Committee on Oversight and Government Reform
Republican Briefing Memo
Hearing on the Collapse of Fannie Mae and Freddie Mac

Executive Summary

Fannie Mae and Freddie Mac, the "Government-Sponsored Enterprises" (GSEs) that hold or guaranty over half of all mortgages in the U.S., were the primary or at least two of the primary actors in driving up home prices and driving mortgage lending standards downward, causing the financial crisis. Their leadership maintains the companies did not significantly lead the market into the subprime housing crisis but were rather victims of the bursting of a historic housing bubble. Both Fannie Mae and Freddie Mac maintain they did not purchase a significant share of default-prone subprime and Alt-A mortgages. However, this is at best mistaken and at worst disingenuous and purposely misleading.

Fannie and Freddie manipulated their definition of "subprime" to accommodate the progressive lowering of their underwriting standards. This allowed them to engage in a "race to the bottom" with Wall Street and subprime mortgage brokers, lowering their underwriting standards and backing as much as $1.6 trillion in risky mortgages.

Incredibly, in meetings with Committee staff, representatives of both companies said the GSEs defined a subprime mortgage as, "anything that was not prime" while a prime mortgage was, "anything that was not subprime". Fannie Mae only called a mortgage it purchased "subprime" if the originator identified itself as a "subprime lender". Extending this logic, presumably if a mortgage lender made risky loans that were by definition "subprime", but called them "prime", then that was good enough for Fannie and Freddie. If true, this would represent an astonishing abnegation of the GSEs' long-standing responsibility to maintain high underwriting standards. Instead, Fannie and Freddie gave the green light to subprime lenders, backing risky mortgages that would eventually cause the financial crisis.

Some of the consequences of these actions have been to:

- Drive the rise of the speculative housing bubble that, now that it has burst, is sucking the equity out of the US housing market, severely damaging the entire economy. US housing has fallen from $22 trillion in value (2006) to $18.5 trillion (2008) and will likely fall even farther as defaults on the GSEs book of mortgages continues to rise;

- Expose the American taxpayers to untold billions to prop up Fannie Mae and Freddie Mac;

- Trap low- and moderate-income homebuyers, the most vulnerable in our society, in predatory and unsustainable mortgages.

Fannie Mae and Freddie Mac could have prevented the rise of such a severe housing bubble and its associated economic fallout by choosing not to dive into risky subprime and Alt-A mortgages. They chose this path because of a well-intentioned but market-distorting federal housing policy that encouraged them to do so and because it was extremely profitable for their shareholders and executives. As market leaders in the mortgage industry, Fannie Mae and Freddie Mac drove what types of loans lenders could make. They should have demonstrated leadership in refusing to lower their underwriting standards. While Wall Street and unscrupulous subprime mortgage brokers would have continued making risky loans, it is certain that without Fannie and Freddie's participation the scale of the current crisis would not be nearly as great.

Were Fannie and Freddie Enabling Subprime Lending? Yes.

The GSEs in fact purchased about $1.6 trillion of subprime, Alt-A (mortgages with reduced documentation of borrowers' income and assets), and other default-prone junk loans. Fully $1 trillion of these were purchased between 2005 and 2007 alone. This totals over 1/3 of their risk portfolios and amounts to 34% of all the subprime loans and 59% of all Alt-A loans outstanding in the economy today.[1]

The discrepancy between what the GSEs say they did and what they actually did is an argument over the definition of "subprime". Federal banking regulations define subprime borrowers as those with, "weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies…Generally, subprime borrowers will display a range of credit risk characteristics…includ[ing]: … a credit bureau risk score (FICO) of 660 or below…" Loan-to-value (LTV) ratios – the proportion of a mortgage's size relative to the value of the property – are another key indicator of subprime borrowers. A borrower who puts only 5% down on a house has an LTV of 95% -- a fairly risky proposition since the borrower has only 5% equity in the home. Finally, both Fannie and Freddie delved into so-called Alt-A mortgages where borrowers were not required to fully document their income or assets.

However, in their glossy investor packets, Fannie Mae and Freddie Mac dumb down the definition of "subprime" so much that they claim to be exposed to a mere $8 billion of "subprime" mortgages out of a total single-family home mortgage book of $4.7 trillion.

According to an analysis of GSE financial filings by former Fannie Mae chief credit officer Edward Pinto, who will testify at Tuesday's hearing, this is a gross under-representation of the entities' exposure to subprime, Alt-A and other risky junk mortgages. In fact, Fannie Mae and Freddie Mac are currently responsible for:

- $203 billion of mortgages to borrowers with FICO scores less than 620
- $435 billion to borrowers with FICOs between 620 and 660
- $243 billion of mortgages with a LTV ratio >90%
- $244 billion of Alt-A loans where lenders failed to fully verify borrowers' income and assets
- $83 billion of interest-only loans

In total, the GSEs are exposed to about $1.6 trillion in mortgages with some combination of LTV ratios in excess of 90%, borrower FICO scores less than 660, Alt-A, and interest-

[1] Edward Pinto, Testimony, Dec. 9, 2008.

only loans. This exposure accounts for 34% of the companies' exposure to mortgages that are, by definition, risky subprime and Alt-A mortgages.

Why Did Fannie Mae and Freddie Mac Dive Into Subprime and Alt-A Mortgages?

To make money and to win back market share. In the 1990s, Fannie and Freddie began to lose market share to Wall Street firms that began packaging subprime loans into private-label mortgage-backed securities backed by risky subprime loans. The GSEs sought to counter by dipping into subprime and Alt-A mortgage markets to compete directly with the private sector. Freddie Mac also had to compete with Fannie Mae in order to retain its relative market share. Increased market share generally meant higher stock prices which drove executive compensation bonuses. The more business, risky or not, the more executives were compensated.

To turn the attention away from their accounting woes. In 2003-2004, Freddie and Fannie were embroiled in an accounting scandal where they were found to have to have improperly manipulated the rules in order to maximize profits and executive compensation. Fannie and Freddie suddenly opened up to the idea of expanding their underwriting standards (subprime loans) under the guise of their affordable housing "mission" as a means to curry favor with Members of Congress who, because of the accounting scandal, wanted to limit or regulate the GSE activities.

Because the federal government created policies that incentivized risky, market-distorting behavior.

Fannie and Freddie have a number of unfair competitive advantages granted by the Federal government that distort the market and create moral hazard in the mortgage industry and risks for the taxpayer. Some of these distortions are:

- Capital requirements for Fannie and Freddie that are lower than banks, encouraging the proliferation of high-risk mortgage lending rather than time-honored lending standards of solid down-payments and ability to repay

- An implied Treasury guarantee of the GSEs' debt which gave them a subsidized rate for borrowing money in the form of debt issuance. This meant Fannie and Freddie could borrow more cheaply than any truly private company because the market believed the GSEs were "too big to fail". This allowed the GSEs to get larger and larger, leaving only the riskiest subprime market to the private sector. When Fannie and Freddie decided in the late 1990s to start competing for even this risky market, it created a "race to the bottom", driving lending standards downward

- The Federal government allowed Fannie and Freddie to issue "preferred stock" that offered a better return than any other private sector offering available. This sucked billions of dollars into the GSEs and away from safer investments, putting investors at risk. For example, the government told small community banks that Fannie and Freddie preferred stock was so safe that they could count it toward their capital base – along with Treasury bonds. Now these small banks have had to write down billions in losses on Fannie and Freddie preferred stock.

To meet their affordable housing goals. In 1992, Congress passed the Federal Housing Enterprises Financial Safety and Soundness Act, which created the first HUD-mandated affordable housing goals for Fannie and Freddie. The GSEs would be required to devote a certain percentage of its investment in low- and moderate-income housing, special affordable housing, and underserved areas. These goals were at first relatively modest, but by 2005 HUD had increased them dramatically, requiring 55% of all GSE loans to be for affordable housing. Meeting these goals in an environment of rapidly appreciating home prices and competition from Wall Street meant loosening underwriting standards and experimenting in exotic new "innovations" such as 100% loans.

Was the Decision to Move into Risky Mortgages Uncontested Within the GSEs? No.

Emails obtained by the Committee reveal that key executives at Freddie Mac raised serious questions about the company's loosening of underwriting standards with respect to Alt-A loans. These employees expressed concern that:

- While Alt-A loans Freddie Mac was buying were contributing to its HUD affordable housing goals, they were also increasing the risk the company might be engaging in predatory lending specifically targeting the Hispanic community;[2]

- GSE models used to predict default risk for Alt-A loans had become unreliable because the company was also lowering the quality of its borrowers beyond what the models were designed for;[3]

- GSEs were caving in to pressure from mortgage brokers to continually lower their underwriting standards;[4]

- GSEs were lowering standards in order to recapture market share from Wall Street, to maximize their share price, and to compete with each other.[5]

Despite the concerns of some within the GSEs, Fannie and Freddie plunged headlong into subprime and Alt-A mortgages, particularly after 2004. All told, the two companies bought $1.6 trillion of risky subprime, Alt-A, and other default-prone mortgages.

Brief Overview of Fannie Mae and Freddie Mac

[2] FMAC0013695
[3] FMAC0013794
[4] Ibid, FMAC0013677
[5] FMAC0013673, FMAC0013695

The GSEs were intended to create a secondary housing market by allowing mortgage originators such as banks, thrifts and brokers to sell their mortgages to Fannie Mae and Freddie Mac. Because banks must maintain a certain level of capital to offset the risk of defaults, they are constrained in the number of mortgages they can make. Offloading these mortgages to Fannie and Freddie allows them to make more mortgages, expanding the availability of home financing.

Fannie Mae and Freddie Mac were not always so exposed to risky mortgages. During the S&L crisis in the late 1980s, the GSEs purchased large quantities of reduced documentation (Alt-A) mortgages. However, many of these mortgages turned out to be so-called “liar loans” – the borrowers had not been truthful about their income and assets. They also proved to be popular with real estate speculators. Not surprisingly, these loans defaulted at much higher rates than the traditional prime mortgages. Hence the GSEs decided to stop buying Alt-A mortgages and returned to purchasing solid prime loans. However, the lessons learned were soon forgotten and the GSEs plunged back into Alt-A and subprime lending.

The GSEs make money in two main ways. First, they purchase mortgages from primary mortgage lenders such as banks and brokerages and then package them into mortgage-backed securities which they sell to investors. They charge a fee to these investors in return for their guaranty of the underlying mortgages. If a borrower defaults, Fannie or Freddie takes responsibility for the bad debt. This guaranty business makes mortgage-backed securities both liquid and profitable for investors, including US banks. However, while the income stream from this line of business is relatively steady, it is also relatively modest on a per-mortgage basis.

The second line of business for the GSEs is far more profitable but also far more risky – the portfolio investment business. Fannie and Freddie keep huge portfolios of whole mortgages and mortgage-backed securities on their books (a high of $1.58 trillion in 2003 and a combined $1.4 trillion in mid-2008). This is about 8 times more profitable than the plain-vanilla guaranty business. However, it also requires Fannie and Freddie to dramatically increase their leverage, or exposure to debt, in order to cover their risks. Both companies issue large amounts of debt in order to finance their lucrative portfolios. It is estimated that Fannie and Freddie are leveraged at about 75-to-1. At the Committee’s hearing on the collapse of Lehman Brothers on October 6, Lehman’s CEO Dick Fuld was criticized because his firm was leveraged at over 30-1. Having a portfolio also means that Fannie and Freddie must use complicated hedging methods to decrease portfolio volatility. Portfolios also present a liquidity risk, meaning that if the market suddenly decides it no longer wants to buy the GSEs’ debt, they will run into a liquidity crisis.

Accounting Scandals at Fannie and Freddie

As mentioned, the GSEs both built up huge mortgage portfolios which were the most profitable yet risky part of their business models. Part of the risk is that the companies must use complex hedging operations to compensate for the inherent volatility of an undiversified portfolio of home mortgages. The markets were willing to grant Fannie and Freddie such favorable rates of lending in part because of the perception that investing in the GSEs was almost as safe as T-bonds. Anything that dispelled the myth of steady and predictable growth in Fannie and Freddie would threaten this perk, reducing the profitability of the portfolio. The problem was, the hedging itself was imperfect and so Fannie and Freddie decided to cheat by manipulating accounting rules improperly to hide volatility.

Freddie Mac announced in January 2003 that it was preparing to issue a major revision of its prior financial statements. It turned out that Freddie Mac had been underreporting earnings on derivatives and bonds by $5 billion that had dramatically increased in value due to falling interest rates between 2000 and 2003. Then in 2004, OFHEO, the GSEs' regulator, announced that Fannie Mae had "deviated from generally accepted accounting principles in order to conceal losses, reduce volatility in reported earnings, present investors with an artificial picture of steadily growing profits, and to meet financial performance targets that triggered the payment of large bonuses" to its executives.[6] The Securities and Exchange Commission (SEC) conducted an independent review of OFHEO's findings and within weeks the leadership team led by Mr. Raines resigned from Fannie Mae. The company's earnings were eventually revised upward by $6.3 billion.

The GSEs' regulator, OFHEO, found that, "Fannie Mae's executives were precisely managing earnings to the one-hundredth of a penny to maximize their bonuses while neglecting investments in systems internal controls and risk management."[7] The regulator found that earnings management, "made a significant contribution to the compensation of [CEO] Franklin Raines".[8] Raines ultimately earned over $50 million at Fannie Mae while Leland Brendsel earned almost $20 million in salary, bonuses and dividends at Freddie Mac.

Doubling Down on Affordable Housing

The accounting scandals caused outrage on Capitol Hill and resulted in the resignations of Freddie Mac CEO Leland Brendsel and Fannie Mae CEO Franklin Raines. For the first time, the companies began to truly fear that Congress would create a strong regulator with the power to limit their issuance of debt, which would in turn make it impossible to make huge profits on their portfolio business. Fed Chairman Alan Greenspan called for a limit on GSE debenture, which would have effectively ended their portfolio investment. Fannie and Freddie had to find a way to achieve political cover on the Hill in order to head off congressional reform attempts and retain their competitive perks. The solution was for the GSEs to move full-bore into affordable housing.

In order to continue meeting these rising goals for affordable housing, and to curry favor with key supporters in Congress, Fannie and Freddie loosened their underwriting

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[6] Jickling, Mark, "Accounting Problems at Fannie Mae," Congressional Research Service, Dec. 7, 2006.
[7] OFHEO Report: Fannie Mae Façade, OFHEO, May 23, 2006.
[8] Ibid.

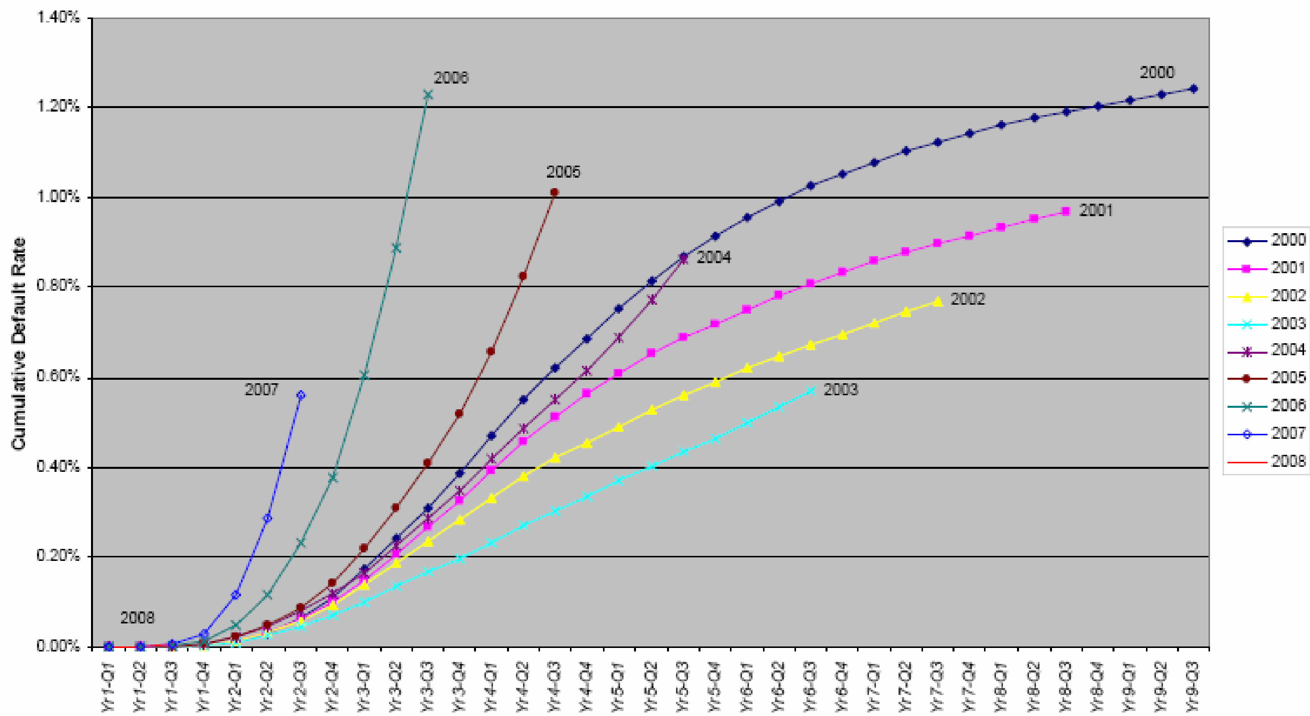
standards by purchasing billions in low-down payment, low-FICO, subprime and Alt-A mortgages.

Conservatorship

On September 7, 2008, FHFA, the new regulator for Fannie Mae and Freddie Mac, announced it was placing the GSEs into conservatorship. This exposed the taxpayers to up to $200 billion in expenses shoring up the failing mortgage giants. Fannie and Freddie profited for years from the implied backing of the federal government. Now that the backing of the taxpayers is explicit, and with defaults on GSE mortgages certain to rise (see attached chart), it is critical that the GSEs restore their underwriting standards to minimize continued fallout from making bad mortgage loans.

FannieMae

Overall Cumulative Default Rates - Overall Originations from 2000 through 2008 Q3



Note: Cumulative default rates include loans that have been liquidated other than through voluntary pay-off or repurchase by lenders and include loan foreclosures, preforeclosure sales, sales to third parties and deeds in lieu of foreclosure.

Consistent with industry trends, 2006 and 2007 vintages performing poorly. Defaults for the 2008 vintage through 2008 Q2 have been negligible.

Data as of September 30, 2008 is not necessarily indicative of the ultimate performance and are likely to change, perhaps materially, in future periods.