

Fannie and Freddie *Post-Election*

The significance of the Democratic victories.

BY OWEN ULLMANN

A decade ago, Fannie Mae and Freddie Mac, the United States' two mortgage financing behemoths, were flying high. They were among the most profitable companies in the world, had political connections to the White House and Congress, earned enormous bonuses for their corporate chieftains, and did not have to play by the same rules as other corporations. For all that, they could thank their congressional charters, which established them as Government Sponsored Enterprises (GSEs).

Those charters, which remain in place, grant them lines of credit from the Treasury, exempt them from local taxes, allow lower capital requirements than banks must meet, and spare them the mandatory disclosure requirements imposed on other public corporations. Most importantly, the implicit guarantee that Uncle Sam would bail them out in a crisis means a lower risk premium of roughly twenty-five basis points when they borrow money. That quarter-point advantage is the basis of their lucrative business of buying and securitizing mortgages in the secondary market.

As they grew larger and richer, critics warned that their lack of transparency and weak federal oversight would get them in deep trouble. Not a chance, they

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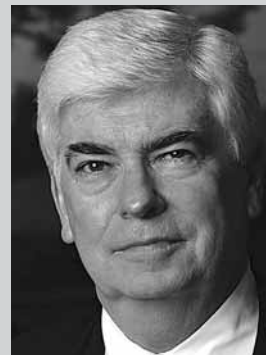
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— GSE Scorecard —

Rep. Barney Frank (D-MA),
*Chairman of the House
 Financial Services Committee.
 Intellectual powerhouse, would
 like a bill that tightens
 regulation. Faces Senate
 opposition.*



Sen. Chris Dodd (D-CT),
*Chairman of the Senate
 Banking Committee.
 No interest in going after
 the GSEs.*



Rep. Richard Baker (R-LA), *former
 Chairman of the House Financial
 Services Subcommittee on Capital
 Markets, Insurance, and
 Government Sponsored
 Enterprises. Modest effort, was the
 equivalent of whipping Fannie and
 Freddie with a wet noodle.*

James B. Lockhart III,
*Director of OFHEO. Man of
 the hour. A lot will depend if
 he's tough enough. Will need
 a thick skin. Plenty of
 litigation launched by
 the GSEs, themselves.*



**Sen. Richard Shelby
 (R-AL),** *former
 Chairman, Senate
 Banking Committee. Was
 the toughest at trying to
 bring the GSEs in line.*

countered arrogantly. Well guess what? Like Icarus flying to close to the sun, the two companies have fallen far and fast onto their—dare we say—fannies.

It turns out the critics were right on the mark about the abuses that could result from lax accountability.

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Democratic control of Congress.
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Freddie paid a fine in 2003 to settle charges that it misstated prior earnings by nearly \$5 billion. Last December, Fannie reported that it overstated past profits by \$6.3 billion. Meanwhile, federal regulators are trying to recover bonuses the top executives of each company received during the time earnings were misstated. In a suit filed against Fannie on December 18 to recover \$115 million in compensation, the Office of Federal Housing Enterprise Oversight (OFHEO) said former Fannie Mae CEO Franklin D. Raines and other executives used numerous ruses to boost the company's bottom line, and thus their bonuses.

Yet amid all the turmoil, lawsuits, and financial uncertainty befalling the companies, the current management teams at Fannie and Freddie have something to be thankful for in 2007: Democratic control of Congress.

The Democrats are less likely than Republicans to rein in the two companies' financial practices. For the most part, Democrats like having leverage over the two GSEs so they can prod them to establish larger funds to make housing more affordable to low-income families. It is one of the top goals that the new House Financial

Services Committee Chairman Barney Frank (D-MA) has promised to pursue.

Frank, who has one of the sharpest minds in Congress, also has predicted that Congress will pass a bill in 2007 to tighten regulation of Fannie Mae and Freddie Mac. That may be his intention, but the political reality is that the Democratic Party has many higher priorities to pursue after twelve years out of power. Frank's counterpart in the Senate, Chris Dodd (D-CT) has not expressed any interest in going after the GSEs. So it is likely that any legislation will remain on the backburner.

The failure of Republicans to pass legislation in spite of all the problems that have ensnared Fannie and Freddie attests to the difficulty of the task.

Republicans are philosophically opposed to government intervention in the market and they made several runs at tightening or altogether severing congressional links to the GSEs. They failed in the face of a huge, powerful, and relentless lobbying campaign by Fannie and Freddie. The GSEs' argument was that any change in the status quo would mean higher mortgage rates for homebuyers. It is an untested assertion that many critics doubt would occur in a fully deregulated housing market. Still it sent shudders down the spines of enough lawmakers to thwart legislation.

In the House of Representatives, Fannie and Freddie had a persistent opponent in Representative Richard Baker (R-LA), chairman of the capital markets subcommittee. Still, the House bill he championed was but a modest effort establishing a new regulator. "It was the equivalent of whipping Fannie and Freddie with a wet noodle," says GSE critic Peter J. Wallison, a senior fellow at the American Enterprise Institute who served as General Counsel at the U.S. Treasury Department and White House Counsel to President Reagan.

A more serious threat to Fannie and Freddie emerged in the Senate, where lawmakers backed an overhaul of the GSEs' regulation that would have forced them to reduce their portfolios of mortgages, a key source of their

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profits. The bill had the support of the Bush administration.

A former GSE went the privatized route voluntarily and has flourished since. Sallie Mae was created as a GSE in 1972 to make student loans. It began privatizing its operations in 1997 and terminated its ties to the federal government in 2004. In January, Sallie disclosed the federal investigation of its marketing practices.

The forced privatized approach, however, had no appeal to Fannie, Freddie, or Senate Democrats. The ranking Democrat on the Senate Banking Committee, Paul Sarbanes (MD), opposed the bill and Republicans figured they lacked the sixty votes to overcome a possible Democratic filibuster. So they never brought the bill to the floor for a vote. It died along with Republican control of Congress in the November midterm elections.

Wallison says the Treasury Department seems eager to press for legislation controlling Fannie and Freddie, even in the Democratic-run Congress. He does not give up hope of seeing the GSEs dismantled during the next two years.

Wallison has read the language in a new oversight bill that Frank has circulated and concludes that a determined regulator could use it to address GSEs' huge portfolios of mortgages, which he considers the key issue. "He will need a thick skin and be willing to face litigation" that the two mortgage giants would surely launch to protect their interests, Wallison says.

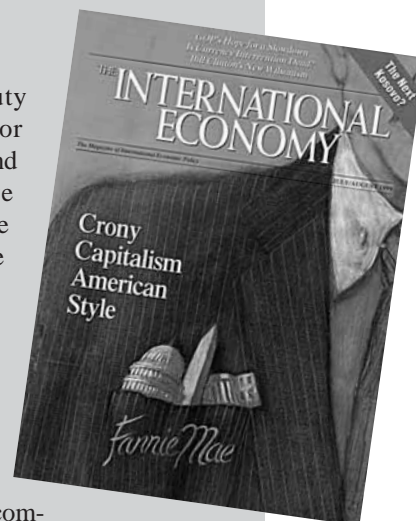
James B. Lockhart III, the director of OFHEO since last June, may be just that type of regulator. Before taking on his current job, he served as deputy

The Dangling Consulting Fee

Owen Ullmann, Deputy Managing Editor for News at *USA Today* and *TIE*'s long-time Executive Editor, first wrote about Fannie Mae and Freddie Mac in the July/August 1999 issue of this magazine ("Crony Capitalism: American Style"). The article was the first critical analysis of an industry that until then had received only widespread praise. Ullmann's cover article highlighting the industry's coming problems was prophetic.

Roughly a month before its publication, however, a curious development unfolded. A "consultant," who said he represented one of the GSEs, approached a business associate of *TIE* editor and publisher David Smick. The question: would there be any interest in a consulting contract to cover GSE-related regulatory issues coming out of the Federal Reserve? He's not certain this individual was aware an article was in the works, but needless to say the offer was rejected.

—The Editors



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commissioner of Social Security. A graduate of Yale University and Harvard Graduate School of Business Administration, Lockhart also served in the first Bush administration as executive director of the Pension Benefit Guaranty Corporation.

Lockhart has personal ties to the president, who also attended Yale and Harvard Business School. Even so, it will take a lot more than presidential friendship to end Fannie Mae's and Freddie Mac's dependence on their federal charters. Even when they are down they are dangerous adversaries when anyone tries to take away their special government status.

Without the benefit of a Republican-controlled Congress, Lockhart will have a tough time bringing Fannie and Freddie to heel. So don't bet the mortgage money. ♦