Fannie Mae and Freddie Mac:
Where Are They? How Did They Get There?

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In the late summer and early fall of 2008, major public and private actors in the financial services policy domain in the United States deliberately, though reluctantly, began to clear away the smoke and mirrors that concealed – from the public and from themselves – the fragility of the system they had constructed.[1] As they did so the inter-relationships among giant players and consequent systemic risk came into stark relief. Were there nodes in the web that could be reinforced to prevent its failure? The government's seizure of Fannie Mae and Freddie Mac on September 8, 2008 indicates that insiders viewed them as comprising such a node.

Fannie Mae and Freddie Mac had been constructed in the public policy process in pursuit of the macroeconomic benefits of a robust housing industry and the cultural value of home ownership; sound financial institutions are means toward these ends – intermediate ends. For most of their long histories, Fannie and Freddie have been effective, and though their current functioning is not widely understood, in 2012 they are again an important tool of the government for shoring up U.S. housing markets and thus macroeconomic performance. But these two organizations also supported irresponsible and probably predatory home ownership finance: both purchased Alt-A mortgages in significant volume and they were the two largest buyers of private-label mortgage-backed securities collateralized with subprime mortgages, thus contributing to the collapse of the U.S. housing market in 2008. Macroeconomic performance, home ownership, and the health of U.S. financial institutions all deteriorated.

In this paper, we first consider briefly the condition and role of Fannie Mae and Freddie Mac in 2012. Next, we describe development of both organizations in statute and practice. We proceed to focus on historical processes in two tangential policy domains that intersected to transform Fannie and Freddie (Hacker, 2004): In one related domain, Fannie and Freddie were enlisted to meet affordable housing goals for lower income households (layering). In a distinct policy trajectory, broader financial services deregulation implied new discretion and new incentives for Fannie and Freddie to respond to new business activity by Wall Street and other private competitors (drift). Finally, we ask how the two organizations undermined themselves and their public policy purposes in the buildup to the financial crisis of 2008.

Where Are We in 2012?

How healthy is each organization financially?

Fannie Mae and Freddie Mac are in conservatorship. "Conservatorship" means loosely that control over the affairs of a person or organization has been vested in some other person or organization. For an individual, a court sets up a conservator, while for an organization, state or federal statutory or regulatory authority comes into play and the general purpose is to maintain the organization as a going concern. In the cases of Fannie Mae and Freddie Mac – both government-sponsored enterprises (GSEs) chartered by the U.S. Congress – provisions for the current conservatorship were laid out in the Housing and Economic Recovery Act (HERA) passed on July 30, 2008. This statute established the Federal Housing Finance Agency (FHFA)

[1] For a lens on these weeks from the viewpoints of major public players involved, see PBS, Frontline, *Inside the Meltdown*, Feb. 17, 2009 at http://www.pbs.org/wgbh/pages/frontline/meltdown/view/

as regulator for the three housing GSEs – Fannie Mae, Freddie Mac, and the Federal Home Loan Banks – and provides authority to the new regulator to declare a conservatorship and to appoint itself as conservator.

Acting under HERA's authority, the Federal Housing Finance Agency took control of Fannie Mae and Freddie Mac on September 6, 2008, sidelining their directors, officers and shareholders and appointing new CEOs. Each GSE had lost billions of dollars in 2007 and 2008 and their capital was close to exhaustion. According to the FHFA, the goals of the conservatorship are "to help restore confidence in [Fannie Mae and Freddie Mac], enhance [their] capacity to fulfill [their] mission, and mitigate the systemic risk that has contributed directly to the instability in the current market" (FHFA, Questions and Answers). In practical terms, both "restore confidence" in Fannie and Freddie and "mitigate systemic risk" required that the government assure investors in Fannie and Freddie's bonds and mortgage-backed securities (MBS) that the two companies would continue to make good on their obligations, even as they exhausted their pre-crisis capital cushion. The long-perceived "implicit guarantee" is now explicit.

The mechanism by which the U.S. Treasury is injecting money into Fannie and Freddie is the purchase of senior preferred stock: Fannie and Freddie pay all of their obligations each quarter and if they are short, Treasury buys more stock. By the end of 2011, Treasury had injected $187 billion of capital into the two companies (cite..) and FHFA estimates that by the end of 2014, Treasury's stake will be $220-331 billion (FHFA-OIG, March 28, 2012, p.2). It appears that taxpayers have provided a substantial subsidy.

But that appearance is misleading: calculating taxpayer subsidy requires calculations beyond adding up Treasury's capital infusions. Since the first quarter of 2009, Fannie Mae and Freddie Mac have paid dividends on Treasury's preferred stock at an annualized rate of ten percent. Each quarter, each of the two companies pays what it owes to investors in its debt, what it owes on guarantees to purchasers of its MBS, and what it owes to the Treasury in dividends. These three types of obligations are added up and if there is a shortfall, Treasury buys more senior preferred stock to make up the difference (which means the dividend obligation will be higher in the succeeding quarter). Through the end of 2011, taxpayers had received a total of $37.5 billion in dividends on their $187.3 billion investment in Fannie Mae and Freddie Mac.

Across the six quarters ending in December 2011, Freddie Mac paid considerably more in dividends to taxpayers than it drew from Treasury in the form of additional capital (SEC 10-K filings, FNMA and FHLMC, 2009-2011). This means that Freddie Mac has been profitable since the beginning of 2010, that taxpayers earn a handsome return on their investment in the company, and that *but for the dividend on Treasury's stock*, Freddie would not have needed new investment from Treasury across those six quarters. Though Fannie Mae has paid more in total dividends than Freddie Mac, Fannie's draws of additional capital continue to exceed dividends paid every quarter – and under the terms of the conservatorship agreement, the company projects that they always will: In its 2011 10-K filing with the SEC, Fannie reports that its 2011 dividend of $11.9 billion exceeds the company's reported annual net income *for every year since [its] inception*, and that the company does "not expect to earn profits in excess of our annual dividend obligation to Treasury for the indefinite future" (SEC 10-K, 2011). This means that though Fannie Mae is making money, it owes more than it makes to the Treasury every quarter, must therefore draw more senior preferred stock, and will owe even more in dividends the next quarter: Fannie Mae is in a death spiral constructed by the terms of the conservatorship agreement. (Table 1 shows capital infusions and dividends for each company since the conservatorships began.) [2]

Why is the dividend so large? In response to the credit crisis of 2008, the U.S. Treasury and Federal Reserve Bank of New York provided assistance to the full range of privately-owned financial institutions – commercial banks, investment banks, money market funds, hedge funds, insurance companies, thrifts – by a variety of means: capital infusions, short- and long-term loans, asset purchases – and in no case except the two housing GSEs has the cost to the assisted entity been so high. This suggests that in addition to the stated goals of the conservatorship, Bush Administration decision-makers who designed its terms intended to put the companies out of business. The provisions of the "Treasury Senior Preferred Stock Purchase Agreement" executed on the day the conservatorships were established may be taken as evidence of this unstated policy objective from the beginning: In addition to the ten percent dividend, the agreement provides for a 12 percent dividend under certain circumstances, and for an additional "commitment fee" to be established at the discretion of Treasury and the conservator.

The Obama administration made this unstated goal of the conservatorship arrangement explicit in its 2011 housing reform proposal: "We believe that under our current Preferred Stock Purchase Agreements there is sufficient funding to ensure the orderly and deliberate wind down of Fannie Mae and Freddie Mac, as described in our plan (U.S. Treasury, 2011, p.2)." Consistent with this goal, Fannie Mae SEC filings highlighted elements of the conservators' plan for the long-term performance of the GSEs. Specifically, one of three strategic goals is to "Gradually contract [Fannie Mae and Freddie Mac's] dominant presence in the marketplace while simplifying and shrinking their operations…(FNMA 2012 SEC 10-K) It is not difficult to see the outcome for both organizations: smaller business operations coupled with increasing dividend burdens will lead to failure.

What roles do Fannie and Freddie play in the housing market and financial system?

In the meantime, beyond deploying Fannie Mae and Freddie Mac to prevent a general credit freeze (by ensuring that their obligations are paid), the government is using them to support housing finance specifically. Fannie Mae and Freddie Mac are performing the function that has always been central to each: providing a secondary market for home mortgage loans. About 90% of all new home mortgage loans since the crisis are backed or insured by Fannie, Freddie, or the FHA. In 2009, Fannie and Freddie accounted for 76% of single-family originations (FHFA, 2010). They have packaged most new loans into agency MBS, which has in turn mostly been purchased by the Federal Reserve Bank of New York. Because the net earnings of the Federal Reserve System go to the U.S. Treasury, this means that taxpayers are

[2] Further, note 11 (Investments in and Liabilities to Government-Sponsored Enterprises) to the 2011 Financial Report of the U.S. Government states the "fair value" of U.S. investments in the housing GSEs (senior preferred and common stock warrants) is $133 billion. If this is accurate and the government sold the stock at fair value, the government would nearly break even on the GSE conservatorship.

buying Fannie and Freddie's post-crisis MBS and capturing the return on that MBS – as well as making money on their stock in Fannie and Freddie.

Freddie Mac and Fannie Mae are also being used to address the ongoing foreclosure crisis: twelve million U.S. home owners (*one in five* homeowners with a mortgage) owe more on their mortgages than their homes are worth. The potential and reality of delinquency and foreclosure are more significant than at any time since the great depression and the situation is ongoing. "From the start of the conservatorships through December 2011, [Fannie and Freddie] have completed 2.1 million foreclosure prevention transactions including permanent loan modifications and other forms of assistance (FHFA-OIG, 2012, p. 24)." As Fannie and Freddie contract and fail, policymakers will need to find other agencies or actors to support the mortgage market and home owners. This outcome is ironic, given that Fannie and Freddie were the mainstays of mortgage finance for over 70 years.

Policy Development for Fannie Mae and Freddie Mac: 1938-1992

The question of how Fannie and Freddie came to undermine their own public purposes – to jeopardize widespread home ownership, effective financial markets, and macroeconomic performance – is a question of policy development that benefits from the long view described by Pierson (2005). We identify statutory enactments that formally structured and restructured Fannie and Freddie, summarize the politics and interests in play, and follow formal enactments into implementation. Understanding what happened with Fannie and Freddie also requires attention to developments over time in separate policy domains, as Hacker found to be the case in U.S. social policy (2004). Accordingly, we highlight significant developments in financial services deregulation since 1980 and in the domain of affordable housing programming since 1968.

Policymakers and policy watchers in 2012 tend to say "Fannie Mae and Freddie Mac" as though one noun. Indeed, the organizations are functionally the same at the core: each was deliberately constructed in the public policy process to make home ownership finance work. Workable home ownership finance requires a form of mortgage that is sustainable by house buyers, and a financial system that can relieve mortgage originators of interest rate risk on loans they have already originated and channel capital to them for additional loans. Nevertheless, Fannie Mae and Freddie Mac are separate entities with separate policy development trajectories.

Fannie Mae

Fannie Mae came first. Marriner Eccles tells a story of its origin from a seat inside the play (Eccles, 1951). Eccles would become Chairman of the Federal Reserve in 1935, but in 1934 he was new to Washington and positioned at the Treasury. He represented Treasury on an administration committee tasked to invent a large-scale housing program that could stimulate employment (as the government's direct employment through the CWA was wound down) and contribute to macroeconomic health without the deficit spending for which President Franklin Roosevelt had no further appetite. Eccles had strong ideas about bringing private money to bear on the public's problems by incentivizing bankers to finance efforts to fix up, build, and buy houses and apartment buildings; he maneuvered himself into the chair of a subcommittee to draft a bill. The eventual *National Housing Act of 1934* is the basis for Fannie Mae as well as the Federal Housing Administration (FHA).

The FHA and Fannie Mae were closely related in Eccles's design and continued so in practice for decades. Prior to the depression, loans for home purchases typically had short terms – three to five years – during which only interest was paid; at the end of the term, the home had to be refinanced. (This protected the loan originator from interest rate risk and permitted new origination fees.) To incentivize borrowers, Eccles envisioned a reformed loan structure: the 20- or 30-year, fixed rate, fully amortizing mortgage loan that subsequently became standard practice in the United States. But why would a mortgage originator be willing to make a promise that entailed exposure, for twenty or thirty years, to both credit risk (the risk that the borrower would default) and interest rate risk (the risk that interest rates would rise)? Eccles expected that mortgage insurance and a secondary market for the insured loans would motivate the lender: mortgage insurance protects the lender from credit risk and a place to sell the loan protects the lender from interest rate risk. Congress authorized the FHA and the mortgage insurance it sells in Title II of the National Housing Act, and the government followed through in short order to set up the FHA. Title III authorized creation of National Mortgage Associations, which Eccles envisioned as private companies that would buy FHA-insured and other housing-related mortgages from across the country and issue bonds against them. But here Eccles's vision hit a snag: no such companies formed. Congress followed up in the *National Housing Act Amendments of 1938*, authorizing the Reconstruction Finance Corporation to capitalize a Federal National Mortgage Association (FNMA) to buy the FHA's insured mortgages. The RFC followed through.

Over time Congress directed Fannie Mae to deal in additional categories of mortgages. In part, the policy objective was to provide housing benefits to particular groups: In 1944, the GI bill authorized FNMA to buy home mortgages insured by the Veterans Administration. In the 1950s and 1960s, various subsidized multi-family mortgage programs were introduced and FNMA was charged to guarantee the bonds issued to finance such rental housing. In 1968, FNMA was authorized to buy conventional mortgages for middle-income families as well as government-insured mortgages. A *conventional* mortgage is one that is not insured by a government agency. Legislators' intent to confine this support to the benefit to middle-income – not upper-income – home purchasers played out in practice not with a limit on borrower income, but rather with a statutory limit on the principle of the mortgage. Mortgages that comply with this limit are termed *conforming*. In addition to providing housing benefits to particular groups with these developments, Congress's policy purpose remained the macroeconomic payoff that active housing markets provide.

Fannie Mae's organizational form and governance structure also changed over time. In 1954 the original government corporation was transformed to a mixed ownership public/private corporation. In 1968, the Housing and Urban Development Act divided Fannie Mae into two organizations. The Government National Mortgage Association (Ginnie Mae) remained in the Department of Housing and Urban Development (HUD) to guarantee subsidized single- and multi-family housing loans. The part that retained the Fannie Mae name became a publicly-traded, stockholder-owned, government-sponsored corporation. One motivation for the Johnson administration's spinoff of Fannie Mae was to get its debt off the government's books. (See the 2011 Financial Crisis Inquiry Commission report for a contemporary account of this transformation). The company's new board was composed of 15 directors, five of whom were appointed by the president of the United States, with at least one to represent each of home building, mortgage lending, and real estate industries. The remaining ten directors would be elected by the shareholders; servicers of FNMA-insured mortgages were required to buy stock, thus always among the shareholders electing directors. (The board was later expanded to 18 directors.) Finally, HUD was designated as Fannie Mae's regulator with authority to establish affordable housing goals, which will be discussed further below, and over such safety and soundness concerns as were anticipated.

From Fannie Mae's beginning in 1938, the categories of groups in the policy community around the organization have included peak associations for the industrial interests formally recognized in the 1968 re-charter: real estate, home builders and mortgage bankers. The commercial bankers whom Eccles wanted to lure into making long-term, fully-amortizing mortgages opposed the National Housing Act in 1934, believing that the depression-era housing market would sort itself out without government intervention. Developers of subsidized rental housing entered the policy community over time, along with advocacy organizations for lower income renters and urban neighborhoods.

Freddie Mac

Freddie Mac – the Federal Home Loan Mortgage Corporation (FHLMC) – came second, established in 1970, more than thirty years after Fannie Mae. Why did Congress create a second organization to provide a secondary market for home mortgages?

The transcript of hearings held by the Senate Banking and Currency Committee in 1970 permits us to listen in on discussion of the policy problem and alternatives for addressing it as understood by formal policy actors involved in designing Freddie Mac. We hear from a member of the board of governors of the Federal Reserve, the president of Fannie Mae, the Secretary of HUD and the Chairman of the Federal Home Loan Bank Board.[3] Administration officials, along with members of the committee, were concerned with ensuring the macroeconomic and particularistic benefits long-associated with housing construction and healthy housing finance. The volatile interest rate environment of the middle and later 1960s had been a challenge: High interest rates generally drive money away from housing development and home mortgage financing. There had been dramatic interest rate spikes in 1965 and 1969, triggering discussions of a national housing crisis.

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[3] The hearings also included non-governmental participants representing peak associations for housing developers, real estate brokers, construction trades unions, and mutual and commercial lenders who spoke to the policy problem from their perspectives. Specifically, witnesses represented the Council of Housing Producers, the National Association of Real Estate Boards, US Savings & Loan League, National Association of Home Builders (NAHB), American Bankers Association, Administration Foundation for Cooperative Housing, the AFL-CIO's Department of Urban Affairs, Mortgage Bankers Association of America, National Housing Conference, National Association of Mutual Savings Banks, National League of Insured Savings Associations, Home Manufacturers Association (pp. 305-311 in the transcript).

The idea of securitizing mortgages was a central feature of discussions about solutions to this problem. Fannie Mae bought mortgages and held them. In securitization, by contrast, mortgages would be pooled and investors would buy a security representing an interest in the pool. Policy makers expected that securities backed by home mortgages would facilitate tapping into new sources of funds for housing finance. For example, conservative investors – such as pension funds – were specifically expected to be interested in this new kind of security. Accordingly, Title II of the resulting Emergency Home Finance Act of 1970 created the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac). The company was authorized to buy conforming mortgages and charged to work out the technology for securitizing them. Like Fannie Mae, Freddie Mac could also hold the loans in portfolio.

Even so, why did Congress need *another* secondary market organization to facilitate development of securitization? Why did they not task Fannie Mae to work it out? The same statute did in fact authorize Fannie Mae to develop mortgage-backed securities. But a second reason for establishing Freddie Mac, in addition to the strategy of drawing funds into housing finance through securitization, was that Freddie Mac would function within a distinct policy community. Freddie Mac would buy mortgages from savings and loan associations (S&Ls) and other thrifts. S&Ls had not typically sold their loans, and if they could be persuaded to do so, they were unlikely to work well with Fannie Mae due to their distinctive organizational culture and business model, compared to those of the mortgage bankers who relied upon Fannie Mae.[4] In providing a secondary market that thrifts would use, policy makers intended to motivate thrifts to sell their loans and originate more (Hoffmann and Cassell, 2010, 45-48). For a long time, Fannie Mae continued to rely more heavily on portfolio holdings while Freddie Mac relied more on securitization.

Freddie Mac's governance structure, as set out in the authorizing statute in 1970, reflected that Freddie was embedded in an organizational network distinct from Fannie Mae's. Freddie was originally wholly owned by the twelve Federal Home Loan Banks, which had been chartered by Congress in 1932 to provide wholesale lending to thrifts and were owned by the thrifts. Freddie's board of directors was the Federal Home Loan Bank Board, which was the original regulator of the Federal Home Loan Banks and of federally-chartered thrifts. Freddie's governance structure changed in 1989: in the statute that resolved the thrift crisis of the 1980s, Freddie Mac was cut loose from the Federal Home Loan Bank System. Like Fannie Mae, Freddie Mac became a publicly-traded, shareholder-owned, for-profit company. Its board of eighteen directors would include thirteen elected by stockholders and five appointed by the president of U.S to represent real estate and real estate finance-related interests. Also like Fannie Mae, the organization was placed under HUD's regulatory authority for both mission and safety and soundness.

Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac succeeded in their core public policy mission of establishing and sustaining a well-functioning secondary market for home mortgages – as a means to home ownership and macroeconomic performance. This was not a small achievement.

[4] Elaborate distinctions in a next draft: Mutual ownership, local focus. Savings and Loan League opposed Eccles idea in the first place, in 1934.

FNMA faced, at inception, obstacles to functioning as a nationwide secondary market that were rooted in the local nature of mortgage origination and appraisal practices; they worked it out. As Freddie Mac came on line in 1970, its challenge was to invent technologies for securitizing mortgages from across the country for sale across the country. By 1992, the two organizations had "become essentially identical with respect to mission, structure and regulation (Miles, 1992, p.3)." Both held mortgages from across the U.S. in portfolio or securitized them and both had responsibility for affordable housing goals; the composition of their boards had been aligned by statute; and HUD was their regulator.

Though both GSEs were healthy and profitable, impetus was building for reform. There were at least two motivations for reform: government actors were concerned about the potential liability to taxpayers that the companies posed (Miles, 1992), and private sector actors pointed to the two mortgage market giants as unfair competitors (Cites…).

The S&L crisis of the 1980s had heightened formal policymakers' appreciation for the array of risks presented by government-chartered financial institutions: interest rate risk, management risk, political risk, credit risk – as well as the moral hazard involved when financial institutions discount those risks in their business decisions because they expect the government to pick up the downside. Though the bonds and mortgage-backed securities of Fannie Mae and Freddie Mac were explicitly *not* guaranteed by the government, structural features of the companies – a contingent line of credit with the Treasury, certain tax and regulatory exemptions, and the congressional charter itself – convinced investors of an implicit guarantee.

Congress and administration officials initiated the move toward firmer regulation. Illustrating the "policy creates politics" dynamic noted by policy history scholars in various policy domains, Fannie Mae and Freddie Mac entered the discussion to resist. Fannie Mae in particular flexed its lobbying muscle, deploying high profile lobbyists of both political parties with congressional or administration experience on their resumes. The resulting Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (P.L. 102-50, Title XIII) established a new safety and soundness regulator with purview over both companies – the Office of Federal Housing Enterprise Oversight (OFHEO) – that was considerably weaker than bank supervisors in terms of its enforcement powers, capital requirements, funding, and receivership prerogatives (FCIC, 2011, p. 40). OFHEO was to be within HUD but independent of the Secretary of HUD, who was given authority to set affordable housing goals, which will be discussed below.

A second motivation for reforming Fannie Mae and Freddie Mac was the concern of private sector financial services firms and conservative policy analysts that the implicit guarantee rendered the giant GSEs unfair competitors. Because investors believed that Treasury would make good on their debt, Fannie and Freddie could borrow less expensively. No major participant in the policy debate denied this advantage, but Fannie and Freddie's position was that the reduced cost of their borrowing passed through to home buyers in the form of lower mortgage interest rates. Fannie and Freddie's opponents argued that much of the benefit of the lower borrowing cost turned into profit for Fannie and Freddie shareholders and compensation for their executives. Competitors were further concerned that Fannie and Freddie would extend beyond operations in the secondary mortgage market to related lines of business such as mortgage insurance. Opponents' preferred reform was not a new regulatory regime, but rather revocation of Fannie and Freddie's federal charters – essentially, privatization. The 1992 statute gestured in opponents' direction by requiring studies of the impact of privatization by the GAO, CBO, HUD and Treasury.

Affordable Housing Policy

Alongside reformers concerned about risk and size, other policy advocates saw opportunity. In the social welfare policy domain, an affordable housing strand concerns itself with the housing needs of lower-income households generally and an increasing number of place-based categories of lower-income households in particular. Since the 1960s, Congress has aimed to meet these needs centrally through market-based programs. Public housing is still out there, built and managed through programs initiated as long ago as the 1930s, but direct public ownership grates ideologically in the U.S. with conservatives and even with liberals, and the social problems and pathologies exacerbated by the high-rise design of much early public housing reinforced ideological distaste for publicly-owned assets.

Beginning in the 1960s, one federal program after another was introduced that provided subsidies to incentivize the market to provide affordable housing. These can be classified into supply-side and demand-side subsidy programs. Supply-side programs offered developers low- or no-interest loans, grants and tax credits to develop apartment buildings or houses; the lower cost was to be passed through to renters or home buyers. In demand-side subsidies, qualifying households receive a voucher which can be applied toward rent in the market. There have also been demand-side subsidies for house buyers such as down payment assistance, likely flowing from the federal government through local governments. As a student of U.S. policy process might expect without knowing anything about affordable housing policy in particular, the policy community in this domain is a mix of odd bedfellows including peak associations for real estate developers and real estate brokers, non-profit developers, housing and neighborhood advocacy organizations, public housing authorities and other local governments; HUD; and activist committees in both chambers of Congress.

This kind of programming involves two things that trigger scrutiny or skepticism from critics of social welfare programs: direct appropriations and federal bureaucracies with discretion. One response of advocates is to seek ways to keep affordable housing goals in view, but skirt appropriations and obligate private players. When Fannie and Freddie – off-budget private corporations - are on the congressional agenda for whatever reason, they are thus implicated in efforts to meet social welfare needs. The rationale is that since the GSEs benefit from an implicit federal subsidy and a federal charter, they may be expected to help meet the need for affordable rental and owner-occupied housing. Consistent with the insights of John Kingdon (1995), the solution of government-sponsored enterprise is often attached to the problem of affordable housing.

Fannie Mae was drawn into the affordable housing policy domain from the beginning of its incarnation as a publicly-traded company. When FNMA was partitioned into Ginnie Mae and Fannie Mae in 1968, HUD was designated as Fannie's regulator. HUD's regulatory purview included both prudential regulation and the authority to "require that a reasonable portion of the corporation's mortgage purchases be related to the national goal of providing adequate housing for low and moderate income families, but with reasonable economic return to the corporation (P.L. 90-448, p. 541)." This statutory language strongly suggests that legislators recognized, from the beginning, the tension between setting Fannie up as a private entity to operate in the market and requiring it to advance particular congressional objectives in lieu of appropriations. Freddie Mac came under HUD's regulatory authority twenty-one years after Fannie did, in 1989, but was not charged with affordable housing goals until three years later, in 1992. Recall that OFHEO was established in 1992 as prudential regulator for both Fannie and Freddie: this means that the Secretary of HUD lost the role of safety and soundness regulator. The Secretary retained, however, authority to establish affordable housing goals for Fannie, and gained authority to impose these goals on Freddie as well.

[In the context of the demise of S&L system and increasing prominence of secondary market, CRA pressure comes to bear on Fannie and Freddie. (MacDonald, 1995)]

HUD was to establish, in a rulemaking process, specific goals for the percentage of GSE mortgage purchases that should support low and moderate-income housing needs.[5] The agency did not act on this authority during the Johnson or Nixon administrations. President Carter's Department of Housing and Urban Development was the first to issue a rule in1978, setting the goal at thirty percent. The goal remained at this level under Republican presidents Ronald Reagan and George H.W. Bush. Bill Clinton's HUD increased the goal to forty percent in 1996 and 42 percent in 1997. Then in a 2000 rule-making process, Clinton's HUD excoriated the GSEs for having a smaller share of the affordable housing market than their share of the conventional conforming mortgage market– despite the fact that the GSEs had been meeting regulatory affordable housing requirements – and increased the goal to fifty percent. George W. Bush's HUD was even more assertive, ratcheting the goal up to fifty-two, fifty-three, fifty-five, and finally fifty-six percent by 2008. After the Housing and Economic Recovery Act of 2008 designated the new Federal Housing Finance Agency as the companies' regulator, FHFA revised the goal downward to forty-three percent in 2009.

Table 2 shows the level of the regulatory affordable housing goal by year and how well each company performed from 1996, when the goal was raised above thirty percent for the first time, through 2009, the first full year of their respective conservatorships. Fannie Mae consistently exceeded the affordable housing goal every year until 2008. Freddie Mac also exceeded the goal every year from 1996 through 2007, though usually by a lesser margin than Fannie. HUD's discussion of the rationale for the 2000 rule highlights Freddie's lower level of performance.

Deregulation of Financial Services

Parallel to the establishment and expansion of affordable housing goals, Fannie and Freddie were operating in a mortgage market that was rapidly changing, a consequence of both statutory changes and developments in technology and finance. In this section we identify key formal enactments in the domain of financial services policy that enabled origination and

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[5]Regulations and legislation established additional categories and subcategories of low- and moderate-income housing goals over time. Some of these categories emphasize place-based needs. Definitions of the characteristics of families and places, mortgages for which meet the goals, are also spelled out in regulations.

securitization of high-cost and often predatory home mortgages: the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Secondary Market Enhancement Act of 1984. The policy development that these statutes let out of the box is the rise of Alt-A loans and sub-prime MBS, and this is where the effects of the deregulation policy trajectory affect Fannie and Freddie.

As a prelude we clarify some terms. In the current public discourse, "subprime" is used broadly as a label for expensive, often predatory home mortgage loans and for the securities built upon pools of these loans. More accurately, a "subprime" loan is a loan made to a borrower with a low credit rating, often due to limited ability to pay; this means that subprime borrowers are often lower or moderate income borrowers. In the run-up to the financial crisis, home purchase loans made to subprime borrowers had features that are especially problematic precisely for people with lower incomes – high and variable interest rates, high closing costs, and prepayment penalties – and these features were not disclosed clearly in some cases. "Alt-A" is a term that is less used in the public discourse, but appears frequently in firms' financial reports and in government and think tank studies. An "Alt-A" loan is made to a borrower with a credit score higher than the subprime level, though possibly lower than prime, and has one or more alternative features. Prominent features of Alt-A loans in the 2000's included low or no documentation of income, minimal down payments, and variable interest rates. A sophisticated borrower might be able to use such a loan to his or her advantage.

Depository Institutions Deregulation and Monetary Control Act, 1980

Passed by a Congress with large Democratic majorities in both chambers and signed by President Jimmy Carter, the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) is a far-reaching statute that simultaneously deregulated financial depository intermediaries (in pursuit of a more competitive and therefore more efficient financial system) and attempted to give the Federal Reserve better leverage for monetary policy. We wish to highlight just one of its myriad provisions. This federal statute pre-empted state usury laws as they apply to home mortgages:

> "The provisions of the constitution or the laws of any State expressly limiting the rate or amount of interest, discount points, finance charges, or other charges which may be charged, taken, received, or reserved shall not apply" to mortgage loans (Title V, Section 501, cited in Cargill and Garcia, 1982).

The language is clear and simple, and the effects have been stunning. Without Congress's pre-emption of long-standing state law that had the effect of preventing origination of high-cost home mortgages, the surge in sub-prime and Alt-A lending and subsequent foreclosure crisis would not have occurred.[6]

The pre-emption of usury limits was a misguided attempt to relieve lenders of interest rate risk at the expense of borrowers. In doing so, policy makers remembered one side of the

[6] Dan Immergluck (2009, 42) points to the Alternative Mortgage Transaction Parity Act (AMPTA) in 1982 as a further step in federal pre-emption of state consumer protection. AMPTA overrode state laws that addressed specific features of alternative loans, such as balloon payments and variable interest rates. It also permitted mortgage companies, which had been primarily state regulated, to choose federal regulation by the OTS.

depression's lesson about sustainable home ownership finance: it requires healthy financial institutions. They forgot or discounted the other side: sustainable home ownership for moderate and middle income home buyers requires mortgage loans structured with the borrowers' needs and income firmly in view.

Secondary Mortgage Market Enhancement Act, 1984

It is one thing for regulated financial depository institutions (banks and S&Ls) and less regulated non-depository lenders (mortgage brokers and mortgage bankers) to be legally able to make alternatively structured home mortgage loans. It is another matter to be permitted to assemble a pool of alternative mortgages originated in various states and sell securities based on that pool. Fannie Mae and Freddie Mac had succeeded, since 1970, in creating technologies for assembling and securitizing mortgages from across the country. But their approach relied precisely on the mortgages having standard features and standard underwriting criteria that make them largely safe for borrowers and therefore low risk for investors. *The mortgages that Fannie and Freddie securitize are what alternative mortgages are alternative to.* They are alternative in that their features and underwriting criteria render them higher risk for borrowers and investors. Nevertheless, the federal government took essential steps to facilitate securitization of these mortgages by private financial services companies in 1984 in the Secondary Mortgage Market Enhancement Act. These steps included exempting these securities from state-level registration and expanding permission for regulated depositories to buy them (McCoy and Renuart, cited in Immergluck, 2009, p. 43).

How Did Fannie and Freddie Undermine Themselves and their Public Purposes?

We began this paper with a look at the current condition of Fannie Mae and Freddie Mac. In this section, we are interested in how they got into this condition. We ask three questions: What behavior of the two companies undermined their performance in the years leading immediately to the crisis? To what extent does this behavior make the two companies culpable for the collapse of home ownership financing in 2008 and the ongoing deterioration of home ownership? Why did they engage in behavior that undid themselves and undercut their public purpose?

What Did Fannie and Freddie Do?

How Fannie Mae and Freddie Mac lost all that money has become clear. While these companies are very big, they are not especially complex: They have three primary lines of business. In the single-family business, they buy single-family residential mortgages from mortgage originators and either hold them in portfolio or pool them to produce securities – the familiar agency MBS. Fannie and Freddie guarantee their MBS: if mortgages in their pools fail to perform, the agencies make good to investors in the securities. Their second line of business is multi-family: the two companies purchase loans on apartment buildings and either hold them in portfolio or securitize them. Third, in their "investments and capital markets" line of business, the companies manage their portfolios of mortgages, mortgage-backed securities, and other investments (FHFA-OIG, 2012, p 9). There is some overlap between this third line and the first.

Choices made for the investments and capital line of business accounted for the dramatic operating losses that precipitated seizure of the companies in 2008. According to the conservator's 2009 annual report to Congress (FHFA, 2009, p iv), "Investments in private-label MBS were primarily responsible for eliminating Freddie Mac's pre-conservatorship net worth of $27 billion and played a significant role in the initial draws under the Preferred Stock Purchase Agreements. Given that Fannie Mae had less than half the amount of private-label MBS as Freddie Mac, the overall impact was similar but less severe." The effect of this category of bad business moved through the respective balance sheets quickly, specifically, the conservator reported that the investments and capital line accounted for only nine percent of losses in 2010 and this business line returned to profitability in 2011. Losses from subprime MBS cleared quickly because Fannie and Freddie had concentrated their purchases in the senior (AAA) tranches of subprime MBS, and these top tranches had short duration. Gorton (2008) explains that "the expectation was for the underlying mortgage collateral to be refinanced in two years with any amortization of principal prior to the refinancing generally directed to the AAA tranches purchased by the GSEs." The companies' investments in subprime MBS thus either paid off or failed quickly.

A second surge in losses occurred in 2009, when Fannie Mae and Freddie Mac were already in conservatorship, and is accounted for by different behavior, this time in the single family business line. Fannie and Freddie had acquired significant amounts of Alt-A and interest-only mortgages (not mutually exclusive categories) in 2005, 2006 and 2007, which they included in their MBS pools. While it is difficult to separate the effects of the companies' poor underwriting from the effects of falling house prices on the performance of these mortgages, it is clear that mortgages originated in these years are responsible for the second surge in operating losses.[7] The most recent conservator's report indicates that an overwhelming proportion of the credit losses in the "Single Family Credit Guarantee" business segment was concentrated in mortgages originated in 2005, 2006, and 2007 during the height of the home mortgage boom.

A third surge in losses experienced by both companies in 2011 is attributable to a third distinct dynamic. Prime borrowers with conventional conforming mortgages are now failing to perform on their mortgages as the macroeconomic effects of the burst housing bubble play out in falling house prices and sustained high unemployment. This foreclosure crisis has been an intractable problem for policymakers, with a variety of interventions failing to stabilize home prices.

Figure 1 shows the three peaks in operating losses for each company, reflecting these distinct dynamics. The picture is very clear for Freddie Mac. The figure reveals the very high operating losses attributable to subprime MBS in the fourth quarter of 2008. Operating losses fall dramatically for two quarters, but rise again in mid-2009 as Alt-A mortgages purchased in 2005, 2006, and 2007 fail. Losses mount a third time in 2011 as prime borrowers default. Fannie also experiences spectacular operating losses in fourth quarter 2008. Unlike Freddie,

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[7] The conservator reports that "Fannie Mae's high risk 'prime' lending (Alt-A and Interest Only) accounted for 37 percent of mortgage acquisitions in 2006, the same categories were 35 percent of Freddie's acquisition. By the end of 2010, the delinquency rate for these high risk loans was 15-20 percent, compared to 5 percent for the entire mortgage portfolio.

Fannie's second spike occurs well before Fannie's quarterly operating losses reached zero, and the third rise in operating losses, in 2011, bumps up twice.

Why did Fannie and Freddie buy Alt-A mortgages and subprime MBS?

Two narratives have been advanced to account for why Fannie Mae and Freddie Mac behaved as they did. These explanations rely on the long view in policy development. The explanations are not mutually exclusive. Simply put:

The affordable housing goals made them do it (the Wallison/Pinto view).

They wanted to make some money for shareholders and executives (the consensus view).

As HUD updated housing goals for the GSEs in 2000 and 2005, the agency noted that the GSEs were noticeably lagging the industry in supporting loan products that served the needs of low and moderate income borrowers, especially first-time home buyers and minority home buyers. From 1996-2002, for instance, the conforming market that was at the heart of the GSE single family business had a smaller proportion of lending to minority homebuyers (19.8 percent) than the broader private market (21.5 percent). The GSEs were criticized for this failure to lead the market (HUD 2004).

In a 108-page dissent from the majority of the Financial Crisis Inquiry Commission, Republican appointee Peter Wallison argued that the root cause of the financial crisis was affordable housing policy goals initiated in 1992 and expanded in 2000 and 2005. HUD rulemaking targeting the GSEs (and related provisions that required lending in underserved communities) led directly to the creation of nearly thirty million risky mortgages. In Wallison's account, the GSEs were by far the largest sources of support for these mortgages, ultimately holding over one third of the credit risk of the mortgages. Using data supplied by Fannie Mae to the FCIC, Wallison shows that Fannie relied on subprime (FICO<660) mortgages and private label MBS to reach and exceed low- and moderate-income housing goals in the mid-2000s. Interestingly, purchases of Alt-A mortgages – which accounted for the huge losses in the single family business segment in 2010 – actually hurt the pursuit of affordable housing goals. For instance, in 2006 forty percent of Alt-A originations served the low and moderate-income housing goal of fifty-two percent. (See Wallison, 2011: Table 5.)

The significance of Fannie and Freddie's purchase of private-label subprime MBS has been the subject of intense scrutiny. Did the two companies drive the growth of the subprime market? Several accounts (notably Wiecher 2010 and Thomas and Van Order 2010) come to the conclusion that the housing GSEs responded to, rather than initiated, the huge growth in subprime. Even so, the evidence is clear that the two GSEs became the two largest buyers of subprime MBS. Fannie and Freddie's purchases accounted for nearly a fourth of the volume of subprime MBS originated in 2004, 2005 and 2006. So while the GSE's demands for subprime ARM MBS may not have fueled the original development and early growth of the market (2000-2003), their purchases sustained the growth as the market matured (2004-2006).

An alternative view, informing the majority report of the Financial Crisis Inquiry Commission and much of the academic and government research on the crisis, reaches a slightly different conclusion than Wallison. The consensus view identifies private label MBS, Alt-A mortgages, and subprime mortgages as key elements of the crisis and the failure of the GSEs, but concludes that is was profits and business incentives, not affordable housing goals, that drove the outcome. A 2009 GAO report describes the 2004 accounting scandal that directed new scrutiny towards Fannie Mae management (GAO, 2009). After the adoption of stronger internal controls and new accounting practices, the GSEs turned to new mortgage products in order to gain market share, generate profits and produce earnings per share that would translate into high compensation for senior management.

Provisional Conclusions and Further Research

What does this tell us about Fannie Mae and Freddie Mac's culpability for the financial crisis, about housing policy, about policy history? The bitter struggle over the financial crisis narrative reveals the challenges – for accountability and for simply understanding public policy – created when agencies are subjected to multiple reform initiatives with fragmented and diffuse goals. Two central prescriptions of the policy history approach – 1) follow a policy enactment into implementation to see how it changes its environment and 2) pay attention to developments in tangential policy domains – help us to see what happened here. The initial conception of Fannie and Freddie – a simple line of business to serve the well-defined public purpose of supporting a secondary mortgage market – was obscured or complicated by the series of reforms that placed the organizations under private ownership, introduced social welfare objectives, and transformed the publicly supported and structured secondary mortgage market into a competitive private market.

Our story implicates all three policy trajectories – privatization, affordable housing, and deregulation – and suggests the kind of multiple conjunctural causation that Charles Ragin identifies (2000). But this paper is a first pass: Are the companies necessarily tangled in today's institutional and ideological environments such that they cannot succeed in any of their public policy goals? Would constructing counterfactual scenarios in which conflicting trajectories are removed, one at a time, suggest reforms that would leave socially useful agencies? A second area to investigate further is whether there are differences between Freddie Mac and Fannie Mae that matter. Though we emphasized that they began as different organizations, we worked within the conventional wisdom that they are now largely the same, especially since the 1992 reforms. But even as we told the story, different results suggest that there may be differences in structure and process that matter. Freddie Mac has returned to earning a robust return, while Fannie is weaker. A search for workable reforms should probe for these differences.

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Table 1
Senior Preferred Stock Draws and Dividends Paid, 2008-2012 (in millions of $)

	Fannie Mae		**Freddie Mac**		**Combined cumulative**	
	Annual Treasury draw	Quarterly Dividend	Annual Treasury draw	Quarterly Dividend	Annual Treasury draw	Quarterly Dividend
2008Q4	16,200	0	31,800	0	48,000	0
2009Q1		29		378		407
2009Q2		411		1,142		1,960
2009Q3		883		1,293		4,136
2009Q4	60,000	1,151	19,900	1,292	127,900	6,579
2010Q1		1,527		1,292		9,398
2010Q2		1,907		1,296		12,601
2010Q3		2,116		1,558		16,275
2010Q4	15,000	2,154	13,000	1,603	155,900	20,032
2011Q1		2,216		1,605		23,853
2011Q2		2,282		1,617		27,752
2011Q3		2,494		1,618		31,864
2011Q4	25,900	2,622	6,600	1,658	188,400	36,144
2012 Q1		2,817		1,804		40,765

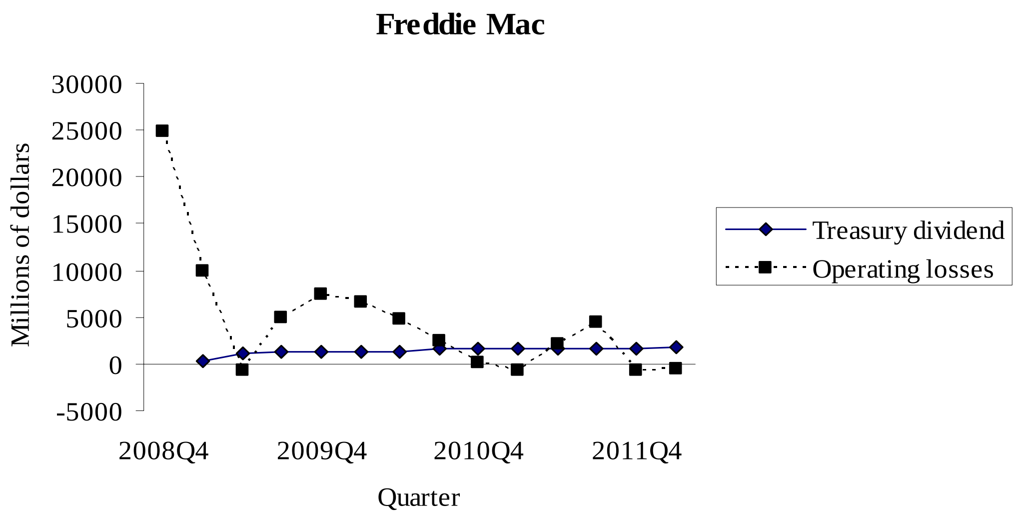
Notes: Annual Treasury draw includes $1 billion 2008 liquidation preference. Source for quarterly dividend payments - SEC 10-K and 10-Q filings. Source for annual Treasury draw - quarterly and annual conservator's reports.

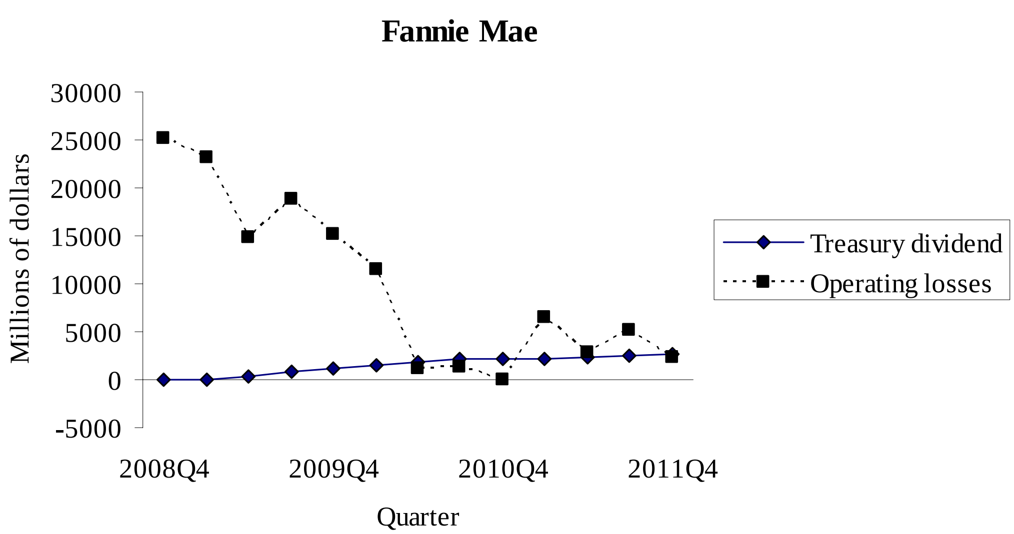
Table 2
Affordable Housing Goals and Performance, Fannie and Freddie, by year

	Performance		Goal	
	Fannie Mae	Freddie Mac		
1968				<-Fannie made a GSE under HUD authority
1978			30%	<-HUD rule 1978
1989				<--Freddie placed under HUD authority (FIRREA)
1992			30%	<-Housing goals extended to Freddie(HFEFSSA)
1996	45.6%	41.1%	40%	
1997	45.7%	42.6%	42%	
1998	44.1%	42.9%	42%	
1999	45.9%	46.1%	42%	
2000	n/a	n/a	42%	
2001	51.5%	53.2%	50%	<---HUD rule 2000
2002	51.8%	50.3%	50%	
2003	52.3%	51.2%	50%	
2004	53.4%	51.6%	50%	
2005	55.1%	54.0%	52%	<--HUD rule 2004
2006	56.9%	55.9%	53%	
2007	55.5%	56.1%	55%	
2008	53.7%	51.5%	56%	
2009	47.6%	44.7%	43%	<--FHFA revised in 2009
2010				

Sources:
For 1996-99: Housing and Urban Development, Department of. 2000. HUD's Regulation of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Final Rule. *Federal Register*. 65(211): 65044-65229 (October 31).
For 2001-2010: Federal Housing Finance Agency. July 2010. Overview of the Enterprises Housing Goal Performance. Accessed 24 April 2012.

Figure 1
Freddie Mac and Fannie Mae Treasury Dividend and Operating Losses, by quarter





Notes: Quarterly dividend for Fannie Mae is now about 2.6 billion (2600 million) and for Freddie Mac about 1.8 billion (1800 million). Total losses (not displayed) are the sum of Treasury dividend and operating losses. Source: Securities and Exchange Commission filings. First quarter 2012 available for Freddie Mac only.