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Fannie, Freddie, and the Subprime Mortgage Market

by Mark Calabria

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Executive Summary

The recent financial crisis was characterized by losses in nearly every type of investment vehicle. Yet no product has attracted as much attention as the subprime mortgage.

What is generally agreed is that subprime mortgages disproportionately contributed both to the severity of the crisis and to the size of losses imposed upon the taxpayer. What remains in dispute is the role of government—specifically, that of Fannie Mae and Freddie Mac—in expanding the availability of subprime mortgage credit.

Changes in the mortgage market, resulting largely from misguided monetary policy, drove a frenzy of refinancing activity in 2003. When that origination boom died out, mortgage industry participants looked elsewhere for profits. Fannie and Freddie, among others, found those illusionary profits in lowering credit quality.

Foremost among the government-sponsored enterprises' deleterious activities was their vast direct purchases of loans that can only be characterized as subprime. Under reasonable definitions of subprime, almost 30 percent of Fannie and Freddie direct purchases could be considered subprime.

The government-sponsored enterprises were also the largest single investor in subprime private-label mortgage-backed securities. During the height of the housing bubble, almost 40 percent of newly issued private-label subprime securities were purchased by Fannie Mae and Freddie Mac.

In order to protect both the taxpayer and our broader economy, Fannie Mae and Freddie Mac should be abolished, along with other policies that transfer the risk of mortgage default from the lender to the taxpayer.

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From 2000 to 2003, the size of the mortgage market increased by almost 400 percent.

Introduction

By most accounts, the subprime mortgage market played a key role in the recent financial crisis. Yet there remains considerable debate over what drove that market. Liberal pundits continue to claim runaway greed, and deregulation allowed predatory lending to flourish, while conservatives and libertarians point to the role of government, particularly the role played by the government sponsored enterprises (GSE) Fannie Mae and Freddie Mac. This briefing paper, relying largely on data reported by the GSEs and their regulator, illustrates the massive involvement of the GSEs in the subprime mortgage market.

Mortgage Market Trends

Fannie Mae and Freddie Mac had a tremendous impact on the U.S. mortgage market. That impact, however, was a two-way street, as the unique characteristics of the U.S. mortgage market, particularly over the last decade, helped to create an environment conducive to the rapid expansion and subsequent failure of many companies, including Fannie Mae and Freddie Mac.

The early 1990s were a period of relative stability in the mortgage market. Thirty-year rates began a slow decline from over 10 percent in 1990 to just below 7 percent in 1998—at the time the lowest rates in decades. That 30 percent decline in rates helped to push single family mortgage originations to over $1.5 billion annually for the first time in 1998 (Figure 1). The average level of points paid by the borrower to close a mortgage also dropped in half over this time, from 2.1 percent in 1990 to 1.1 percent in 1998.[2] Getting a mortgage had rarely been cheaper or easier.

The late 1990s also set a momentary peak for the subprime mortgage market. Growing from a relatively small base and percent of total originations, the subprime share of the market peaked in 1997 at 14.5 percent, a figure that would not be topped until 2004.[3]

After 1998, the mortgage market, including the subprime market, cooled as the Federal Reserve slowly inched up the Federal Funds rate. From 1998 to 2000, the dollar volume of subprime mortgages originated actually fell by 8 percent.[4]

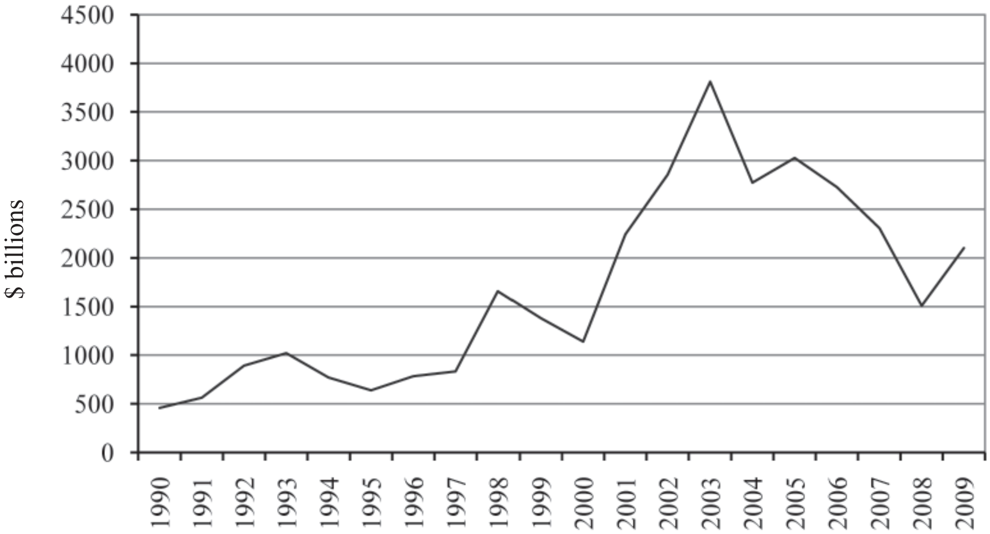
That decline in the mortgage market was to be short-lived, however. In response to the bursting of the dot-com bubble and the terrorist attacks on 9/11, the Federal Reserve began a rapid reduction in the federal funds rate. In 2003, a 30-year fixed-rate mortgage could be had for an average of 5.8 percent, while one could get a one-year adjustable-rate mortgage (ARM) for only 3.76 percent. In just under four years, from 2000 to 2003, the size of the mortgage market increased by almost 400 percent, as new mortgage originations grew from just over $1 trillion to $3.8 trillion.[5]

In many ways 2003 marked the beginning of the end. Although house prices and sales would continue to climb until 2006, the mortgage market was beginning to retreat. Origination volume fell 27 percent from 2003 to 2004. Mortgage rates also began a steady increase; record lows would not be seen again until after the financial crisis struck.

Why would the mortgage market shrink in the face of a housing market that was continuing to expand? The increase in mortgage rates back toward historical norms took the air out of the demand for refinancing. Refinancing activity is driven by the degree to which market rates are below the rates of mortgages currently outstanding. Without further rate declines, the remaining number of households who have yet to refinance also declines, further reducing mortgage demand. From 2003 to 2004, refinancing volumes dropped by over 40 percent.

Most participants in the mortgage market, including Fannie and Freddie, derive a substantial part of their income not from the slow, steady collecting of mortgage payments from borrowers, but from fee income or gains realized upon the sale of a mortgage or mortgage-backed security. The decline in refinancing volume more than offset the

Figure 1
Mortgage Market Booms, 1990–2009, Total Residential Originations



Source: Mortgage Bankers Association, "Mortgage Origination Estimates."

increase in new purchase volume, reducing fee income across the mortgage industry.

The flattening of the yield curve—the difference between short-term and long-term rates—after 2003 also put pressure on GSE profits. When the spread between short-term and long-term rates is wide, the GSEs can profit handsomely just from floating short-term debt and buying back their own mortgage-backed securities, which are tied to long-term rates. After 2004 this spread began to narrow, reducing the arbitrage profits from the GSEs' portfolio trading activities. From 2003 to 2005, the GSEs' combined net interest income fell by 45 percent. Net interest income continued to fall in 2006 to the point where the total net interest income was only a *third* of its 2003 level. This decline in earnings is all the more dramatic when one recognizes that net interest income comprised 85 percent of total income for the GSEs in 2003.[6]

The combination of declining fee income and reduced interest rate spreads put pressure on all mortgage-market participants to find income elsewhere. Many, including Fannie and Freddie, chose to make up that income by reducing the credit quality of their loans. While the GSEs' guarantee fee income, derived from taking on the credit risk of its direct loan purchases, increased almost 20 percent from 2003 to 2005, credit losses more than doubled (and this was before the bursting of the housing bubble).[7] To a large extent, it was not a competition to retain market share that drove the GSEs into subprime, but an attempt to maintain the outsized profits and revenue growth experienced from 2000 to 2003.

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Direct Loan Purchases

> The increase in our exposure to credit risk resulting from the increase in these loans with higher credit risk may cause us to experience increased delinquencies and credit losses in the future, which could adversely affect our financial condition and results of operation.
>
> —Fannie Mae, 10-K, May 2, 2007

A common refrain of GSE apologists is that Fannie and Freddie could not have been involved in subprime because they are not allowed, by law, to do subprime.[8] Nothing could be further from the truth. Both Fannie Mae and Freddie Mac's charters, along with statutory provisions governing their regulation, place only two conditions on which

Congress gave Fannie Mae and Freddie Mac the ability to buy almost any mortgage they wanted to.

residential mortgages they may purchase. The first condition relates to the amount of the mortgage loan, while the second requires that any mortgage with a loan-to-value ratio of over 80 percent, at origination, have private mortgage insurance.

There are no statutory or regulatory restrictions on the credit quality of mortgages that can be purchased. Nor are the GSEs limited to fixed-rate mortgages. Congress very specifically delegated to the GSEs wide discretion in setting the standards for which mortgages they could purchase. This guiding principle is illustrated in Section 305 of the Federal Home Loan Mortgage Corporation Act: "The operations of the Corporation [Freddie Mac] under this section shall be confined so far as practicable to residential mortgages which are deemed by the Corporation to be of such quality, type, and class as to meet generally the purchase standards imposed by private institutional mortgage investors."[9] In plain English, Congress gave Fannie Mae and Freddie Mac the ability to buy almost any mortgage they wanted to.

The regulations imposed upon Fannie Mae and Freddie Mac did not go much further. Requirements only mandated that "An Enterprise *should* establish and implement policies and procedures to adequately assess credit risks before they are assumed, and monitor such risks subsequently to ensure that they conform *to the Enterprise's* credit risk standards" (emphasis added).[10] In plain English, the regulations only *suggested* that the GSEs assess risk consistent with their own guidelines. If that doesn't sound like having the fox guard the henhouse, then I am not sure what does.

The starting point of any debate should be agreement on standard definitions. There are some common definitions for elements of subprime mortgages, but others remain in dispute. And of course popular discourse often lumps together "subprime" with "predatory" lending, although both regulators and mortgage professionals recognize that while subprime and predatory may overlap, they are not the same.[11]

Subprime mortgages are generally defined as such by either the credit quality of the borrower, generally determined by FICO score, or the credit quality of the product type.[12] When using borrower credit quality, regulators have generally observed a cutoff of a 660 FICO score as the boundary between subprime and prime. Mortgage professionals have occasionally used a cutoff of 620. I will follow the lead of the bank regulators in using a 660 benchmark when discussing GSE mortgage purchases, but will also present the smaller subset of loans under 620.

Examining data reported by Fannie Mae in its annual 10-K filing with the Securities and Exchange Commission, one sees a clear pattern of consistent and sizable purchases of mortgages with FICO scores below 660 (Table 1). As late as 2007, 18 percent of the volume of Fannie Mae direct whole mortgages purchased displayed a FICO of under 660. As the typical subprime loan is smaller than the typical prime loan, measuring loan activity by volume will likely understate the percent of individual loans that are subprime.

This 18 percent subprime share was not the result of other lenders leaving the market in 2007. Fannie Mae's percent of loan volume with FICO scores under 660 has consistently remained in the range of 15 to 18 percent over the last decade. So far from being driven by a desire to recapture market share, Fannie Mae already had a substantial lead in this market.

Just comparing Fannie's FICO-based subprime share to the overall market paints a picture of Fannie clearly leading, rather than following, the overall market. In 2000, when Fannie's FICO-based subprime was 18 percent of its business, subprime as a share of the overall mortgage market was only around 12 percent.[13] Subprime's overall share in the market did not begin to approach the percent of Fannie's business which was subprime until around 2004, corresponding with the GSEs' movement into large-scale purchases of private-label mortgage-backed securities.[14] Given the lack of a uniform definition for subprime, comparisons should be interpreted with caution. Who was leading whom will undoubtedly remain in dispute; what is clear, however, is that Fannie Mae was not "late to the party."

Table 1
Fannie Mae–Loan Purchases Characteristics, by Book Year

	2003	2004	2005	2006	2007
Average Original Loan-to-Value (OLTV)	70%	70%	70%	70%	72%
Percent with OLTV > 90%	8%	8%	9%	10%	16%
Average FICO Score	717	719	721	716	716
FICO < 620	5%	5%	5%	6%	6%
FICO < 660	16%	16%	15%	17%	18%
Adjustable-rate	12%	14%	21%	17%	10%
Interest-only	1%	2%	10%	15%	16%
Investor/Vacation	8%	8%	11%	13%	11%

Source: Fannie Mae, Form 10-K, filed with the U.S. Securities and Exchange Commission, for years 2002, 2004, 2005, 2007, and 2008.

Defining subprime based upon characteristics other than borrower credit score becomes a little more subjective. Some products, such as negative-amortizing or interest-only adjustable-rate mortgages are almost always viewed as subprime. Some interest-only fixed-rate loans are also seen in this category. Some cash-out refinancing, as well as very high loan-to-value products can also be viewed (and priced) as subprime. In general, the riskiest of these products are not found among low-FICO borrowers, but among higher-credit borrowers.

During the height of the housing bubble in 2006, 15 percent of the single-family mortgages purchased by Fannie Mae that year were interest-only. Another 3 percent were negative-amortizing, meaning that the borrower was not only just paying interest, they were also adding to the principal balance—a particularly risky product once house prices start to decline. Approximately 10 percent of Fannie Mae's single-family business was mortgages that displayed loan-to-value ratios above 90 percent, leaving borrowers with little or no cushion of equity were house prices to decline. Fannie, however, purchased hardly any mortgages with negative equity at origination.

Setting aside mortgages that simply had a low or zero downpayment, the above statistics indicate that approximately 30 percent of Fannie Mae's single-family purchases would generally be considered subprime, even if they were not always categorized by Fannie Mae in such a manner. During the bubble years, Fannie's subprime direct purchases equaled between $100 billion and $200 billion annually.[15] Other researchers have found higher percentages when looking solely at purchases, where the above statistics focus on the overall book of business (a flow versus a stock comparison).[16]

Fannie Mae was not alone in driving the subprime market: Freddie Mac played a starring role as well. As the bubble expanded, Freddie Mac continued to lower its credit standards. The average FICO for all borrowers for 2003 and prior was 726, which reached a low of 710 in 2007 when Freddie Mac belatedly began efforts to contain risk (Table 2).[17] As of March 2010, 12 percent of Freddie Mac's portfolio displays FICO scores under 660. This decline is actually understated given that the average FICO scores of the general population increased after 2003, partly as a result of the Fair and Accurate Credit Transactions Act passed in 2003.[18] In all likelihood, a 710 FICO in 2007 represented a greater credit risk than a 710 FICO in 2003. While the average credit quality of Freddie Mac's business remained well into the territory of prime, the trend in credit quality indicates a continued lowering of credit

During the bubble years, Fannie's subprime direct purchases equaled between $100 billion and $200 billion annually.

Table 2
Freddie Mac–Total Portfolio as of March 31, 2010, by Book Year

	2003	2004	2005	2006	2007
Unpaid Loan Balance ($ Billions)	$344	$148	$217	$193	$255
Average FICO Score	726	720	721	715	710
Original Loan-to-Value (OLTV)	69%	71%	72%	74%	76%
Percent with OLTV > 90%	7%	7%	6%	8%	15%
Current Loan-to-Value (CLTV)	52%	70%	88%	99%	99%
Percent with CLTV > 100%	4%	12%	28%	40%	42%
Percent with CLTV > 110%	2%	8%	20%	30%	29%
FICO < 620	4%	4%	4%	5%	7%
FICO < 660	7%	8%	9%	10%	13%
Adjustable-rate	4%	14%	16%	20%	13%
Interest-only	0%	2%	9%	19%	20%
Investor	3%	4%	4%	5%	7%
% Seriously Delinquent (D90+)	2.11%	3.10%	5.68%	9.99%	11.24%

Source: Freddie Mac Update, May 2010, www.freddiemac.com/investors/pdffiles/investor-presentation.pdf.

quality after 2003. As a point of reference, TransUnion reports the 2010 median U.S. credit score as 730.[19]

Freddie Mac was also aggressive in the purchase of interest-only and high loan-to-value mortgages. Prior to 2004, Freddie Mac rarely purchased any interest-only products, having essentially no such mortgages on its balance sheet in 2003.[20] By 2007, fully 20 percent of its single-family business was interest-only, while 15 percent of its business was in loans with original loan-to-values in excess of 90 percent, most of these with ratios around 97 percent.[21] The interaction of falling house prices and low downpayments is illustrated by the fact that 40 percent of loans purchased by Freddie Mac and originated in 2006 are now underwater (where the value of the mortgage exceeds the home value).[22] This may also explain why approximately 10 percent of 2006 vintage Freddie Mac loans are now more than 90 days delinquent, the usual trigger to begin a foreclosure proceeding.[23]

Forty percent of loans purchased by Freddie Mac and originated in 2006 are now underwater.

The above statistics indicate that Freddie Mac, just before the bubble burst, was also heavily involved in fueling the subprime mortgage market, with around 30 percent of its book characterized as subprime (if not outright toxic).

Despite their avowed devotion to expanding homeownership, both companies also played a large role in the market for investor properties. Over the last decade, single-family investor properties regularly constituted about 5 percent of each company's book. Another 3 to 4 percent of their books consisted of mortgages for vacation properties and second homes.[24] In addition to providing no expansion of homeownership, investor and vacation properties have traditionally defaulted at rates considerably in excess of owner-occupied homes.[25]

The Company You Keep

> Countrywide has . . . played a significant role in extending the reach of the secondary market by working with the

GSEs to develop new affordable lending products.

—Fannie Mae Foundation[26]

Fairly or not, in life you're often judged by the company you keep. And while any case against Fannie Mae and Freddie Mac should not simply be one of "guilt by association," it's worth looking at who they were buying mortgages from.

To a surprisingly large degree, both companies concentrated their purchases from a handful of lenders. While both maintained well over 50 "partners," both also purchased the majority of mortgages from just 10 lenders.[27] At the market's peak in 2005, only 10 lenders made up two-thirds of Fannie Mae's business, and 10 lenders also made up over three-fourths of Freddie Mac's business.[28]

Near the top for both was Countrywide Mortgage, one of the nation's largest subprime lenders. In 2005, one out of every four loans purchased by Fannie Mae was from Countrywide.[29] One of out every 10 for Freddie Mac was also from Countrywide.[30]

Apparently the affection was mutual, for as much as the GSEs depended on Countrywide, Countrywide also depended on them. According to the Fannie Mae Foundation, almost half of Countrywide's production was sold to Fannie Mae.[31] Additionally, Countrywide used Ginnie Mae to guarantee another third of their production.[32] Close to 90 percent of Countrywide's loan originations were bought or guaranteed by some arm of the federal government.[33] Far from being a product of the free market, Countrywide could have only existed and prospered in an atmosphere of government guarantees.

The list of the GSEs' other partners reads like a Who's Who of the top subprime lenders. Second in overall sales to the GSEs was Wells Fargo, the nation's seventh-largest subprime lender.[34] Their third-largest partner, the now-failed Washington Mutual (WaMu), was the nation's ninth-largest subprime lender.[35] The rest of the GSEs' top sellers include such subprime lenders as Chase Home Finance, CitiMortgage, and Lehman Brothers.

The extent to which Fannie and Freddie provided oxygen to the subprime mortgage industry is illustrated by the failure of one of its biggest players, New Century Financial. Despite its securities and accounting problems, New Century was able to stay afloat until March 2007, when Fannie Mae terminated its relationship with New Century.[36] Two weeks later, New Century was in Chapter 11. New Century deserved bankruptcy, if not worse—but its very existence was supported by Fannie Mae.

Many subprime lenders did not sell their loans directly to Fannie and Freddie. A significant portion of subprime lending was securitized and sold to investors as private-label mortgage-backed securities. As we shall see, however, the largest "investors" in these securities were Fannie and Freddie.

Private-Label Securities

The vast majority of Fannie Mae and Freddie Mac activity in subprime was via the direct purchase of whole mortgages. The purchase of private-label subprime-mortgage-backed securities also helped to fuel the housing bubble.

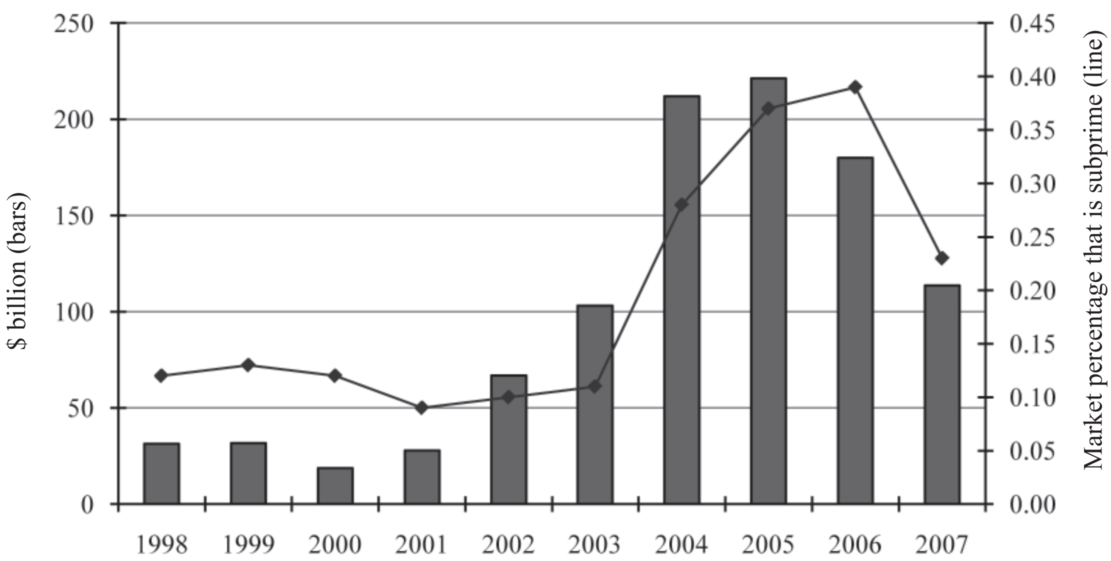
Up until 2002, the GSEs purchased relatively small amounts of private-label mortgage-backed securities. Before 1997, neither the GSEs nor their regulator even bothered to publicly report such purchases. From 1998 to 2001, private-label purchases averaged around $30 billion annually for both companies combined, rarely approaching even 10 percent of their retained mortgage portfolios.[37]

Beginning in 2002, just before its accounting problems were coming to light, Freddie Mac decided to double its acquisitions of private-label securities, reaching almost $60 billion. Despite—or perhaps because of—its larger size, Fannie Mae was slow to follow Freddie Mac's lead. Throughout their buying spree, which reached an annual average of $200 billion from 2004 to 2006, Freddie Mac remained the dominant buyer.

Fannie Mae and Freddie Mac did not simply follow the market, but also fueled its expansion. During the recent housing bubble, the largest jump in the subprime market

Close to 90 percent of Countrywide's loan originations were bought or guaranteed by some arm of the federal government.

Figure 2
GSE Purchases Fuel Subprime Mortgage-Backed Securities



Source: Freddie Mac Update, May 2010, www.freddiemac.com/investors/pdffiles/investor-presentation.pdf.

During the 2003–2004 housing bubble, almost 40 percent of the newly issued private-label subprime securities were purchased by Fannie Mae and Freddie Mac.

occurred from 2003 to 2004, when the level of private-label securitizations increased by over 50 percent, from $522 billion to $806 billion. Behind this explosion was more than a 100 percent increase in private-label mortgage-backed security purchases by the GSEs. Almost 40 percent of these newly issued private-label subprime securities were purchased by Fannie Mae and Freddie Mac, making the GSEs the largest single source of liquidity for this market.

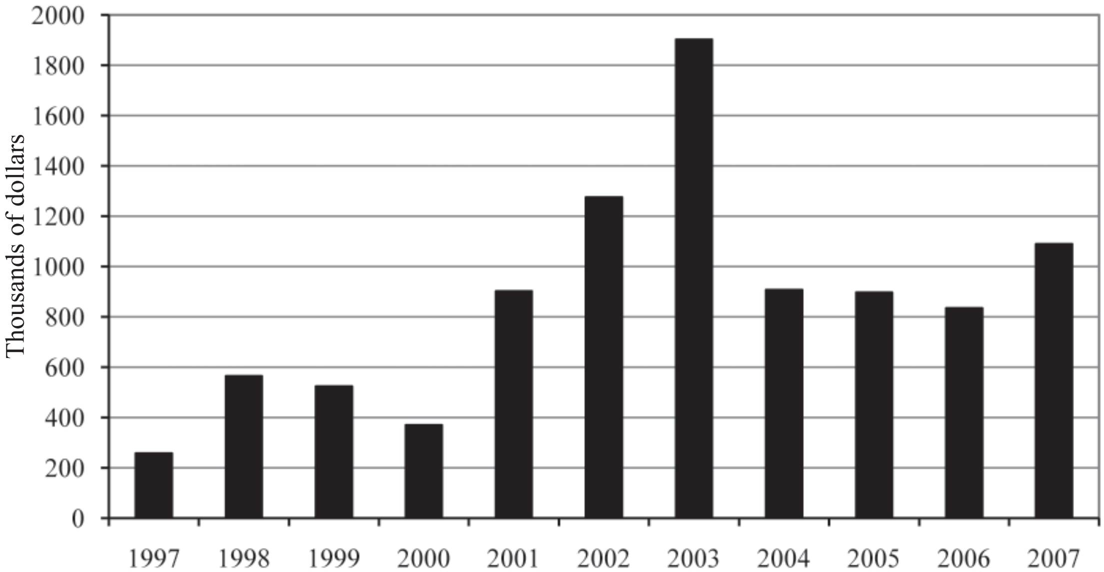
Figure 2 indicates the movement of both the GSEs' purchases of subprime mortgage-backed securities as well as the overall growth of the subprime mortgage market, showing the close relationship between these two numbers. The substantial decline in issuance of GSE mortgage-backed securities starting in 2004, both in terms of market share and absolute numbers, is often used as evidence that the GSEs were "sidelined" during the worst of the bubble years (Figure 3). Adding their purchases of private-label securities to their own issuances demonstrates that Fannie Mae and Freddie Mac remained the dominant players in the mortgage market even after their accounting and management scandals.[38]

The Housing Goals Made Me Do It

> We have made, and continue to make, significant adjustments to our mortgage loan sourcing and purchase strategies in an effort to meet these increased housing goals and the sub-goals. These strategies include entering into some purchase and securitization transactions with lower expected economic returns than our typical transactions. We have also relaxed some of our underwriting criteria to obtain goals-qualifying mortgage loans and increased our investments in higher-risk mortgages that are more likely to serve the borrowers targeted by HUD's goals and subgoals, which could increase our credit losses.
>
> —Fannie Mae 10-K, May 2, 2007

"While the market was changing, Fannie Mae struggled to meet aggressively increasing HUD goals. The goals were extremely challenging, increased significantly every year, and permitted no leeway to account for the changing lending environment. Certain

Figure 3
GSE MBS Issuance



Source: Office of Federal Housing Enterprise Oversight, Report to Congress, 2008.

mortgages that may not have met our traditional standards could not be ignored," said Daniel Mudd, the former CEO of Fannie Mae, in a written statement presented before the Financial Crisis Inquiry Commission on April 9, 2010.

What is beyond a doubt is that Fannie Mae and Freddie Mac played a significant role in driving and supporting the origination of subprime mortgages. Hotly debated is the question, "Why"?

Senior officials in the Obama administration, such as Secretary of the Treasury Timothy F. Geithner and Secretary of HUD Shaun Donovan have argued that the GSEs failed because of greed and a struggle to maintain market share in the face of an increasingly aggressive Wall Street. This narrative conveniently paints the GSEs as competitors with Wall Street, when the reality is that they were more like partners.

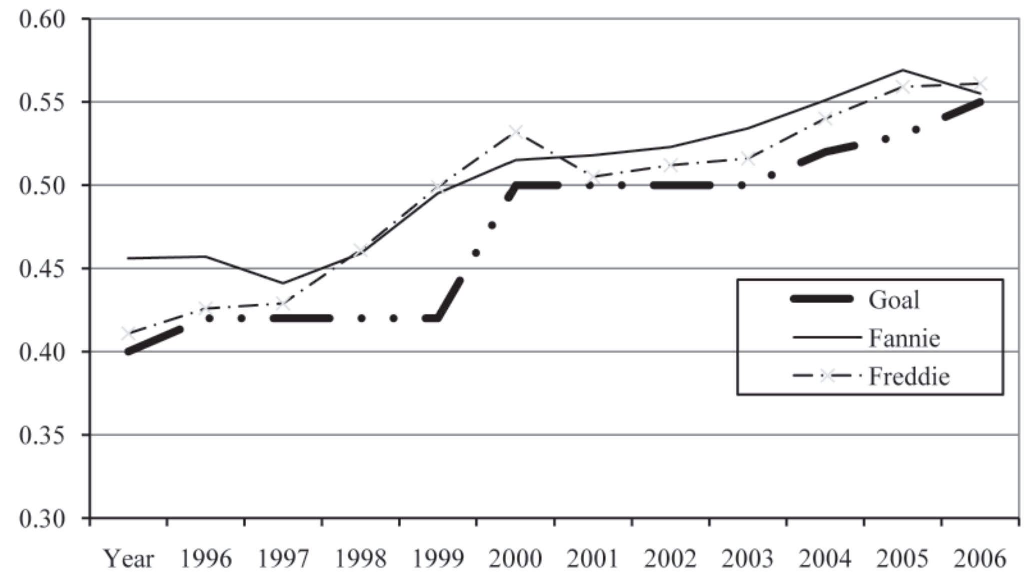
Painting Wall Street and the GSEs as competitors fails to account for the fact that Wall Street firms and their affiliates were among the largest mortgage sellers to Fannie and Freddie. Companies such as Citibank, Chase, Lehman, Morgan Stanley, and Goldman Sachs all did significant business selling mortgages to the GSEs.[39] In part because of the Basel capital standards, which required banks to hold far less capital for a given volume of whole mortgages than for an equal volume of mortgage-backed securities, Wall Street banks were far more inclined to hold mortgage-backed securities rather than whole loans.[40] And in many cases, their preference was those loans issued by Fannie and Freddie. For instance, over 50 percent of Maiden Lane I assets, those Bear Stearns assets guaranteed by the Federal Reserve, consist of GSE securities.[41]

One culprit often discussed is the GSEs' mandated housing goals. In 1992, Congress established a set of housing goals for Fannie and Freddie. The statute established an interim goal with direction for the HUD Secretary to increase such goals on a periodic basis.[42, 43] Although both statute and regulation set out several numeric goals, the primary goal focused on low- and moderate-income borrowers, which will also be the focus here.

The first adjustment to the goals took effect in 1996, when HUD required 40 percent

Wall Street firms and their affiliates were among the largest mortgage sellers to Fannie and Freddie.

Figure 4
GSE Purchases Track Housing Goals



Source: Federal Housing Finance Agency, *Mortgage Market Note 10–2: The Housing Goals of Fannie Mae and Freddie Mac in the Context of the Mortgage Market: 1996–2009.*

Beginning in 2001, HUD increased the low- to moderate-income goals significantly.

of Fannie and Freddie purchases to be mortgages for low- and moderate-income borrowers.[44] HUD estimated that such borrowers were between 48 and 52 percent of the overall market. As initially set, Fannie and Freddie could go about business as usual and with a very high probability hit their goals. For the remainder of the 1990s, the goal was set at 42 percent, also not much of a stretch to meet (Figure 4).

Beginning in 2001, HUD increased the low- to moderate-income goals significantly, raising them from 42 to 50 percent of purchases. HUD's intention in this case was for the GSEs to at least match the market.

The GSEs responded accordingly. Fannie Mae, for instance, increased its purchases of low- to moderate-income loans from 45 percent in 1996 to 57 percent in 2006. Freddie's increase was only slightly less dramatic.

As evidenced in their public disclosures, Fannie and Freddie both took meeting their housing goals quite seriously. Up until 2001, the goals were close to being nonbinding and likely had little impact on the GSEs' business, as the goals were set significantly below the market. After that time, their housing goals mirrored the market and were set to gradually move up from the lower market estimates to the higher end of market estimates.

It is tempting to view the ex post facto explanation by former Fannie CEO Dan Mudd as nothing more than an attempt to deflect attention away from his mismanagement and toward the actions of Congress and HUD. Clearly there was mismanagement at both companies, yet Fannie Mae's disclosures to the SEC, which were subject to the fraud provisions of the Securities Exchange Act of 1934, illustrate that long before their failures Fannie Mae was concerned that the housing goals were creating substantial credit risk. As a staffer for the Senate Banking Committee, I also remember a meeting in 2007 with senior Freddie Mac executives where they expressed a deep concern that both the housing goals and congressional pressure to extend lending to riskier borrowers were going to result in substantial losses.

After their accounting scandals in 2003 and 2004, both Fannie and Freddie were facing the possibility of substantial new regulation. Having served as a staffer on every Senate Banking Committee hearing on the GSEs between 2003 and 2009, I can attest that many Democratic members of the Committee made very clear their belief that Fannie and Freddie were not currently meeting the needs of low-income borrowers, and that if Fannie and Freddie expected to continue receiving public benefits, it was in their best interest to comply with these demands.

With so few years of data, it is likely impossible to gauge the exact impact of the GSEs' housing goals. What we do know is that at the same time that the housing goals increased and became binding, the GSEs increased their purchases of subprime mortgages and mortgage-backed securities. This suggests that in the absence of the housing goals, GSE purchases of subprime would likely have been lower. Of course, none of this changes the fact that when an institution has a line of business leveraged over 200 to 1, as was the GSE guarantee business, then even the best managers who only bought prime mortgages would still see massive losses. Given the nature of their implicit guarantee, Fannie and Freddie were always a disaster waiting to happen. The increase in their housing goals, beginning in 2001 and accelerating in 2005, simply made that disaster a larger one.

Conclusion

Reviewing their own financial disclosures and the statistical releases of their regulator, it becomes abundantly clear that Fannie Mae and Freddie Mac were not only the largest players in the subprime mortgage market, they were drivers of that market. During the height of the bubble, close to 30 percent of each GSEs' direct mortgage purchases could be characterized as subprime. At the same time, Fannie and Freddie also purchased about 40 percent of newly issued private-label subprime mortgage-backed securities, making them the largest single source of liquidity for that market. Less clear is why in the middle of the first decade of the 21st century these two companies embarked on a strategy of massive involvement in subprime. Fannie Mae and Freddie Mac would have required a massive bailout anyway, but their significant involvement in subprime made that bailout substantially larger.

Defenders of Fannie and Freddie have painted the companies as nothing more than "victims" of a housing market gone sour. To the degree they were victims, it was victims of political meddling and perverse monetary policy. While eliminating Fannie and Freddie would go a long way toward protecting the taxpayer and our economy, such a step should only be the beginning of much needed reform to our system of financial regulation and monetary policy.

Ultimately taxpayers and the broader economy will only be protected from future bailouts by a full withdrawal of the federal government from housing policy. Policy interventions, such as those by the Federal Housing Administration and the Federal Home Loan Banks, continue to distort capital toward the housing market, while our commercial banking system remains vulnerable to downturns in the housing market. Our financial system would become considerably more stable were Washington to abandon its attempts to direct capital to politically favored segments of the economy.

Notes

1. For a list of subprime lenders, including a time series of firms, see HUD's list at http://www.huduser.org/portal/datasets/manu.html.

2. Data on mortgage rates and terms are taken from the Federal Housing Finance Agency's Monthly Interest Rate Survey for various dates. See http://www.fhfa.gov/Default.aspx?Page=250.

3. Remarks by Federal Reserve Governor Edward Gramlich, May 21, 2004, http://www.federalreserve.gov/boarddocs/speeches/2004/20040521/default.htm.

4. Ibid.

5. Mortgage Bankers Association, Mortgage

At the same time that the housing goals increased and became binding, the GSEs increased their purchases of subprime mortgages.

Origination Estimates, http://www.mbaa.org/files/Research/HistoricalWAS/HistoricalMortgageOriginationEstimates 102610.xls.

6. Balance-sheet and income-statement data for Fannie Mae and Freddie Mac are taken from the Office of Federal Housing Enterprise Oversight 2008 Report to Congress, http://www.fhfa.gov/Default.aspx?Page=210.

7. Ibid.

8. Typical of this claim is James Kwak, who writes "that Fannie and Freddie simply could not legally buy or guarantee the worst of the subprime loans." See James Kwak, "The Calomiris-Wallison Citation," 13 Bankers, May 18, 2010, http://13bankers.com/2010/05/18/calomiris-wallison-citation/. Paul Krugman claims "they [Fannie and Freddie] didn't do any subprime lending, because they can't: the definition of a subprime loan is precisely a loan that doesn't meet the requirement, imposed by law, that Fannie and Freddie buy only mortgages issued to borrowers who made substantial down payments and carefully documented their income." "Fannie, Freddie and You," *New York Times*, July 14, 2008.

9. Pub L. No. 91-351, 12 U.S.C. 1451.

10. 12 C.F.R. 1720.

11. It should be noted that there is no generally accepted definition of "predatory" lending. While fraud is accepted as "predatory" the inclusion of high interest rates and certain features, such as prepayment penalties, is hotly debated as to whether such voluntary agreed-to contract features are "predatory."

12. A FICO score is a number that measures the likelihood that a borrower will repay the loan in question. FICOs, developed by the Fair Isaac Corporation, are the most widely used of such scores. The scores range from 300 to 850, with higher scores indicating greater probability of repayment.

13. See *The Subprime Mortgage Market*, 2007 Annual Report, Federal Reserve Bank of San Francisco, http://www.frbsf.org/publications/federalreserve/annual/ 2007/subprime.pdf.

14. The Office of Federal Housing Enterprise Oversight 2008, Report to Congress, http://www.fhfa.gov/Default.aspx?Page= 210.

15. Earlier estimates were significantly lower both because of differing definitions of subprime as well as a restatement of data by Fannie Mae. See James Barth, *The Rise and Fall of the U.S. Mortgage and Credit Markets* (Hoboken, New Jersey: John Wiley & Sons, Inc., 2009).

16. Wallison and Calomiris, "The Last Trillion-Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac," *AEI Financial Services Outlook*, September 2008.

17. Freddie Mac Update, May 2010, www.freddiemac.com/investors/pdffiles/investor-presentation.pdf.

18. See *The Credit Scoring Site* at http://www.creditscoring.com/average/trend.html.

19. TransUnion Consumer Solutions, "Your Credit Score," TransUnion, https://www.transunioncs.com/TCSWeb/samples/ficoScoreSample.do;jsessionid=34dHNK1T552j1jLpl8VHGLwfBhVcLbqyJKQdjlv3vTlL9YswWT9T!1507477424.

20. Freddie Mac Update, May 2010, www.freddiemac.com/investors/pdffiles/investor-presentation.pdf.

21. Ibid.

22. Ibid.

23. Ibid.

24. Ibid.

25. See, generally, Kerry D. Vandell, "Handing over the Keys: A Perspective on Mortgage Default Research," *Journal of the American Real Estate and Urban Economics Association* 21, no. 3 (1993): 211–46.

26. Fannie Mae Foundation, "Making New Mortgage Markets: Case Studies of Institutions, Home Buyers and Communities," 2000.

27. *Mortgage Market Statistical Annual 2008*, Inside Mortgage Finance Publications.

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31. Fannie Mae Foundation, "Making New Mortgage Markets."

32. Ibid.

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34. *Mortgage Market Statistical Annual 2008*.

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36. "New Century Files for Chapter 11 Bankruptcy," *CNNMoney.com*, April 3, 2007, http://money.cnn.com/2007/04/02/news/companies/new_century_bankruptcy/.

37. Federal Housing Enterprise Oversight 2008, Report to Congress, http://www.fhfa.gov/Default.aspx?Page=210.

38. "Mortgage Markets and the Enterprises in 2006," Office of Federal Housing Enterprise Oversight, 2007, http://www.fhfa.gov/webfiles/1161/MortgageMarkets 2006.pdf.

39. *Mortgage Market Statistical Annual 2008*.

40. For the failures of Basel, see Kevin Dowd and Martin Hutchinson, *Alchemists of Loss* (Chichester, UK: John Wiley & Sons, 2010).

41. Board of Governors of the Federal Reserve System, *Monthly Report on Credit and Liquidity Programs and the Balance Sheet*, July 2010, http://www.federalreserve.gov/monetarypolicy/clbs_specific_lending_201007.htm.

42. The statutory interim target was to have 30 percent of purchases going to low- and moderate- income households.

43. 12 U.S.C. 4561.

44. Federal Housing Finance Agency, Mortgage *Market Note 10-2: The Housing Goals of Fannie Mae and Freddie Mac in the Context of the Mortgage Market: 1996–2009*, http://www.fhfa.gov/webfiles/15419/Housing_Goals_1996-2009_02-01. pdf.

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