Joint Economic Committee
Republicans
Senator Sam Brownback *Ranking Member*
Representative Kevin Brady *Senior House Republican*

Republican Staff Commentary

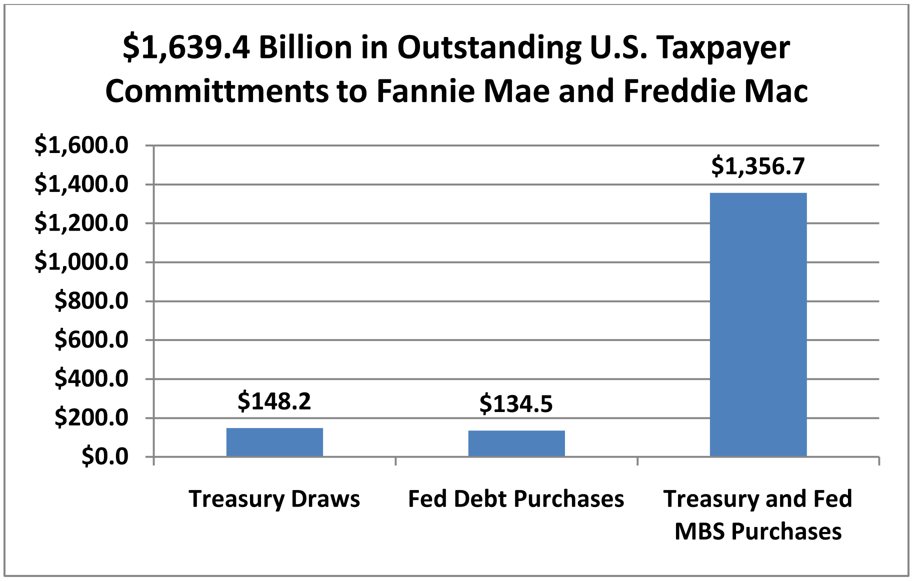
- Three and a half years after the housing collapse, Congress has done little to address the housing finance market's basic problem: Fannie Mae and Freddie Mac.
- These two firms were primary actors in the creation of a housing bubble, the bursting of which triggered the global financial crisis.
- The government-sponsored enterprise business model is inherently flawed because it inevitably creates significant market distortions.
- These distortions flow both unintentionally, from the competitive market dynamics the GSEs create, and intentionally, from government interventions into the housing market through the GSEs.
- The distorted incentives created by the interaction among Fannie, Freddie and affordable housing policy have been particularly costly for taxpayers.
- Allowing the GSE model to persist perpetuates a major source of systematic risk in financial markets.

Unresolved Systemic Threat:
How Fannie and Freddie Triggered a Global Financial Crisis and Could Do It Again

November 17, 2010

THREE YEARS LATER AND LITTLE TO NO ACTION

On April 2, 2007, New Century Financial Corporation, the Nation's second largest subprime mortgage lender, filed for bankruptcy, signaling the bursting of the housing bubble and the onset of the global financial crisis.[1] Although President Obama signed the *Dodd–Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank) into law on July 21, 2010, Congress has so far failed to fix the housing finance market's basic problem: the distorted incentives created by the interaction among two housing finance government sponsored-enterprises (GSEs)—the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac)—and policies aimed at providing affordable housing for low-and moderate-income families.[2] Fannie and Freddie proved to be a **systemic risk**; they helped inflate the housing bubble that triggered the global financial crisis. The GSEs' business model distorted the market for housing finance and ultimately led to their insolvency. And, American taxpayers are paying for it.



"These two entities—Fannie Mae and Freddie Mac—are not facing any kind of financial crisis. The more people exaggerate these problems, the more pressure there is on these companies, the less we will see in terms of affordable housing."

Rep. Barney Frank
Chairman, House Financial Services Committee
New York Times, September. 11, 2003

The U.S. Treasury has injected $148 billion into Fannie and Freddie. Some observers predict that mounting losses at Fannie and Freddie may cost the Treasury up to $363 billion.[3] Additionally, the Treasury and Federal Reserve together have purchased more than $1.35 trillion in residential mortgage-backed securities (RMBS) issued by Fannie and Freddie, and the Federal Reserve alone has purchased $134.5 billion in unsecured debt issued by Fannie and Freddie.[4] Additional losses associated with these "investments" may be recognized in future years.

In the wake of the global financial crisis, Congress enacted two major pieces of housing regulatory reform legislation—the *Housing and Economic Recovery Act of 2008* (HERA) and Dodd-Frank.[5] Neither addresses the underlying problems Fannie and Freddie create in the housing finance market, nor do they do anything to confront the ambiguity surrounding the fate of Fannie and Freddie and their burden on taxpayers. HERA, described as "the most far-reaching and historic reform of our nation's housing finance system in a generation[,]" created the Federal Housing Finance Authority (FHFA), a unified prudential GSE regulator.[6] But, more than anything else, FHFA simply shores up a previous oversight regime that had been largely illusory.[7] Dodd-Frank, touted as a "sweeping overhaul of the nation's financial services industry," increased capital requirements for certain mortgage securitizers and created new mortgage-related consumer protections.[8] Yet, it ignored the primary role that Fannie and Freddie played in inflating the housing bubble, the bursting of which triggered the global financial crisis.[9]

This response is best characterized as penny-wise, pound-foolish, because it neglects to resolve the insolvency of Fannie and Freddie and to reform these giant players in the residential housing finance market. Fannie Mae and Freddie Mac are broken; the government-sponsored enterprise business model is inherently flawed because it inevitably creates significant market distortions. Allowing the GSE model to persist perpetuates a major source of systematic risk in financial markets.

This commentary, the first in a two-part series, discusses the structural flaws of the government-sponsored enterprise business model in the pre-conservatorship era. The second part of this series will present alternatives for reforming Fannie Mae, Freddie Mac and the residential housing finance market.

FANNIE'S AND FREDDIE'S PURPOSE AND BUSINESS

Congress initially chartered Fannie and Freddie "to address concerns that private institutions were not adequately meeting the credit needs of homebuyers."[10] Because of interest-rate risk and localized market conditions, banks and other depository institutions were ill-equipped to hold long-term, fixed-rate residential mortgage loans on their books, limiting the availability of residential mortgage credit. The primary function of Fannie and Freddie was to "enhance the availability of mortgage credit across the nation."[11] Congress envisioned that Fannie and Freddie would purchase conforming residential mortgage loans from originators, package these loans into federal agency RMBS, guarantee the performance of these federal agency RMBS, and sell them to investors that were better able to take interest-rate risk.[12] The securitization and guarantee function provided "liquidity and stability to the secondary market for residential mortgages."[13]

A secondary function of Fannie and Freddie was to support "targeted groups of borrowers."[14] Targeted borrowers were defined by goals imposed by the Department of Housing and Urban Development (HUD).[15] Collectively, both the primary and secondary functions became known as the GSEs' public mission (or mandate).

Fannie Mae was nominally privatized in 1968, and Freddie Mac was nominally privatized in 1989.[16] Once these government agencies had private shareholders, their senior managements were required to maintain a delicate balance between the GSEs' public mission and their fiduciary duties to the GSEs' shareholders.

As undiversified financial services firms, Fannie and Freddie had two distinct lines of business. The securitization of conforming residential mortgage loans and the guarantee of the performance of these federal agency RMBS for a fee, known as "the guarantee business," was initially their main line of business. However, Fannie and Freddie became increasingly engaged over time in a second, riskier, but more profitable line of business—purchasing and retaining whole residential mortgage loans, federal agency RMBS, and RMBS issued by private firms for the GSEs' own investment portfolio. This was their so-called "portfolio business." To fund these operations, Fannie and Freddie sold unsecured debt securities to investors in the capital markets.

A Fundamentally Flawed Business Model

The GSE model is fundamentally flawed because it inevitably leads to dangerous market distortions. These distortions can occur unintentionally, as a result of the competitive dynamics created by the GSE model, or intentionally, as a result of government interventions into the housing market through Fannie and Freddie. Theory might suggest that the GSEs should be able to reconcile their various responsibilities, navigate the potential conflicts of interest, and simply act like privately owned and operated corporations with public missions. But, experience demonstrates otherwise.

Fannie Mae and Freddie Mac create market distortions for four reasons:

First, their government charter burdens Fannie and Freddie with an **irreconcilable dual mandate**. On one hand, the GSEs must act like private firms—taking risks to maximize profits. On the other hand, they must act like government agencies—maximizing social welfare. Former Fannie Mae CEO Daniel Mudd, described his firm as being "engaged in a continual struggle to balance all of the requirements of its public mission, along with all of the duties owed to its shareholders."[17] Of course, both mandates are legitimate. But, over time, one of two things will happen when they compete within one organization: either one mandate will take priority and marginalize the other or the tension between the mandates will frustrate the GSEs' ability to fulfill either mandate.

The public mission, in particular, also creates a statutory hook by which interested policymakers can direct the activities of Fannie and Freddie. This phenomenon will be discussed later with respect to affordable housing policy. It was a key factor that caused market distortions leading up to the global financial crisis.

Second, Fannie and Freddie have **market power**. Specifically, the government has granted them several regulatory advantages over their private rivals. These advantages were initially intended to facilitate the firms' ability to achieve their public mission. That they did. However, they also contributed to the GSEs' ability to engage in risky behavior, increase leverage, and literally move markets. Table one provides a summary of the myriad advantages the GSEs were granted:

TABLE 1: The Pre-Conservatorship Advantages of Fannie and Freddie over Private Rivals	
Borrowing Costs:	Borrowed at lower interest rates than private rivals due to an implicit government guarantee
Reserves:	Allowed lower capital ratios than private rivals
Credit:	Held a permanent $2.5 billion line-of-credit to the U.S. Treasury
Taxes:	Exempt from state and local taxes
Investment:	Issued securities received a reduced risk-weighting; characterized similarly to U.S. Treasuries[18]
Transparency:	Exempt from SEC registration and filing requirements[19]
Oversight:	Subject to the weak regulation and oversight under OFHEO

These advantages also led to the widely held belief (that ultimately proved correct) that Fannie and Fannie had a government backstop. Thus, these advantages encouraged their managements to take excessive risks without market discipline.

Third, "[d]espite having a unique legal status and a long history linking them closely to the federal government," Fannie's and Freddie's operations are considered off-budget for Federal budget purposes.[20] In effect, Fannie and Freddie can be **used to dispense housing subsidies outside of the appropriations process**. They create the largest "earmark" in history. According to the Congressional Budget Office, this subsidy amounted cumulatively to $291 billion for GSE operations at the time the government imposed conservatorships.[21] In practice, this special status protected the GSEs from facing proper oversight and accounting. It was a case of "out of sight, out of mind."

Finally, the public mission of Fannie and Freddie addresses a particularly sensitive policy area—**affordable housing**. This phenomenon is highlighted by President Clinton's "National Homeownership Strategy: Partners in the American Dream[,]" adopted in 1995.[22] It continued in 2002 with President Bush's "A Home of Your Own: Expanding Opportunities for All Americans."[23] Over time, homeownership became sacrosanct—a political third-rail. For example, under these initiatives, prudent lending standards were re-characterized as "barriers to homeownership," and consequently, barriers to the American Dream. This further immunized the GSEs' operations from those who raised red flags leading up to the housing crisis.[24]

Each of these risky characteristics is inextricably linked to the GSE model of Fannie and Freddie. Therefore, the model itself should be phased-out in order to mitigate future risks.

TWO WAYS THAT FANNIE AND FREDDIE DISTORTED THE HOUSING FINANCE MARKET

In the lead-up to the global financial crisis, Fannie and Freddie distorted the housing finance market in two fundamental ways: by disrupting competitive markets and by implementing affirmative efforts to expand homeownership to low- and moderate-income households. Each contributed to a wholesale loosening of residential mortgage loan underwriting standards and increased risk-taking, which drove the unsustainable increase in homeownership rates and the associated appreciation in housing prices.

An unintentional distortion: Competitive market dynamics. The first market distortion is best explained using basic economics. Because of their regulatory advantages, Fannie and Freddie are endowed with unmatched market power. These advantages lower their cost of capital and enable Fannie and Freddie to crowd private firms out of the markets they enter. Competitors can't generate sufficient returns-on-equity to justify operating head-to-head with Fannie and Freddie. As a result, the conforming loan financing market became essentially a duopsony.[25]

However, private firms don't sit idly on the sidelines. Naturally, they seek profits elsewhere. For example, for years, private firms operated in the profitable jumbo loan market where Fannie and Freddie were statutorily prohibited from entering because of their conforming loan limits. As Fannie and Freddie grew and their conforming loan limits were increased, private firms sought additional profits at the margins of the market by servicing less creditworthy borrowers and entering the subprime market. Again, Fannie and Freddie grew and began to encroach on the private market by entering the A- subprime arena beginning in 2000.[26] A natural response was for private firms to move further out the risk curve and service even higher-risk borrowers. It also necessitated a loosening of lending standards in order to enable less creditworthy borrowers to qualify for residential mortgage loans. This increased systemic risk.

An intentional distortion: Affordable housing policy. The increase in risk-taking was not solely an unintended effect of the Fannie's and Freddie's presence in the market, but also a response to affirmative government intervention in the housing finance market through the GSEs.[27] In the early 1990s, the interests of three groups converged and focused on housing policy: (1) Fannie and Freddie, seeking to retain their advantages, (2) community groups, seeking to improve low-income homeownership rates, and (3) policymakers, seeking popular policy ends within the constraints of new budget and accounting rules.[28]

The *Budget Enforcement Act of 1990* and the *Federal Credit Reform Act of 1990* had recently passed, the combined effect of which was to restrain government spending and require an accounting of Federal subsidies as a budget item.[29] Among other things, the *Budget Enforcement Act* created new caps on discretionary spending. The *Federal Credit Reform Act* required Federal agencies to account for the cash value—or "subsidy cost"—of direct loans and loan guarantees in the year the loans were made, rather than year by year over the term of the loan or guarantee. Together, these rules made the traditional instruments of affordable housing policy—the FHA, VA and USDA, utilizing the explicit guarantee of Ginnie Mae—less attractive because it effectively made them more costly. This created a problem for groups seeking increased affordable housing subsidies. A solution was found by exploiting the flawed off-budget GSE model; the groups lobbied for legislation that eventually became *The Federal Housing Enterprises Safety and Soundness Act of 1992* (a.k.a. the GSE Act).[30]

The GSE Act had a powerful effect. Fannie and Freddie effectively became the primary instruments that policymakers used to subsidize low-income home ownership, ensuring the GSEs their regulatory advantages.[31] Community groups and policymakers supercharged the effect of affordable housing by moving the bulk of federal housing subsidies off balance-sheet.[32] While the primary purpose of Fannie and Freddie had traditionally focused on providing liquidity and stability to the residential mortgage market, the GSE Act shifted the firms' focus to their secondary goal of targeting HUD-specified borrower groups.

Immediately following the enactment of the GSE Act and increasingly over time, HUD ratcheted up the affordable housing mandates it imposed on Fannie and Freddie under the GSE Act. They began at 30% (measured as a percentage of total business). That was the rate the GSEs' had previously fulfilled. Then in 1996, they were increased to 40%. By 2001, the percentage was equal to 50% of total business, and from 2005-2008 it was incrementally increased to an even more unsustainable level of 56%.

TABLE 2: HUD-Imposed Affordable Housing Purchase Goals[33]

	1993-1995	1996	1997-2000	2001-2004	2005	2006	2007	2008
Low- and Moderate-Income[34]	30%	40%	42%	50%	52%	53%	55%	56%
Special Affordable[35]	N/A	12%	14%	20%	22%	23%	25%	27%
Underserved Areas[36]	30%	21%	24%	31%	37%	38%	38%	39%

These affordable housing goals drove the GSEs and the market into new territory, particularly with respect to the special affordable goals during the period between 2001 and the beginning of the crisis. For example, some reports estimate that Fannie and Freddie purchased $434 billion in privately issued RMBS securities backed by subprime loans to fulfill the goals as they increased.[37] Former Fannie Mae Chief Business Officer Robert Levin, who worked at the firm from 1981 until shortly after conservatorship was imposed, explains:

> Our mission regulator raised these goals from time to time, and they frequently required levels of affordable housing and underserved market business that were higher than what our market was naturally producing. This required the company to engage in **affirmative efforts**, including outreach programs and application of different underwriting and pricing standards, **to create business** to help us meet our goals [emphasis added].[38]

Engaging in affirmative efforts to create business in the affordable housing arena required Fannie and Freddie to support the proliferation of "innovative" residential mortgage loan products. Essentially, these are residential mortgage loan products that have fewer risk mitigation characteristics than the traditional 20% down, 30-year fixed rate mortgages. For example, lowering the required downpayment from 20% to 10%, and then eventually to 3% made homes more affordable. It also pushed housing prices up, and reduced borrower's "skin in the game." As a result, as the bubble approached its height, it only took a minimal decrease in home prices to put millions of borrowers underwater. This increased the rate of foreclosures and reinforced the downward spiral in prices.

Fannie's and Freddie's appetite for AAA-rated tranches of privately issued subprime RMBS helped fan the market. They also embraced so-called Alt-A mortgage loans, which had higher risk characteristics because they did not require borrowers to fully document their income and assets, and thus their ability to service their mortgages.

Fannie, Freddie, and HUD took a leadership role in pushing the market to loosen standards, thereby achieving their goals and increasing homeownership, but also increasing risk. It appears that this was HUD's intended result:

> While leadership may be exhibited through the GSEs' introduction of innovative products, technology, and processes through established partnerships and alliances with local communities and community groups . . . **[t]he GSEs' obligation to lead the industry** entails leadership in facilitating access to affordable credit in the primary market for borrowers at different income levels and housing needs, as well as for underserved urban and rural areas [emphasis added].[39]

The GSEs fulfilled this obligation, and Fannie and Freddie did influence the direction of the housing finance market. This was partially because they were the largest providers of capital to the market. Fannie and Freddie also led the standardization and use of automated electronic underwriting systems. However, it was largely due to a joint, concerted effort by Fannie, Freddie, and HUD:

> More liberal mortgage financing has contributed to the increase in demand for housing. During the 1990s, lenders have been encouraged by HUD and banking regulators to increase lending to low-income and minority households. *The Community Reinvestment Act* (CRA), *Home Mortgage Disclosure Act* (HMDA), government-sponsored enterprises (GSE) housing goals and fair lending laws have strongly encouraged mortgage brokers and lenders to market to low-income and minority borrowers. Sometimes these borrowers are higher risk, with blemished credit histories and high debt or simply little savings for a down payment. Lenders have responded with low down payment loan products and automated underwriting, which has allowed them to more carefully determine the risk of the loan. . . . The net effect has been a booming mortgage market that has generated strong demand for housing, which, in turn, has boosted house prices.[40]

Fannie and Freddie, acting with HUD's encouragement, set the stage for the housing bubble, its bursting, and the ensuing global financial crisis. Fannie and Freddie played a major role because their GSE business model made them inherently susceptible to political influence.

THE GLOBAL IMPACT OF FREDDIE AND FANNIE

Fannie and Freddie pose a global systemic threat because their preferred regulatory status artificially increased their size as well as the riskiness of their operations.[41] To begin, global investors perceived GSE-issued securities as inherently safe because they carried the implicit guarantee of the U.S. government. This naturally increased the demand among global investors for debt securities and RMBS issued by Fannie and Freddie.

Worldwide bank capital standards reinforced this perception. Under the Basel I Accord, commercial banks and other depository institutions were allowed to hold securities issued by Fannie and Freddie—RMBS, unsecured debt, and even preferred shares—at a 20% risk-weighting.[42] This equated to a 1.4% minimum required capital ratio for holding such securities. In contrast, other loans to households and private firms had a 100% risk-weighting that equated to an 8.0% minimum capital ratio. This differential strongly incentivized commercial banks and other depository institutions around the world to load up on debt securities and RMBS issued by Fannie and Freddie as a means for increasing leverage and returns.

Ironically, this preference in bank capital standards undermined one of the major objectives that Congress had in chartering Fannie and Freddie, that is, using securitization to transfer the interest-rate risk associated with long-term, fixed-rate residential mortgages away from banks and other depository institutions dependent on deposits and other short-term funding sources and to long-term equity investors, such as insurance companies and pension funds that can more easily handle this risk. What happened instead was a concentration of RMBS and their associated risks in banks and other depository institutions.

The government-granted advantages Fannie and Freddie enjoyed enabled them to grow much larger than they otherwise would have, all else equal. However, the government's limitations on Fannie and Freddie were also problematic. Because they were necessarily undiversified, Fannie and Freddie managed their portfolio interest rate risk profile by engaged in extensive hedging strategies with a wide range of counterparties.[43]

Taken together, these factors make the market for GSE-issued securities very large and very important. In fact, there were $6.6 trillion in outstanding GSE-issued securities in the market as of the second quarter of 2010.[44] This is 58% the size of the entire U.S. corporate and foreign bond market.[45] It also meant that Fannie and Freddie had a global investor and counterparty base that was both diverse and wide-ranging. As a result, when Fannie and Freddie became insolvent in 2008, Secretary of the Treasury Henry Paulson felt that Fannie and Freddie had to be placed into conservatorships and receive taxpayer funds to cover their losses to dampen the negative impact their failure would have on financial institutions and markets around the world.[46]

CONCLUSION

The missteps Fannie and Freddie took, and the market disruptions they caused, were direct consequence of the government-sponsored enterprise business model. Four basic characteristics —irreconcilable mandates, government-granted market power, off-budget status and the affordable housing policy—make the GSE model an inevitable failure. The natural market dynamics the model creates lead to increased risk-taking over time. And, Fannie and Freddie are particularly vulnerable to the meddling of policymakers seeking to circumvent the appropriations process to promote affordable housing. These characteristics are fundamental to the GSE model. They cannot be resolved through enhanced regulation or oversight alone. As GSEs, Fannie and Freddie remain systemic threats to global financial markets.

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[1] For a comprehensive financial crisis timeline, *see* Federal Reserve Bank of St. Louis, The Financial Crisis: A Timeline of Events and Policy Actions, *available at* http://timeline.stlouisfed.org.

[2] PL 111-203 (July 21, 2010), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_public_laws&docid=f:publ203.111.pdf.

[3] Federal Housing Finance Agency, Projections of the Enterprises' Financial Performance (October 2010), *available at* http://www.fhfa.gov/webfiles/19409/Projections_102110.pdf. Regardless of the ultimate cost, the U.S. Treasury made an open-ended commitment to support Fannie and Freddie through the end of 2012.

[4] These figures exclude commitments to Ginnie Mae. Federal Housing Finance Agency, Data as of October 1, 2010 on Treasury and Federal Reserve Purchase Programs for GSE and Mortgage-Related Securities, *available at* www.fhfa.gov/webfiles/17990/TreasFED10012010.pdf.

[5] PL 110-289 (July 30, 2008), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_public_laws&docid=f:publ289.110.pdf.

[6] Pelosi, Nancy, Press Release, Pelosi Statement on Sending Housing Bill to White House (July 28, 2008), *available at* http://pelosi.house.gov/news/press-releases/2008/07/releases-July08-housing-bill.shtml.

[7] The former regulatory scheme was fragmented—consisting of the Office of Federal Housing Enterprise Oversight (OFHEO), the Federal Housing Finance Board, and the Department of Housing and Urban Development—and ill-equipped to oversee the GSEs' financial soundness or housing mission. See e.g.; Government Accountability Office, Housing Government-Sponsored Enterprises: A New Oversight Structure is Needed (April 21, 2005), *available at* http://www.gao.gov/new.items/d05576t.pdf.

[8] Frank, Barney, Press Release, President Signs Dodd-Frank Wall Street and Consumer Protection Act (July 21, 2010) *available at* http://www.house.gov/frank/pressreleases/2010/07-21-10-wall-street-reform-signing.html.

[9] Section 1074 of Dodd-Frank essentially passed the buck to the 112th Congress by calling for the U.S. Treasury to conduct and complete a "study on ending the conservatorship of Fannie Mae, Freddie Mac, and reforming the housing finance system" by January 31, 2011. PL 111-203, Section 1074, *available at* http://frwebgate.access.gpo.gov/cgibin/getdoc.cgi?dbname=111_cong_public_laws&docid=f:publ203.111.pdf.

[10] A New Oversight Structure is Needed, *supra* note 7.

[11] Federal National Mortgage Association Charter Act, *available at* http://www.fhfa.gov/GetFile.aspx?FileID=29.

[12] Mortgage originators include commercial banks, other depository institutions, and mortgage banks, while mortgage investors include insurance companies and pension funds, among others. Conforming loans are those mortgages that meet the GSEs' underwriting requirements, as set by their regulator, *see* FHFA, Loan Limits for Conventional Mortgages (2010), *available at* https://www.efanniemae.com/sf/refmaterials/loanlimits/.

[13]A New Oversight Structure is Needed, *supra* note 7.

[14] *Id*.

[15] *Id*.

[16] The initial quasi-privatization removed Fannie's and Freddie's debt from the Federal government's balance sheet.

[17] Written Testimony of Daniel H. Mudd, Former President and CEO of Fannie Mae, before the Financial Crisis Inquiry Commission (April 9, 2010), *available at* http://www.fcic.gov/hearings/pdfs/2010-0409-Mudd.pdf.

[18] GSE-issued securities with only a given a 20% risk-weighting, rather than the 100% risk weighting of similarly issued private securities. 12 C.F.R. 3, App. A Section 3(A)(2)(vii). *See also* Office of the Comptroller of the Currency, Interpretive Letter #964 (May 2003), *accessed at* http://www.occ.gov/static/interpretations-and-precedents/may03/int964.pdf.

[19] Fannie Mae voluntarily registered its common stock with the Securities and Exchange Commission (SEC) effective March 31, 2003, although "[u]nfortunately, many of Fannie Mae's periodic disclosure [were] late or incomplete." Testimony of Christopher Cox, SEC Chairman, before the U.S. Senate Committee on Banking, Housing and Urban Affairs (June 15, 2006), *available at* http://www.sec.gov/news/testimony/2006/ts061506cc.htm. Freddie Mac voluntarily registered its common stock with the SEC effective July 18, 2008.

[20] Congressional Budget Office, CBO's Budgetary Treatment of Fannie Mae and Freddie Mac (January 2010), *available at* http://www.cbo.gov/ftpdocs/108xx/doc10878/01-13-FannieFreddie.pdf.

[21] *Id*.

[22] *See e.g.*, Clinton, William J., Remarks on the National Homeownership Strategy (June 5, 1995), *available at* http://www.presidency.ucsb.edu/ws/index.php?pid=51448; The National Homeownership Strategy: Partners in the American Dream (May 1995) *available at* http://web.archive.org/web/20010208183325/www.huduser.org/publications/affhsg/homeown/toc.html.

[23] *See e.g.*, Bush, George W., Remarks by the President on Homeownership (June 17, 2002), *available at* http://georgewbush-whitehouse.archives.gov/news/releases/2002/06/20020617-2.html; A Home of Your Own: Expanding Opportunities for All Americans (June 2002), *available at* http://georgewbush-whitehouse.archives.gov/infocus/homeownership/toc.html.

[24] *See* McLean, Bethany, Fannie Mae's Last Stand, Vanity Fair (February 2009), *available at* http://www.vanityfair.com/politics/features/2009/02/fannie-and-freddie200902.

[25] A duopsony is an economic condition, similar to a duopoly, in which there are only two large buyers for a specific product or service. Members of a duopsony have great influence over sellers and can effectively lower market prices for their supplies. *See* Investopedia, Definition: Duopsony, *available at* http://www.investopedia.com/terms/d/duopsony.asp.

[26] 24 CFR Part 81, Department of Housing and Urban Development, HUD's Regulation of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac): Final Rule (October 31, 2000), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=2000_register&docid=f:31ocr2.pdf.

[27] *See* Committee on Oversight and Government Reform, Staff Report, The Role of Government Affordable Housing Policy in Creating the Global Financial Crisis of 2008 (Updated May 12, 2010), *available at* http://republicans.oversight.house.gov/images/stories/Reports/20100512affordablehousingpolicyandthefinancialcrisis.pdf.

[28] PL 91-508. For a comprehensive analysis of the convergence of affordable housing policy and the GSEs in the lead-up to the financial crisis, *see* Pinto, Edward J., Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study, Discussion Draft (August 2010) *available at* http://www.aei.org/docLib/Pinto-Government-Housing-Policies-Crisis.pdf.

[29] *Id*. *See also* Titles V and XIII, PL 101-508.

[30] Title XIII, PL 102-550.

[31] Previously, the Federal Housing Authority (FHA) and the Veteran's Administration (VA) serviced most of the low-income market. As Fannie and Freddie expanded into that area, their market shares declined precipitously, and the risk of their portfolios increased because the GSEs took on many of the higher quality subprime loans that would have gone to the FHA.

[32] Wallison, Peter J. and Calomiris, Charles W., The Last Trillion-Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac, AEI Press (September 2008), *available at* http://www.aei.org/docLib/20080930_Binder1.pdf.

[33] Table 1, Preliminary Staff Report, Financial Crisis Inquiry Commission, Government-Sponsored Enterprises and the Financial Crisis (April 7, 2010), *available at* http://www.fcic.gov/reports/pdfs/2010-0409-GSEs.pdf. *See also* FHFA, Mortgage Market Note 10-2, The Housing Goals of Fannie Mae and Freddie Mac in the Context of the Mortgage Market: 1996-2009 (February 1, 2010), *available at* http://www.fhfa.gov/webfiles/15408/Housing%20Goals%201996-2009%2002-01.pdf.pdf.

[34] The low- and moderate-income goal targets "borrowers or renters earning no more than the area median income where they reside." 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 (Feb. 2010). *Id*.

[35] The special affordable goal targets "borrowers or renters earning no more than 60 percent of area median income or residing in low-income census tracts and earning no more than 80 percent of area median income." *Id*.

[36] The underserved areas goal targets "borrowers or renters residing in lower income areas (90 percent of area median income in metropolitan areas and 95 percent of area median income in nonmetropolitan areas), or higher minority areas (tract minority percentage at or above 30 percent where the tract median income is no more than 120 percent of area median income)." *Id*.

[37] *See* Leonnig, Carol D., How HUD Mortgage Piolicy Fed the Crisis, The Washington Post (June 10, 2008), *available at* http://www.washingtonpost.com/wp-dyn/content/article/2008/06/09/AR2008060902626.html. It is difficult to account for Fannie's and Freddie's actual subprime purchases because there is no consensus on what constitutes a subprime loan. This can lead to accounting problems. For example, FHFA had to revise their Annual Report to Congress by re-characterizing $53.53 billion in private-label securities Fannie Mae purchased from 2002-2008 as "subprime." *See* FHFA, Report to Congress (Revised) (2008), *available at* http://www.fhfa.gov/webfiles/2335/FHFA_ReportToCongress2008508rev.pdf.

[38] Written Testimony of Robert J. Levin, Former CBO of Fannie Mae, before the Financial Crisis Inquiry Commission (April 9, 2010), *available at* http://www.fcic.gov/hearings/pdfs/2010-0409-Levin.pdf.

[39] 24 CFR Part 81, *supra* note 26.

[40] U.S. Department of Housing and Urban Development, Recent House Price Trends and Homeownership Affordability (May 2005), *available at* http://www.huduser.org/Publications/pdf/RecentHousePrice.pdf.

[41] The Federal Reserve Bank of Cleveland has described one useful framework for understanding systemic risk, focusing on: (1) contagion, (2) concentration, (3) correlation, and (4) context. Applied to this framework, the characteristics of Fannie and Freddie suggest that they are systemically important. Federal Reserve Bank of Cleveland, 2009 Annual Report Essay: Putting Systemic Risk on the Radar Screen, *available at* http://www.clevelandfed.org/About_Us/annual_report/2009/2009_essay.cfm.

[42] *See supra* note 18. The standards also created a general preference for investing in residential mortgage assets by giving such assets a 50% risk-weighting, in effect requiring a 4% capital buffer.

[43] *See e.g.* Jaffee, Dwight, Journal of Financial Services Research, The Interest Rate Risk of Fannie Mae and Freddie Mac (2003), *available at* http://faculty.haas.berkeley.edu/jaffee/papers/FinalJFSR.pdf.

[44] Federal Reserve, Flow of Funds Accounts of the United States: Annual Flows and Outstandings 2005-2009 (September 17, 2010), *available at* http://www.federalreserve.gov/releases/z1/current/annuals/a2005-2009.pdf.

[45] *Id*.

[46] Secretary Paulsen acknowledged that the structure of Fannie and Freddie inherently creates systemic risks. *See* Statement by Henry M. Paulsen, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (September 7, 2008), *available at* http://www.ustreas.gov/press/releases/hp1129.htm.