Fannie Mae and Freddie Mac:
What Happened and Where do We Go From Here?

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Chairman Waxman, Ranking Member Issa, and members of this distinguished committee:

Thank you for the opportunity to testify at this hearing today on the insolvency of Fannie Mae and Freddie Mac, their takeover by the federal government, and their role in the ongoing financial crisis. I am Thomas H. Stanton, a Fellow of the Center for the Study of American Government at Johns Hopkins University. I am also a Fellow of the National Academy of Public Administration and consult to government agencies and other entities to improve the design of organizations and programs.

In 1991 I wrote a book called *A State of Risk: Will Government-Sponsored Enterprises be the Next Financial Crisis?* and worked with a small band of reformers led by Representatives J.J. Pickle (D-TX) and Bill Gradison (R-OH) of the House Ways and Means Committee to try to improve federal supervision of safety and soundness of Fannie Mae and Freddie Mac. These efforts led to creation of a new regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), in 1992. Strenuous lobbying by Fannie Mae and Freddie Mac assured that the new regulator lacked the authority needed to do its job.

In my view, the 1992 legislation provided the last clear chance to create a system of accountability that might have helped to protect the two companies from the high leverage and lax practices that allowed them to expand to unmanageable size and then brought them down this year. Since 1992 and until enactment of the Housing and Economic Recovery Act of 2008 (HERA) the two companies, which gained strength as they grew, were able to block even modest pieces of regulatory reform legislation.[1]

In my testimony today I would like to make several basic points:

1. While Fannie Mae and Freddie Mac did not cause the mortgage credit debacle, they did engage in risky practices that turned them into sources of vulnerability rather than strength for the mortgage market and larger economy.

2. As it becomes clear that Fannie Mae and Freddie Mac in fact are insolvent, it would be helpful to place them into receivership and thereby remove private shareholders from the two failed companies. Once the shareholders are clearly gone, the next Administration can use the two companies to provide much needed support and reform of the home

[1] Major bills in these years were H.R. 3703, Housing Finance Regulatory Improvement Act, 2000; H.R. 1409, Secondary Mortgage Market Enterprises Regulatory Improvement Act, 2001; H.R. 2575, Secondary Mortgage Market Enterprises Regulatory Improvement Act of 2003; S. 1656, Federal Housing Enterprise Oversight Modernization Act of 2003; H.R. 2022, Leave No Securities Behind Act, 2003; H.R. 2803, Housing Finance Regulatory Restructuring Act of 2003; S. 190, Federal Housing Enterprise Regulatory Reform Act of 2005; Federal Housing Finance Reform Act of 2005 (This bill passed the House on October 26, 2005); H.R. 1427, Federal Housing Finance Reform Act of 2007 (This bill passed the House on May 22, 2007); S. 1100, Federal Housing Enterprise Regulatory Reform Act of 2007; and H.R. 3221, American Housing Rescue and Foreclosure Prevention Act of 2008, which was signed into law as part of the Housing And Economic Recovery Act of 2008 (HERA) after undergoing numerous iterations in House and Senate.

mortgage market. If the companies remain in conservatorship rather than receivership, then government will face conflicting objectives about the role of the two companies in serving urgent public purposes versus serving financial interests of the companies and their shareholders.

3. Fannie Mae and Freddie Mac should not be restored to their previous status as privately owned organizations that operate with pervasive federal backing. The two companies and their powerful constituencies have consistently fought for high leverage and against an effective accountability structure. Even if a regulator were created with the appropriate mandate, discretion, and authority, the political power of the two companies can be expected to weaken that accountability structure over time and thereby restore the companies to their dominant market positions, high leverage, and financial vulnerability.

I. Fannie Mae and Freddie Mac Engaged in Risky Practices that Helped Lead to Their Failure and Greatly Increase Likely Taxpayer Costs

Fannie Mae and Freddie Mac committed serious misjudgments that helped to bring about their insolvency. The most serious misjudgments involved the companies' resistance to accepting more effective supervision and capital standards. For years, starting with their successful efforts to weaken the legislation that established OFHEO,[2] the two companies managed to fend off capital standards that would have reduced their excessive leverage and provided a cushion to absorb potential losses. In 2007 Freddie Mac concluded a stock buyback program that further weakened the company's ability to withstand a financial shock. As late as this March Freddie Mac defied calls to increase its capital cushion.[3] As late as this summer Fannie Mae continued to object to giving a federal regulator the discretion to set higher capital standards.[4]

The companies fought for high leverage because this benefited their shareholders, at least until the companies failed. Freddie Mac reported returns on equity of over 20 percent for most years since it became an investor-owned company in 1989, reaching highs of 47.2 percent in 2002 and 39.0 percent in 2000. Fannie Mae reported earnings of almost as much, reaching a high of 39.8 percent in 2001. The two companies fought higher capital requirements because more capital would have diluted those returns to shareholders.

[2] Among the many reports documenting the successful efforts of Fannie Mae and Freddie Mac at weakening the regulator and their capital standards, see, e.g., Carol Matlack, Getting Their Way, *National Journal*, October 27,1990, pp. 2584-2588; Jill Zuckman, "Bills To Increase GSE Oversight Move Ahead in House, Senate," CQ Weekly, August 3, 1991; Stephen Labaton, "Power of the Mortgage Twins: Fannie and Freddie Guard Autonomy," *New York Times*, November 12,1991, p. D1; Kenneth H. Bacon, "Privileged Position: Fannie Mae Expected to Escape Attempt at Tighter Regulation," *Wall Street* Journal, June 19,1992, p. A1.

[3] David S. Hilzenrath, "Chief Says Freddie Won't Raise Capital; Mortgage Financier Cites Responsibility to Shareholders, Won't Increase Loan Capacity," *Washington Post*, March 13, 2008, p. D4.

[4] Steven Sloan, "Fannie CEO Details Issues with GSE Bill," *American Banker*, June 5, 2008.

The two companies compounded the problem of their self-inflicted structural vulnerabilities with a series of misjudgments that involved taking on excessive risk just at the point that housing prices were peaking. According to press reports, the chief executives of both Fannie Mae and Freddie Mac disregarded warnings from their risk officers and sought to catch up with the market by greatly increasing their purchases of risky loans.[5]

Freddie Mac reported in its 2007 Annual Report that,

> "The proportion of higher risk mortgage loans that were originated in the market during the last four years increased significantly. We have increased our securitization volume of non-traditional mortgage products, such as interest-only loans and loans originated with less documentation in the last two years in response to the prevalence of these products within the origination market. Total non-traditional mortgage products, including those designated as Alt-A and interest-only loans, made up approximately 30% and 24% of our single-family mortgage purchase volume in the years ended December 31, 2007 and 2006, respectively."[6]

Fannie Mae's 2007 Annual Report states:

> "We are experiencing high serious delinquency rates and credit losses across our conventional single-family mortgage credit book of business, especially for loans to borrowers with low credit scores and loans with high loan-to-value ("LTV") ratios. In addition, in 2007 we experienced particularly rapid increases in serious delinquency rates and credit losses in some higher risk loan categories, such as Alt-A loans, adjustable-rate loans, interest-only loans, negative amortization loans, loans made for the purchase of condominiums and loans with second liens. Many of these higher risk loans were originated in 2006 and the first half of 2007."[7]

Fannie Mae reported that purchases of interest-only and negative amortizing ARMs amounted to 7% of its business volume in 2007 and 12% in each of 2006 and 2005. Moreover, Alt-A mortgage loans "represented approximately 16% of our single-family business volume in 2007, compared with approximately 22% and 16% in 2006 and 2005, respectively."[8] Both companies also invested in highly rated private-label mortgage-related securities that were backed by Alt-A

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[5] David S. Hilzenrath, "Fannie's Perilous Pursuit of Subprime Loans: As It Tried to Increase Its Business, Company Gave Risks Short Shrift, Documents Show," *Washington Post*, August 19, 2008, p. D01; Charles Duhigg, "At Freddie Mac, Chief Discarded Warning Signs," *New York Times*, August 5, 2008; Charles Duhigg, "The Reckoning: Pressured To Take More Risk, Fannie Reached Tipping Point, *New York Times*, October 5, 2008.
[6] Freddie Mac, *Annual Report*, 2007, p. 13.
[7] Fannie Mae, *Annual Report*, 2007, p. 24.
[8] *Ibid*, pp. 128-9.

or subprime mortgage loans, amounting to total holdings by the two companies of over $ 200 billion in 2007.[9]

In making these mistakes, Fannie Mae and Freddie Mac revealed the inherent vulnerabilities of the government-sponsored enterprise (GSE) as an organizational model.[10] First, the GSE lives or dies according to its charter and other laws that determine the conditions under which it operates. That means that GSEs select their chief officers in good part based on ability to manage political risk rather than on their ability to manage two of the largest financial institutions in the world.

Second, the GSE combines private ownership with government backing in a way that creates a virtually unstoppable political force. Because of their government backing and low capital requirements in their charters, a risky form of subsidy as we have found out, Fannie Mae and Freddie Mac gained immense market power. They doubled in size every five years or so until this year the two companies funded over $ 5 trillion of mortgages, about 40 percent of the mortgage market.

Their market power gave them political power. Whenever someone would urge regulatory reform, such as higher capital standards to reduce the GSEs' dangerous leverage, huge numbers of constituents could be expected to flood Capitol Hill.[11] That political power in turn entrenched the GSEs' market power.

The political power of the two companies is seen in the fact that the regulatory reforms of the Housing and Economic Recovery Act of 2008 (HERA) still fail to give the new regulator, the Federal Housing Finance Agency, the full mandate, authority, or discretion over safety and soundness and systemic risk that is available to the federal bank regulators.

For example, the bill requires the new regulator to conduct an estimated 25-30 rulemakings to implement key provisions of the act, including any increases in capital requirements, in addition to trying to establish itself and increase capacity to oversee the two huge and troubled GSEs. Given their market power, the GSEs have tended to dominate such rulemakings by mobilizing their constituents. HERA seeks to offset this somewhat by requiring the new regulator to consult with and take account of the views of the Federal Reserve Board Chairman on capital, prudential

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[9] Fannie Mae, *Annual Report*, 2007, p. 93; Freddie Mac, *Annual Report*, 2007, p. 94.

[10] A government-sponsored enterprise is a government chartered, privately owned and privately controlled institution that, while lacking an express government guarantee, benefits from the perception that the government stands behind its financial obligations. See, Ronald C. Moe *and* Thomas H. Stanton, "Government Sponsored Enterprises as Federal Instrumentalities: Reconciling Private Management with Public Accountability," *Public Administration Review*. July/August 1989. This definition is consistent with the definition Congress enacted in amendments to the Congressional Budget Act of 1974, codified at 2 U.S.C. Section 622 (8).

[11] Observers have long noted this pattern. "Builders, real estate brokers and bankers across the country rely so heavily on Fannie Mae for mortgage funds that they live in fear of offending the firm and routinely defend it in Washington." David A. Vise, "The Money Machine: How Fannie Mae Wields Power," *Washington Post*, January 16, 1995, p. A14.

management and operations standards, and other matters relating to safety and soundness, but sunsets this provision on December 31, 2009.

Third, the pressure of meeting quarterly expectations of investors meant that the two companies sacrificed the long-term well being of the mortgage market for their own short-term goals of maximizing returns on equity.

In short, the mix of private incentives and government backing created a dynamic that led not only to the hubris that brought about the meltdown of internal controls at both Fannie Mae and Freddie Mac a few years ago,[12] but also to their insolvency in 2008.

That said, it is useful to note that Fannie Mae and Freddie Mac did not cause the housing bubble or the proliferation of subprime and other mortgages that borrowers could not afford to repay. In analyzing the dynamics of Fannie Mae and Freddie Mac I discovered a phenomenon that can be called Stanton's Law: *risk will migrate to the place where government is least equipped to deal with it.*[13] Thus, the capital markets arbitraged across regulatory requirements and ultimately sent literally trillions of dollars of mortgages to Fannie Mae and Freddie Mac, where capital requirements were low and federal supervision was weak.

However, the capital markets also found other places where government could not manage the risk, including structured investment vehicles of commercial banks, private securitization conduits, and collateralized debt obligations that were virtually unregulated except by the vagaries of the rating agencies and exuberance of the market during the housing bubble. Huge volumes of subprime, alt-A, interest-only, and other toxic mortgages went to these parts of the market. As the bubble reached its limits and began to deflate the GSEs tried to catch up and regain the market share that they had lost to the new competition.

One other issue deserves mention in connection with the insolvency of Fannie Mae and Freddie Mac. That is the suggestion that is sometimes made that Fannie Mae and Freddie Mac failed because of the affordable housing goals that were imposed on them by the Department of Housing and Urban Development (HUD). In fact, the affordable housing goals are not designed to cause losses to the companies. It appears that the GSEs became insolvent because of their own misjudgments and especially their eagerness to jump into the market for "nontraditional" mortgages, rather than because of anything that HUD did.

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[12] Thomas H. Stanton, "The Life Cycle of the Government-Sponsored Enterprise: Lessons for Design and Accountability," *Public Administration Review*, September/October 2007. This analysis is presented as the first attachment to this testimony.

[13] This dynamic was first presented in my testimony before the Senate Banking Committee in a hearing on *The Safety and Soundness of Government Sponsored Enterprises*, October 31, 1989, p. 41, pointing out that increases in stringency of capital requirements and government supervision for thrift institutions after the savings and loan debacle would drive many billions of dollars of mortgages from the portfolios of savings and loan associations to Fannie Mae and Freddie Mac because their capital standards and government oversight were much weaker.

Understanding the legal context helps to show the limited nature of HUD's authority to impose affordable housing goals. The charter acts of both Fannie Mae and Freddie Mac prescribe that the companies shall serve four purposes. The third of those purposes is to:

> "…provide ongoing assistance to the secondary market for residential mortgages (*including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities*) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing;…"[14]

The part of the 1992 Act that authorizes HUD to impose housing goals on the two companies states that implementation of those goals shall be consistent with these sections of the two companies' charter acts.[15] In other words, the law prevents HUD from imposing affordable housing goals that would be unprofitable for the two companies, even though the profits may be less than the companies would earn on other mortgages. If HUD sought to impose noneconomic goals upon the two companies, they could simply have refused to comply, secure in the knowledge that HUD's authority would not stand up in litigation. In fact, in 2007 Freddie Mac did decline to comply with some aspects of the housing goals.

Thus, the problem of the purchase of risky loans to nontraditional borrowers is more subtle than a legal mandate. Part of the purchase of nontraditional loans likely involves a desire of Fannie Mae and Freddie Mac to curry favor with policymakers to achieve other political objectives. Another part, such as the purchase by the two companies of over $ 200 billion of private label securities backed by subprime and Alt-A mortgages, did not involve service to the cause of affordable housing as much as a desire to gain yield on the basis of imprudent investments. Although these securities were given high ratings by the rating agencies, one would expect a company that funded trillions of dollars of mortgages to undertake its own due diligence and assessment of credit quality of those assets.

[14] (Emphasis added). Codified at 12 U.S.C. Sec. 1716(3) [Section 301(3) of the Fannie Mae Charter Act] and 12 U.S.C. Note to Sec. 1451 [Section 301(b)(3) of the Freddie Mac Charter Act].

[15] Subsection 1331(a) states that, "The Secretary shall implement this subpart in a manner consistent with section 301(3) of the Federal National Mortgage Association Act and section 301(b)(3) of the Federal Home Loan Mortgage Corporation Act." Codified at 12 U.S.C. Sec. 4561(a). HERA replaced this provision with a comparable provision in Section 1334(b) of the 1992 Act, as amended.

II. The Government Should Place Fannie Mae and Freddie Mac into Receivership and Allow Them to Function Essentially as Wholly Owned Government Corporations to Support the Mortgage Market.

The government placed Fannie Mae and Freddie Mac into conservatorship rather than receivership. Unlike receivership, the voluntary acceptance of conservatorship by Fannie Mae or Freddie Mac was not subject to legal challenge, which could have further roiled the financial markets.

Placing a failed financial institution directly into conservatorship violates the customary practice of the federal bank and thrift regulators who first place an institution into receivership, then separate the assets into a "good-bank/bad-bank" structure and send the good bank, cleaned out of troubled assets, into conservatorship or bridge-bank status. Placing an institution into receivership removes the shareholders of the defunct institution. Thus, when IndyMac failed, it was placed into receivership. The receiver then transferred the deposits and most of the assets to a newly chartered thrift, IndyMac Federal Bank. The FDIC then placed itself as conservator of the new IndyMac Federal Bank.

It now appears, as past losses materialize and are recognized by Fannie Mae and Freddie Mac, that both institutions have lost their entire net worth. Freddie Mac has already reported a negative net worth of $ 13.8 billion and requested government funds to make up the shortfall. It is time to place both companies into receivership.

Placing both companies into receivership will help to remove an inherent conflict in the government's position. Technically, conservatorship means that the government is working to restore the companies to financial health. Thus far the government has preserved the shareholders in the two companies and allowed their stock to trade freely. This is inconsistent in key aspects with the government's need to use the two companies to support the mortgage market. Until shareholders are removed from the equation, officers and directors of the two companies will face conflict as to their fiduciary responsibilities. Do they price mortgage purchases low to support the market or do they price higher to replenish the companies' shareholder value? As the companies themselves point out in their most recent quarterly filings with the SEC, they face conflicts among multiple objectives that "create conflicts in strategic and day-to-day decision making that will likely lead to less than optimal outcomes for one or more, or possibly all, of these objectives."[16]

With shareholders still in the equation government must try to cobble unwieldy forms of support such as recent reports of plans to use the Federal Reserve to buy mortgage-backed securities of the two companies in return for lowering mortgage rates.

[16] Fannie Mae Form 10Q filing for the quarterly period ended September 30, 2008, p. 7; Freddie Mac Form 10Q filing for the quarterly period ended September 30, 2008, p.5.

If the government placed both companies into receivership, then we could use Fannie Mae and Freddie Mac as agents of reform for the mortgage market. The benefits could be enormous:

- They could fund mortgages in a manner targeted to meet pressing public purposes as the new Administration defines them.
- They could begin to provide essential consumer protections for borrowers, such as Alex Pollock's ingenious one-page mortgage disclosure form, borrower counseling, and increased pre-foreclosure loss mitigation services.[17]
- They could begin to devise and impose requirements that primary lenders and other participants in the mortgage process have appropriate financial strength and capability and accountability and engage in appropriate risk-sharing before they are allowed to do business with the two companies. (Implementation of some of these requirements may need to be deferred until when the housing and mortgage markets return to some semblance of stability).
- They could help to adapt their Automated Underwriting Systems, and perhaps other systems and capabilities, for use by other federal agencies, starting with the FHA and perhaps Ginnie Mae and the direct loan program for homeowners (part of the disaster loan program) of the Small Business Administration.

In short, the government could turn the insolvency of Fannie Mae and Freddie Mac into an opportunity to begin to upgrade the quality of federal support for delivery of credit by federal agencies. The benefits for the mortgage market could be considerable as the companies, once they are charged with serving public purposes rather than a mix of public and private objectives, provide support to the housing market and fashion important consumer protections and rules of conduct for the various participants in that market.

The Congress also would be well advised to place a sunset provision of perhaps five years into each company charter. As the sunset approaches, and the mortgage debacle hopefully is behind us, policymakers can decide whether further support for the mortgage market is required, and the organizational form that is most suitable.

III. Fannie Mae and Freddie Mac Should not be Restored to Their Previous Status as Privately Owned Organizations that Operate with Extensive Federal Backing.

The experience of Fannie Mae and Freddie Mac as privately owned institutions with extensive government backing shows the shortcomings of the government-sponsored enterprise as an organizational model. However sound the accountability structure may be when the organization begins, the incentive to satisfy private owners will lead a GSE to try to weaken safety and soundness oversight and lower capital standards. Both Fannie Mae and Freddie Mac arguably

[17] Alex Pollock's one page mortgage form can be found at http://www.aei.org/scholars/scholarID.88/scholar.asp. It is presented as the second attachment to this testimony.

had stronger accountability structures when they were chartered as GSEs than when they were supervised by OFHEO. Between 1968 and 1992, when OFHEO was established, both companies had successfully removed government controls that they considered unacceptable.

It is particularly instructive to note that Leland Brendsel, then CEO of Freddie Mac, testified before the House Ways and Means Committee in 1989 that he would not allow Freddie Mac to build a large portfolio because of the risks involved. Rather, he said, Freddie Mac could serve the housing market just as well through guaranteeing mortgage-backed securities.[18] When Mr. Brendsel made his commitment to the House Ways and Means Committee, Freddie Mac was governed by a board of directors consisting of three federal officials. Shortly thereafter the law was changed to create a shareholder-controlled board of directors. Mr. Brendsel promptly abandoned his objections to a large portfolio. Freddie Mac's portfolio in recent years has amounted to almost a trillion dollars of mortgages and investment assets.

In short, the drive to satisfy shareholders is intense and easily can overwhelm considerations of what might be best for the financial system or the mortgage market or American taxpayers. The fundamental flaws of the GSE structure are compounded by other features of Fannie Mae, Freddie Mac, and their statutory framework:

1. They are chartered by the Congress rather than by actions of a regulator. This can lead, as in the case of Fannie Mae and Freddie Mac, to immense concentrations of risk in a limited number of institutions that benefit from a favorable legislative charter.

2. They are regulated by a federal agency that has only two or three GSEs to regulate. This makes the process of regulatory capture easier than in the case of federal bank regulators that supervise a variety of institutions, large and small, that may have divergent interests.

3. They benefit from a tailored accountability framework, including preferential capital standards. This contrasts with reform of the savings and loan industry after the S&L debacle, which brought thrifts directly into the statutory framework of banks and the capital standards and supervisory requirements that confer authority on all federal bank regulators.

4. They traditionally have been subject only to the authority of specialized committees or subcommittees that authorize their charters and not to oversight by the taxpayer-conscious House Ways and Means and Senate Finance committees, at least concurrently. Given the public debt implications of government backing for the GSEs, both of these committees, which have jurisdiction over matters relating to the public debt, ought to

[18] *Government-Sponsored Enterprises*, Hearing before the Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, Serial 101-65, September 28, 1989 (Testimony of Leland Brendsel, CEO of Freddie Mac), at p. 55

assert jurisdiction over all GSEs and their issuance of debt obligations and mortgage-backed securities.

There are other important considerations as well. The GSEs have now squandered a policy tool that government had used for decades: the perception of an implicit rather than explicit federal guarantee of their debt obligations. The end of the implicit guarantee means that government would need to provide some form of express guarantee if the GSEs were to be restored. One would hope that in such a case government would provide only a limited guarantee of mortgage-backed securities, rather than debt obligations, in return for fees that would be placed into an insurance fund similar to the BIF and SAIF funds of the FDIC. Of course at that point, why not leave the task of mortgage finance to banks and thrift institutions by allowing them to securitize mortgages in a standardized manner?

Finally, as was true of other institutions chartered by the Congress, the enabling legislation for any surviving GSEs should contain a 10-year sunset provision so that policymakers can periodically revisit questions of their public benefits and public costs in the context of changing markets and public priorities.

IV. Conclusion

Mr. Chairman, I would like to end on a note about the human costs of Fannie Mae and Freddie Mac.

- Their actions led to hundreds of thousands of American families, and possibly more than a million, facing delinquency and default on their mortgages and potential foreclosure on their homes.
- They funded the overbuilding of hundreds of thousands of homes that will be vacant or boarded up because no one wants to live there.
- The cost to the American taxpayer will run potentially to hundreds of billions of dollars.

All of this harm occurred on the watch of the four men on the first panel. It could have been avoided with prudent lending, prudent capital, and prudent management. Thank you again for holding this important hearing on two financial institutions that used their high leverage and insatiable appetites to grow to an unmanageable size before they failed. I would be pleased to respond to any questions.

Biography: Thomas H. Stanton

My work for government and other organizations has led to creation of a number of new offices and approaches to delivering public services more effectively. I enjoy helping to design and implement new and improved programs. The General Accounting Office, Congressional Budget Office, Office of Management and Budget, Farm Credit Administration, Department of Education, Department of Housing and Urban Development, Small Business Administration, and the Financial Management Service of the Treasury Department are among those that have requested my services over the years to help provide analyses relating to organizational and program design and operation.

My writings have appeared in publications including *Public Administration Review*, *The Administrative Law Journal*, *American Banker*, and *The Wall Street Journal.* I edited, with Benjamin Ginsberg, *Making Government Manageable: Executive Organization and Management in the 21st Century* (Johns Hopkins University Press, 2004), and also edited, *Meeting the Challenge of 9/11: Blueprints for Effective Government* (M.E. Sharpe Publishers, 2006). My writings on GSEs include many articles and two books, *A State of Risk: Will Government-Sponsored Enterprises be the Next Financial Crisis?* (HarperCollins, 1991); and *Government-Sponsored Enterprises: Mercantilist Companies in the Modern World* (AEI Press, 2002).

I am a Fellow of the Center for the Study of American Government at the Johns Hopkins University, where I teach several courses, including the program's core course for the MBA/MA in Government. In 2006 I received the award for Excellence in Teaching. I am a member of the board of directors of the National Academy of Public Administration (NAPA), and am past Chair of the NAPA Standing Panel on Executive Organization and Management. I served as a member of the federal Senior Executive Service at the Federal Trade Commission for almost five years. My B.A. degree is from the University of California at Davis, M.A. from Yale University, and J.D. from the Harvard Law School.

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The Life Cycle of the Government-Sponsored Enterprise: Lessons for Design and Accountability

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The federal government uses government-sponsored enterprises (GSEs) to allocate credit to sectors such as housing and agriculture that are considered to deserve special support. The GSEs illustrate the importance of life cycle in the design and accountability of federal agencies and instrumentalities. Four case studies are presented here. In general, market and political dominance and rapid growth are inherent in GSE design. Dominance means inadequate feedback, which can foster poor management and financial risk. Government lacks an exit strategy for GSEs that have outlived their usefulness. Government should systematically review the organizational structure, accountability, and design of all agencies and instrumentalities, both at inception and over their life cycles.

The United States has had sufficient experience with government agencies and instrumentalities that it is often possible to foresee likely developments as each type of organization matures. Sometimes the legislation creating an agency or instrumentality may contain compromises at the outset that become manifest only later. Even though the impact of its life cycle lies in the future, it may be possible to predict beforehand some of the critical implications of a flawed organizational design. Zegart (1999) and Comarow (2004) provide useful examples.

In other cases, as Bernstein (1955) explored for regulatory commissions, a historical pattern can be discerned and analyzed. If life-cycle issues cannot be addressed through appropriate design at an organization's inception, the question then becomes how to anticipate and mitigate potential flaws before they cause avoidable harm.

The government-sponsored enterprise (GSE) provides a useful case study of the implications of life cycle for organizational development. When GSEs begin, they may be useful in correcting market imperfections that are adequately addressed by existing institutions. However, their statutory benefits turn most GSEs into large institutions that dominate their markets. Unlike government instrumentalities in the 18th and 19th centuries that operated under renewable charters, government currently lacks an exit strategy for GSEs that have outlived their usefulness.

The Government-Sponsored Enterprise as an Organizational Type

Government-sponsored enterprises are specially chartered financial institutions. The federal government uses them to allocate credit to sectors such as housing and agriculture that are considered to deserve special treatment. The GSE may be defined as a government-chartered, privately owned, and privately controlled institution that lacks an express government guarantee but benefits from the perception that the government stands behind its financial obligations (Moe and Stanton 1989). In return for tax benefits, regulatory exemptions, and reduced borrowing costs (thanks to the perception of the government's implied guarantee), the GSE is confined by its charter to serving specified market segments through a limited range of authorized services.

Three of the GSEs are among the largest financial institutions in the nation. Fannie Mae and Freddie Mac each fund \$1.5 trillion–\$2.5 trillion of home mortgages. The Federal Home Loan Bank System, a trillion-dollar group of 12 cooperative institutions, provides inexpensive funds to commercial banks and thrift institutions that own the individual Home Loan Banks. Even smaller GSEs are multibillion-dollar financial institutions. The Farm Credit System and a small GSE known as Farmer Mac provide loans to agricultural borrowers. A sixth GSE, Sallie Mae, which funds student loans, has given up its government sponsorship and become a completely private company.

This analysis of the GSE life cycle might be summarized as follows:

- Thanks to government backing, which is unavailable to their competitors to the same extent, as well as other special benefits, GSEs often grow rapidly into huge institutions and dominate their markets.

- These GSEs can often call on powerful constituencies to protect them politically and to enact favorable legislation to further expand their franchises and diminish government control. However, GSEs face the continuing prospect of political risk—the chance that an unusual combination of economic or political factors could facilitate the enactment of unfavorable legislation.
- Because of their government backing, most GSEs receive only minimal feedback from the markets; because of their political power, they often receive only minimal feedback from the political process.
- When GSEs grow rapidly, they may depend on people, systems, and processes that remain from the time when the institution was smaller and less complex.
- Rapid growth and limited feedback mean that GSE officers and directors may bask in a favorable environment, even though they have outrun their organizational capabilities and internal controls.

The core argument here is that the combination of market and political dominance, on one hand, and rapid growth, on the other, are inherent characteristics of the GSE structure. There are ways to mitigate these structural failings, but the continuing political power of the larger GSEs—especially Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System and their constituents—makes reform difficult now that they have achieved such market dominance.

If GSEs are to thrive in the future, they need to be supervised by regulators with the mandate and capacity to provide effective feedback before problems get out of control. Structural limitations, such as portfolio size limits for Fannie Mae and Freddie Mac, can also help to mitigate some of the more serious concerns about risks to the financial system if such a huge institution ever failed. Here, too, the political power of the GSEs comes into play in helping to persuade Congress to avoid setting structural limits at levels that might be financially prudent and comparable to limits (such as capital requirements) that the law imposes on other financial institutions. Let us consider here the life cycles of four of the GSEs: the Farm Credit System, Sallie Mae, and Fannie Mae, and Freddie Mac. (A review of the history and activities of the GSEs, including those not covered here, can be found in Stanton 2002).

> If GSEs are to thrive in the future, they need to be supervised by regulators with mandate and capacity to provide effective feedback before problems get out of control.

The Case of the Farm Credit System

The federal government created the Farm Credit System as a cooperative, owned by its farmer borrowers, to provide credit for the agricultural sector. After weathering a difficult beginning and the travails of the Great Depression, the system grew rapidly. At its peak (in terms of market share) in 1982, the Farm Credit System held 34 percent of total farm debt outstanding. At that time, the system's regulator was an extension of the system itself. Special regulatory accounting allowed the system to price loans to its owner-borrowers at prices significantly below those that borrowers could obtain from rural commercial banks. This could not be sustained, however, especially in the face of a serious agricultural downturn.

The Farm Credit System announced in 1985 that it could not meet its obligations. In 1987, the government created a new off-budget federal organization, the Farm Credit System Assistance Corporation, to funnel federally backed funds to the Farm Credit System and its owner-borrowers. At the insistence of the U.S. Treasury Department, the bailout legislation also included statutory changes to create an arm's-length regulator with powers similar to those of the federal bank regulators.

The Farm Credit System continues to grow rapidly today. It has a market share of 31 percent of total farm sector debt, somewhat below the 40 percent share of commercial banks. The system is beginning to perceive the constraints of its charter restrictions and thus is seeking expanded authority. However, especially since the 1987 bailout, commercial banks have manifested a stronger political presence with respect to the system. They seek to block further expansion of the system's authorized powers.

From a life-cycle perspective, the Farm Credit System, until its financial failure in 1985, manifested a combination of market penetration, growth, and political influence that rendered the GSE impervious to important feedback that might have helped the institution stave off failure. Today, the Farm Credit System continues to grow but faces increasing constraints from the limits of its statutory authority and the opposition of a commercial banking industry that is politically stronger with respect to the Farm Credit System than it was before the collapse.

The Case of Sallie Mae

The federal government chartered Sallie Mae in 1972 as part of an effort to provide government funding for the recently established federal student loan program. Student loans were small and costly to service in small numbers. Banks tended to offer student loans to their customers primarily as a way to build consumer loyalty for other financial products. Sallie Mae offered an opportunity to create a specialized financial institution that could purchase large volumes of student loans and develop profitable economies of scale.

Like other GSEs, Sallie Mae was able to use its statutory advantages to grow rapidly, more than doubling in size every five years from 1975 to 1995. By the late 1980s, Sallie Mae dominated the student loan market, holding some 27 percent of federally guaranteed student loans, compared to the second dominant firm, Citibank, which held only 4 percent. By 1994, Sallie Mae's market share had grown to 34 percent.

In the early 1990s, an unusual confluence of factors came together to turn political risk into a serious threat to the company. The Clinton administration came into office and launched an initiative to create a new federal direct loan program for students. For years, policy makers had expressed concern about the extreme profits that Sallie Mae derived from its public purpose of serving the student loan market. Analysts and policy makers had also objected to the complicated structure and high cost of the guaranteed student loan program, compared to the prospect of a direct loan program operated through schools and funded by low-cost borrowing from the U.S. Treasury.

Despite its political strength, in August 1993, Sallie Mae suffered serious legislative defeat. The 1993 Omnibus Budget Reconciliation Act authorized a new federal direct loan program that would compete with the existing federal guaranteed loan program. As the nation's largest holder of student loans, Sallie Mae was affected much more than other companies. The act also levied a special fee on Sallie Mae, measured as percentage of the student loans that Sallie Mae held in portfolio. The fee largely offset Sallie Mae's funding advantage from its GSE status in the debt markets.

Sallie Mae decided to give up government sponsorship. In return, the company, operating as a non-GSE private company, could expand its business activities without regard to the statutory limits that had been imposed on Sallie Mae as a GSE. One major benefit of GSE status, lower funding costs, had already been neutralized by the offset fee. Sallie Mae rolled out its privatization proposal in 1994 and achieved success with enactment of the Student Loan Marketing Association Reorganization Act in 1996. The company argued that it had come to the end of its useful life cycle as a GSE:

> In creating the various GSEs, Congress did not contemplate the need at some point to unwind or terminate their federal charters. However, Congress did not assume the perpetual existence (and continual expansion) of individual GSEs in the context of changing social and economic priorities. The missing element in the GSE concept is the notion of a life cycle for government sponsorship. GSEs are *created* to increase the flow of funds to socially desirable activities. If successful, they grow and *mature* as the market develops. At some point, the private sector may be able to meet the funding needs of the particular market segment. If so, a *sunset* may be appropriate. (Sallie Mae 1994, 13–14)

In 2004, Sallie Mae completed the transition and became a completely private company without government sponsorship. The company retained the economies of scale and market dominance that it had achieved as a GSE and captured 27 percent of the federal student loan market, despite creation of the federal direct student loan program, which today lags Sallie Mae in market share.

The Case of Fannie Mae and Freddie Mac

The life cycles of Fannie Mae (the Federal National Mortgage Association) and Freddie Mac (the Federal Home Loan Mortgage Corporation) are instructive because they show—like the experience of the Farm Credit System—how government subsidies foster rapid growth and a dampening of feedback that can mask problems until they become major threats to the GSE itself.

Taken together, Fannie Mae and Freddie Mac have roughly doubled in size every five years since Freddie Mac was chartered in 1970 (see table 1). This is the result of a combination of lower funding costs and tax and regulatory advantages that are not comparably available to their financial competitors. The unique nature of congressionally chartered GSEs distinguishes them from commercial banks, for example, which face competition from myriad other institutions that benefit from comparable powers under the same general charter. The statutory charters of Fannie Mae and Freddie Mac are unique and unavailable to other competitors. The two GSEs have been extremely profitable, with returns on equity averaging well over 20 percent for many years (OFHEO 2006a, 6, 24).

Table 1 Growth of Fannie Mae and Freddie Mac, 1975–2005 (Mortgage Holdings plus Mortgage-Backed Securities Outstanding)

1975	1980	1985	1990	1995	2000	2005
$ 37.3 billion	$ 77.6 billion	$ 263 billion	$ 740 billion	$ 1.3 trillion	$2.3 trillion	$ 4.0 trillion

Source: Office of Federal Housing Enterprise Oversight (2006a, tables 4 and 14).

As the GSEs have grown, former Treasury secretary John Snow, Comptroller General David M. Walker, former Congressional Budget Office director Douglas Holtz-Eakin, and Federal Reserve chairmen Alan Greenspan and Ben Bernanke have warned about the possibility of financial failure at a GSE spreading to the many holders of GSE obligations, such as commercial banks and foreign central banks. This is what is known as systemic risk, which is the possibility that a failure at one institution could cause market turmoil that then spreads to other institutions in the financial system, with potentially serious effects for the performance of the U.S. economy.

Compared to other financial institutions, Fannie Mae and Freddie Mac hold huge portfolios of mortgages and other assets that they fund at high leverage. If a problem occurred—say, because of changing interest rates—the value of the GSE portfolios could fall dramatically. This happened to Fannie Mae in the early 1980s when the GSE nearly failed, along with many savings and loan institutions that were similarly vulnerable to changing interest rates. If a GSE suddenly lacks the funds to pay off the holders of its debt obligations, there could be ripple effects through the financial system, especially for commercial banks that hold large amounts of GSE securities. At the end of fiscal year 2003, the financial institutions insured by the Federal Deposit Insurance Corporation held more than $1 trillion of GSE-related securities, amounting to substantially more than their shareholder capital.

The GSEs—especially the largest GSEs, Fannie Mae and Freddie Mac—are politically powerful. Yale professor Jonathan G. S. Koppell makes this point about "hybrid organizations," his term for instrumentalities that mix governmental and private characteristics, generally: "Designers of future hybrids should not be surprised if hybrid organizations acquire unusual political influence due to their unique combination of public- and private-sector advantages" (2003, 121).

The GSEs develop and maintain their political power in order to survive and thrive. In contrast to other firms that may exercise influence over parts of the political process, but are chartered under general corporation laws that are available to their competitors, the GSE operates under special authorizing legislation that determines how it comes into existence and outlines its permitted powers, the extent of its special tax and regulatory and other privileges, whether other institutions will receive similar charters, powers, and privileges, the powers of its regulator, and what happens if the GSE fails. As in the case of Sallie Mae at the beginning of the Clinton administration, if political risk materializes, it can impair a company's future as a GSE.

The failure of internal controls at Fannie Mae and Freddie Mac that became manifest in 2003–04 had deeper causes than mere poor management or poor government supervision. The elements of effective supervision of Fannie Mae and Freddie Mac have been understood for many years (see, e.g., Stanton 1991; Walker 2004). However, in good part thanks to the political strength of the GSEs themselves, Congress has regularly balked at enacting such legislation. The GSE, as a hybrid that combines government backing with private ownership and control, involves a concentration of political power that can allow the GSE to obtain a favorable accountability framework and then prevail over its regulator.

As a GSE gains market power, it can use this market power to generate a political constituency among its customers to defend and improve on the status quo. Thus, the *Washington Post* reported on Fannie Mae's use of market power to enlist political support: "Builders, real estate brokers and bankers across the country rely so heavily on Fannie Mae for mortgage funds that they live in fear of offending the firm and routinely defend it in Washington" (Vise 1995).

Market power leads to political power; political power, in turn, leads to favorable changes to the GSE's charter that help expand its market power and reduce the effectiveness of government supervision. Indeed, the statutory framework of Fannie Mae and Freddie Mac arguably gave the government more supervisory control when each company was chartered as a GSE, in 1968 and 1970, respectively, than the government possessed when Fannie Mae and Freddie Mac discovered the failure of their internal controls a few years ago.

The GSEs are active participants in the process of influencing policy makers, especially those who are in a position to affect their charter legislation. On April 19, 2006, Freddie Mac paid a record fine to the Federal Election Commission to settle charges that the company had violated federal law by using company resources to hold some $ 1.7 million in fund-raisers, many involving the then-chairman of the House Financial Services Committee. That committee is responsible for the legislation that created both Fannie Mae and Freddie Mac and had been considering legislation to address their shortcomings.

Current Problems at Fannie Mae and Freddie Mac

Freddie Mac

Freddie Mac changed accounting firms in 2002. The company had been using Arthur Andersen for many years, but when Andersen got into trouble in the Enron debacle, Freddie Mac decided to change to a firm without that taint. The new auditor, PricewaterhouseCoopers, found that Freddie Mac had been engaging in numerous accounting practices that were not in conformance with generally accepted accounting principles (GAAP).

In January 2003, Freddie Mac announced that it would need to restate its financial results for 2002, 2001, and possibly 2000. In June 2003, Freddie Mac announced the termination, resignation, and retirement of the three principal officers of the company. Pursuant to a consent order with its regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), the board retained an outside law firm, Baker Botts LLP, to investigate. In July, Baker Botts reported numerous irregularities to the board of directors.

In December 2003, OFHEO published an extensive *Report on the Special Examination of Freddie Mac* (OFHEO 2003). Its findings included the following:

- The size of the bonus pool for Freddie Mac's senior executives was tied, in part, to meeting or exceeding annual specified earnings per share (EPS) targets. Actions to shift extra earnings to future periods helped ensure the achievement of future EPS goals and the related bonuses.
- The company constrained resources needed for accounting and internal controls. Senior management treated the accounting and financial reporting parts of the company like "second class citizens" (OFHEO 2003, 139).
- Freddie Mac circumvented prevailing public disclosure standards in order to obfuscate particular policies and specific capital market and accounting transactions.

On April 20, 2006, Freddie Mac settled lawsuits with shareholders for $410 million. These suits stemmed from internal control failures and accounting misstatements that forced the company to restate earnings by $5 billion from 2000 to 2002. Freddie Mac ousted its chairman and chief executive officer, its president and chief operating officer, its chief financial officer, and its general counsel, among other top officials. Since 2004, the company has replaced virtually all senior managers—more than two dozen positions. The company paid a civil penalty of $125 million to OFHEO and agreed to take corrective measures specified by that agency.

Fannie Mae

Misconduct at Freddie Mac prompted OFHEO to launch a special examination of Fannie Mae. In September 2004, OFHEO produced an interim report on numerous irregularities. That month, pursuant to an agreement with OFHEO, a board of directors' special review committee retained former U.S. senator Warren Rudman and his law firm, Paul, Weiss, Rifkind, Wharton & Garrison LLP, to investigate. On February 23, 2006, Senator Rudman and his firm reported that it had found numerous improprieties, substantiating OFHEO's findings. The 616-page Rudman Report (Paul, Weiss, Rifkind, Wharton & Garrison 2006), plus another 2,000 pages of appended documents, found the following:

- Fannie Mae had "a culture of arrogance" (443). "Management created an environment that was not conducive to open discussion and exchange of views" (438). The culture discouraged dissenting views, criticism, and bad news. Internally, employees felt uncomfortable telling senior management what it didn't want to hear. Externally, the company maintained an acrimonious relationship with OFHEO, its regulator.
- The achievement of EPS-driven goals was "inextricably linked" to achieving management's maximum bonus pools.
- The company violated GAAP in numerous important ways.
- There were staff shortages and Fannie Mae lacked senior officials with the requisite expertise and experience in key parts of the company. The head of internal audit had no experience or formal training as an auditor; the controller was not a certified public accountant.

Following the release of the Rudman Report, OFHEO issued its final *Report of the Special Examination of Fannie Mae* (OFHEO 2006b). The 340-page report found the following:

- Fannie Mae was engaged in numerous acts of misconduct involving more than a dozen different forms of accounting manipulation and violations of GAAP.
- Senior managers sought to hit ambitious EPS targets that were linked to their own compensation. Fannie Mae's chief executive officer, Franklin Raines, received compensation of $90 million during 1998-2003; of that amount, more than $52 million was directly linked to achieving EPS targets.
- Fannie Mae attempted to apply pressure from Capitol Hill to thwart the special examination report. Documents released by OFHEO described Fannie Mae's implementation of a strategy of "opposing, circumscribing, and constraining OFHEO" (OFHEO 2006a, 36-276).

Fannie Mae estimated that it had overstated its earnings by billions of dollars. It allowed its chairman and chief executive officer to retire with a generous compensation package and ousted its chief financial officer and other top officials of the company. Fannie Mae signed settlement agreements with OFHEO and the Securities and Exchange Commission (SEC) that included a $400 million fine, growth limits, and extensive remedial actions to enhance the safe and sound operation of the GSE. Both the SEC and the U.S. Department of Justice continue to investigate.

The SEC forced Fannie Mae to restate its financial results for 2002 through mid-2004; this was extremely costly. It resulted in "losses of tens of billions of dollars in market capitalization for Fannie Mae shareholders, and expenses for the restatement process, regulatory examinations, investigations, and litigation that the Enterprise has recently estimated will exceed $1.3 billion in 2005 and 2006 alone" (OFHEO 2006a, 1).

Underlying Reasons for the Problems at Fannie Mae and Freddie Mac

These reports raise significant issues concerning the accountability and performance of government-sponsored enterprises. Two issues stand out: (1) a large GSE's ability to dominate its environment, and (2) the wisdom of government support for GSEs in forms that result in a life cycle of rapid growth to the extent that the companies outgrow the capabilities of their people and systems.

Dominance of the Environment

Consider the defense presented by Franklin Raines, Fannie Mae's ousted chief executive. The Rudman Report included a long letter from the law firm representing Raines, part of which contended that he had been misinformed about events at his company:

> [T]his matter involves allegations that accounting professionals misapplied accounting standards and that Fannie Mae's management and Board of Directors relied upon these erroneous judgments in connection with financial disclosure, after the judgments were, or appeared to have been, endorsed by internal auditors, outside auditors, and regulators. (Downey 2005)

This defense assumes that Fannie Mae's executive was entitled to rely on favorable reports of internal auditors, the company's external accounting firms, and OFHEO, among others. In fact, because of Fannie Mae's policies, each of these actors was affected by resource constraints, distorted incentives, and limited capacity to render independent judgments.

As the Rudman Report explains in great detail, Fannie Mae's internal audit organization was deprived of resources. This was motivated, at least in part, by a desire to promote the corporate goal of increasing EPS, and by Fannie Mae's corporate culture, which discouraged the presentation of bad news. The capabilities of the company's longtime external accountant appear to have been shaped by similar resource incapacity and susceptibility to the corporate culture in which it had worked for many years.

Then there is OFHEO, the regulator. Thanks to the lobbying power of Fannie Mae and Freddie Mac, OFHEO was created as an institution that lacked the capacity needed to do its job (Bacon 1992). The OFHEO was limited by the appropriations process and had a budget that was much smaller, compared to its responsibilities, than the budgets of the federal bank regulators.

Whenever OFHEO tried to do its job well, as in the *Special Examination Report on Fannie Mae,* it felt political pressure. Fannie Mae lobbyists generated a congressional request for the inspector general of the Department of Housing and Urban Development to investigate OFHEO's conduct in the special examination. Between October 2002 and June 2004, there were three other congressional requests for investigations of OFHEO. Fannie Mae lobbyists also tried to use the appropriations process to force a change in the leadership of the agency. They convinced the Senate Appropriations Subcommittee to try to withhold $10 million from OFHEO's appropriation until a new director could be appointed. Until Freddie Mac's board acted in 2003, OFHEO's examinations completely missed the failures of internal controls at the two GSEs.

In short, Raines defended himself by stating that he had relied on affirmations from organizations whose behavior had been shaped by the power of Fannie Mae and its centralized leadership structure. As one financial commentator wrote, "If, in the parlance of modern business, controlling one's environment is the name of the game, maybe Fannie controlled its environment too well, getting congenial answers until it was too late" (Connor 2006).

The ability to control their environments, in turn, permitted the management of both GSEs to stress EPS as the critical measure of performance, without fear of contradiction. This led to deprivation of adequate staff and systems in key organizations within the two GSEs. Given the immense resources at the company's disposal, the constraints on staff and systems at Fannie Mae are striking. In 2003, the last year of Raines's program to double EPS in five years, the company's net income was reported as $7.9 billion, and return on equity for that year was 49.9 percent (OFHEO 2006a, 6).

The same parsimony existed at Freddie Mac during the same period. The OFHEO reported that, just as it would later find at Fannie Mae, stringent resource constraints had led to ineffective business units: "Simply stated, the quality and quantity of accounting expertise was too weak to assure proper accounting of the increasingly complicated transactions and strategies being pursued by Freddie Mac" (2003, 13).

Rapid Growth

This relates to the second issue. Government-sponsored enterprises receive numerous tax, regulatory, and other benefits, including statutory authority to operate at high leverage, which may enable them to thrive and take market share from competitors. As table 1 shows, Fannie Mae and Freddie Mac grew rapidly, both in their portfolio businesses and in the outstanding mortgage-backed securities that they guaranteed.

Both the Rudman Report and the OFHEO report on Freddie Mac documented how officials rose within both organizations and reached major positions that were inappropriate for such large and complex organizations. The Rudman Report shows, for example, how Fannie Mae promoted an internal candidate to become senior vice president for internal audit even though he had had no prior training or experience as an auditor. At Freddie Mac, the chief financial officer, also promoted from within, "had little knowledge of GAAP, financial accounting, or disclosure rules" (OFHEO 2003, 91).

In other words, although senior officers and directors at both GSEs were riding high, Fannie Mae and Freddie Mac were outgrowing their internal controls and the capabilities of their managers and systems. This raises the question, not yet answered, of the capabilities of other parts of the companies.

Where Do We Go from Here?

Improving Organizational Design

Once life cycle issues are understood, they can be addressed both in the design and in the supervision of a GSE. Sidney D. Goldberg and Harold Seidman (1953) set forth a template for policy makers to use when considering the statutory framework for creating new wholly owned government corporations. Senators Paul Simon and David Pryor (U.S. Senate 1996), relying on work of Harold Seidman, Alan Dean, and Thomas Stanton, introduced legislation to provide such templates for wholly owned government corporations and GSEs.

Such templates seek to address major life cycle issues and strengthen the quality of organizations that policy makers may wish to establish. The idea of a template is to suggest an appropriate framework that policy makers can adapt to the particular circumstances of new organizations and the legislative process from which they emerge.

For a GSE, it is important to build an exit strategy into the organization's initial design. The Office of Management and Budget, for example, has stated that "GSEs should only be created with a clearly articulated 'exit strategy' and an express sunset date in their charter" (1995, 14–15).

Alex J. Pollock (2005) points out that such a sunset was a feature of charters of instrumentalities that government chartered in early years of the Republic. Most notable were the First and Second Banks of the United States, the lineal ancestors of today's GSEs, which operated under a 20-year sunset provision. However, GSE charter acts do not include such fixed terms.

Implementing an Exit Strategy

If there is no sunset date in a GSE charter, then the option remains of trying to remove government sponsorship at a later date. The U.S. Treasury Department (1995) articulated this position in urging removal of government sponsorship from Sallie Mae:

> The Treasury has for a number of years, in Democratic and Republican Administrations, believed that it is appropriate to wean a GSE from government sponsorship once the GSE becomes economically viable and successfully fulfills the purpose for which it was created with Federal sponsorship, or when the purpose for which it was created ceases to exist.

As the case of Sallie Mae shows, the political strength of a GSE can make privatization difficult except on the most favorable terms to GSE shareholders. This relates to what the Treasury has called "the tension between profit and public purpose" that is inherent in the GSE as an organizational type:

> When creating a GSE, Congress defines the problem (i.e., the market imperfection) it seeks to overcome, provides benefits (subsidies), and imposes limitations on the GSE. But if Congress wishes to revise those decisions in response to changing public needs, it no longer has the same freedom of action. In addition to the usual constraints of the legislative process, it must contend with the private interests of the GSE and its shareholders. Congress must consider, and legislate, any such changes through a process in which the GSEs are significant participants. As a private company, the GSE will act to fulfill its fiduciary responsibilities by promoting and protecting the interests of its shareholders. (1996, 81)

Conclusion: Larger Lessons about the Design and Supervision of Government-Sponsored Enterprises

Koppell (2003) anticipates that hybrid organizations such as GSEs will become even more significant in coming years than they are today. Because the GSE is a mechanism for delivering a federal subsidy outside the federal budget, the GSE would seem to be an instrument that is of continuing interest to policy makers.

The fundamental lesson of the life cycle of the GSEs reviewed here is that the GSE does not offer a free lunch. In creating a GSE, or in permitting it to expand its scale and scope, policy makers make a trade-off. They receive access to an off-budget vehicle that can help funnel government subsidies to preferred purposes. In return, the government takes on risk—in some cases, substantial risk. The savings and loan debacle stands as a warning that—as in the case of Hurricane Katrina with respect to natural disasters—policy makers cannot play the odds forever; high impact events can and do materialize. The current GSEs must be structured to limit financial risk and ensure effective accountability and supervision, or the potential cost of an off-budget subsidy can become very high.

> The fundamental lesson of life cycle of GSEs reviewed here is that the GSE does not offer a free lunch.

What does effective accountability mean? First, feedback is essential for effective operations. Though many organizations strive for autonomy in their environments, appropriately designed organizations should balance the need for flexibility against requirements for accountability. Many examples exist, in both the private and public sectors, of how too much autonomy can lead to subsequent failure. The details of effective financial supervision are well known, especially from the experiences of the federal bank regulators. The GSEs themselves should have a stake in being supervised by a capable independent regulator.

Second, private actors generally are more nimble than government. Government backing of private organizations causes special vulnerability to flaws in structure and accountability. Once problems emerge, as in the savings and loan debacle or with Fannie Mae and Freddie Mac in 2003–04, policy makers find it difficult to act effectively. At the design stage, policy makers should understand and address the potential costs of creating hybrid organizations.

> GSEs should be red flags for policy makers…

Third, in the financial sector, the agility of private actors means that risk will migrate to areas where government is least equipped to deal with it (Stanton 2002, xii). Thus, in the aftermath of the savings and loan debacle, when the supervision of thrift institutions was strengthened, hundreds of billions of dollars of mortgages, and the attendant risks, shifted to the GSEs, where supervision was much weaker. This private sector agility tends to exacerbate design flaws in hybrid organizations. Especially in the financial services arena, legislation tends to lag developments in the marketplace, often substantially.

Fourth, given evidence of design flaws that manifest themselves at considerable cost from time to time, the federal government should establish processes to regularly assess organizational structures of agencies and instrumentalities to anticipate and mitigate the likelihood of unexpected failures.

In the 1960s and early 1970s, the Executive Office of the President included an Office of Management and Organization, housed first in the Bureau of the Budget and then in the new Office of Management and Budget, with responsibility for improving management and organization of government organizations and programs. That office worked on enhancing the institutional capacity of the presidency and, by extension, the rest of the executive branch. One of its functions was to review the way federal agencies and instrumentalities were organized and to propose improvements. As Ronald Moe (2006) has argued and testified, the Executive Office needs to restore such an office. Government-sponsored enterprises are only the most recent examples of organizations with structural shortcomings that, if left unchecked, can weaken or even bring down institutions. As with most issues of salience in the political process, corrective measures (such as portfolio limits on GSEs) are best proposed early, before constituencies become locked into rigid positions.

The GSEs should be red flags for policy makers, not only about financial vulnerabilities but also to highlight the need for government systematically to review organizational structure, accountability, and design across its agencies and instrumentalities. That Fannie Mae and Freddie Mac could stumble so badly without causing failures in other parts of the financial system was a rare benefit; feedback is indeed valuable, and policy makers would be wise to heed it before flaws in these or other institutions manifest themselves in more costly ways.

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THE BASIC FACTS ABOUT YOUR MORTGAGE LOAN

Borrower: ______________________ Property address: ______________________

Lender: ______________________

Amount of loan: $ ______________, which is ______ % of the property's appraised value.

Your loan is for ________ years.

The type of loan you have: ______________________

Your beginning interest rate is________ %. This rate is good for ________ months/years. The rate and your payment can go higher on ________ and each ________ months after that.

Today's estimate of how high the rate will go, called the fully indexed rate, is ________ %.

The maximum possible rate on your loan is ________%.

THIS LOAN IS BASED ON YOUR MONTHLY INCOME OF $ ______________________ .

Your beginning rate = a monthly loan payment of $____________ = ________ % of your income.

-including taxes and insurance this is about $____________ = ________ % of your income.

The fully-indexed rate = a loan payment of $____________ = ________ % of your income.

-including taxes and insurance this is about $____________ = ________ % of your income.*

*This is called your fully indexed housing expense ratio.

Special factors you must be aware of:

-A prepayment fee of ____________ must be paid if ______________________ .

-A "balloon payment" of $ ____________ to pay off your loan will be due on ____________ .

-You do/do not have a "payment option" loan. If you do, make sure you really understand what this means. Start with the definition on page 3.

Total "points" plus estimated other costs and fees due at closing are $ ______________________ .

FOR QUESTIONS CONTACT: Name: ______________________

Phone:____________ e-mail:____________

See definitions of underlined terms and guidelines on pages 2–3.

DO NOT SIGN THIS IF YOU DON'T UNDERSTAND IT!

____
Borrower Date

______________________ ______________________
Authorized Signer of Lender Date Borrower Date

The Basic Facts about Your Mortgage Loan

This form gives you the basic facts, but some mortgage forms may use terms not listed here. For a good, borrower-friendly information source, try the Mortgage Professor online (www.mtgprofessor.com), which includes detailed explanations of the technical mortgage terms in its glossary and much other helpful information.

Definitions and Guidelines Used in This Form

The *appraised value* is what a professional appraisal estimates the house could be sold for in today's market.

The *type of loan* determines whether and by how much your interest rate can increase. If it can, your monthly payments will also increase—sometimes by a lot. For example, in a thirty-year fixed rate loan, the interest rate is always the same. In a one-year ARM, it will change every year. Other kinds of loans have various patterns, but the interest rate may go up a lot. Make sure you understand what type of loan you're getting.

The *beginning interest rate* is the interest you are paying at the beginning of the loan. Especially if it is a low introductory or "teaser" rate, it is the rate which you will hear the most about from ads and salespeople. But how long is it good for and when will rates increase? In many types of loans, the rate will go up by a lot. You need to know.

The *fully-indexed rate* is an essential indicator of what will happen to your interest rate and your monthly payments. It is today's estimate of how high the interest rate on an adjustable rate mortgage will go. It is calculated by taking a defined "index rate" and adding a certain number of percentage points, called the "margin." For example, if your formula is the one-year Treasury rate plus 3 percent, and today the one-year Treasury rate is 5 percent, your fully-indexed rate is 5% + 3% = 8%. At the time the loan is being made, the fully indexed rate will *always* be higher than a beginning "teaser" rate.

The index rates are public, published rates, so you can study their history to see how much they change over time. If the index rate stays the same as today, the rate on your loan will automatically rise to the fully-indexed rate over time. Since the index rate itself can go up and down, you cannot be sure what the future adjustable rate will be. In any case, you must *make sure you can afford the fully-indexed rate*, not just the beginning rate, which is often called a "teaser" rate for good reason.

The *maximum possible rate* is the highest your interest rate can go. Most loans with adjustable rates have a defined maximum rate or "lifetime cap." You need to think about what it would take to make your interest rate go this high. How likely do you think that is?

Your *monthly income* means your gross, pre-tax income per month for your household. This should be an amount which you can most probably sustain over many years. Make sure the monthly income shown on this form is correct!

Your *monthly payment including taxes and insurance* is the amount you must pay every month for interest, repayment of loan principal, house insurance premiums, and property taxes. Expressed as a percent of your monthly income, this is called your housing expense ratio. Over time, in addition to any possible increases in your interest rate and how fast you must repay principal, your insurance premiums and property taxes will tend to increase. Of course, your monthly income may also increase. How much do you expect it to?

Your *fully-indexed housing expense ratio* is a key measure of whether you can afford this loan. It is the percent of your monthly income it will take to pay interest at the fully-indexed rate, plus repayment of principal, house insurance, and property taxes. The time-tested market standard for this ratio is 28 percent; the greater your ratio is, the riskier the loan is for you.

A *prepayment fee* is an additional fee imposed by the lender if you pay your loan off early. Most mortgages in America have no prepayment fee. If yours does, make sure you understand how it would work before you sign this form.

A "*balloon payment*" means that a large repayment of loan principal is due at the end of the loan. For example, a seven-year balloon means that the whole remaining loan principal, a very large amount, must be paid at the end of the seventh year. This almost always means that you have to get a new loan to make the balloon payment.

A "*payment option*" *loan* means that in the years immediately after securing a mortgage loan, you can pay even less than the interest you are being charged. The unpaid interest is added to your loan, so the amount you owe gets bigger. This is called "negative amortization." The very low payments in early years create the risk of very large increases in your monthly payment later. Payment option loans are typically advertised using only the very low beginning or "teaser" required payment, which is less than the interest rate. You absolutely need to know four things: (1) How long is the beginning payment good for? (2) What happens then? (3) How much is added to my loan if I pay the minimum rate? (4) What is the fully-indexed rate?

"Points" are a fee the borrower pays the lender at closing, expressed as a percent of the loan. For example, two points mean you will pay an upfront fee equal to 2 percent of the loan. In addition, mortgages usually involve a number of *other costs and fees* which must be paid at closing.

Closing is when the loan is actually made and all the documents are signed.

The *For Questions Contact* section gives you the name, phone number, and e-mail address of someone specifically assigned by your lender to answer your questions and explain the complications of mortgage loans. Don't be shy: contact this person if you have any questions.

Finally, *do not sign this form if you do not understand it.* You are committing yourself to pay large amounts of money over years to come and pledging your house as collateral so the lender can take it if you don't pay. Ask questions until you are sure you know what your commitments really are and how they compare to your income. Until then, do not sign.