the public offering of new securities." The study would be undertaken by the Treasury, OFHEO and the SEC.

However, it should be noted that Fannie Mae had not issued common stock since the early 1980s, but had made about 1,500 debt issuances and over 40,000 MBS releases annually. Fannie Mae and Freddie Mac were quick to make public announcements to the effect that their exempt security status had not changed, and that there was no effect on the status of Fannie Mae's securities as "government securities." Freddie Mac quoted from the letter it had received from the SEC confirming that "the actions taken have no impact on the status of Freddie Mac's securities as exempt from securities offering registration requirements as well as other aspects of the federal securities laws." As a result, Freddie Mac's access to worldwide capital markets would remain unhindered.³⁸ It also enabled them to reject the Shays-Markey bill, which would have required them to register their debt and MBSs, on the grounds that this would have caused unnecessary disruption to the market, since the SEC registration process was not designed to handle the unique securities market in which Fannie Mae operates.

The tactic was successful. The bill could now be painted as irrelevant, and indeed, the Treasury Secretary Paul O'Neill both welcomed the self-initiated compliance and stated that the Administration did not intend to support the Shays-Markey bill. This was repeated by Peter Fisher, Undersecretary for

Domestic Finance, on the grounds that the Administration was not prepared to support repeal of their exemptions from the Securities Act, 1933 but believed that they should comply with the same corporate disclosure requirements as all other publicly owned companies under the Securities and Exchange Act of 1934. Fisher reiterated the announcement of a study of the initial offering disclosures for all issuers of mortgage backed securities, to be conducted by the Treasury, the SEC and OFHEO.

“Together we will listen carefully to the securities industry, investors, Fannie Mae and Freddie Mac, Ginnie Mae, private-label issuers and others in the regulatory community to gain a fuller understanding of the market structure, the nature of competition and the risks being priced and transferred. This will serve as background to a fundamental reconsideration of the initial offering disclosures that would best serve all of the participants in mortgage-backed markets.”³⁹ The Task Force reported in January 2003, having concluded that if the GSEs’ exemptions were removed, the additional disclosures would be useful to, and not disruptive of, the mortgage-backed securities market. The issue, in other words, had not been settled by the voluntary disclosure announced in July, but came back in 2003, both in the form of a judicious decision to make additional voluntary disclosures on the part of Fannie Mae and Freddie Mac, and in the form of further legislative proposals to be considered.

These attempts to bring Fannie Mae and Freddie Mac under better regulation and to bring about the necessary legislative changes have been covered in some detail, partly because they were significant factors in the subprime mortgage crisis and its part in the financial crisis, but also because it shows how difficult it was for Congress to bring Fannie Mae and Freddie Mac under control, as Congressional oversight responsibilities required. The all-pervasive American dream of home ownership both blurred the vision of politicians and provided the two GSEs with ready weapons to ward off any attempts to limit their powers.