From the Writer

Unfortunately, as an aspiring engineer, my experience with writing extended pieces that are not prefaced with a hypothesis and detailed experimental protocol is limited, to say the least; therefore, I'd like to begin this commentary with a preemptive apology. Formalities aside, for my essay, I decided to pick a topic straight from the front-page of the news for a purely selfish reason: I wanted to learn more about why America, and much of the world, has found itself in a deep recession. After a bit of research and background reading, I settled on Fannie Mae and Freddie Mac as the centerpieces of my paper.

As for the writing process itself, suffice it to say that it's usually a labored process for any engineer, student or professional, and this time proved no different. I started with what's comfortable for me: I made an outline of the essay using the "House" model popular among elementary schools around the country. In short, the foundation is the thesis, the pillars represent the argument, and the roof symbolizes the conclusions drawn. Needless to say, conceptualizing these sections of the essay was every bit as helpful as the drawing and coloring of the house itself (I still take great pride in coloring inside the lines).

After getting the skeleton of the essay down, I read through the paper several times, making additions and changes in an iterative manner. I do find it extremely helpful to have absolutely everybody else read through what I've written because I'm never able to pick out every mistake or awkward phrasing, so peer-review sessions were a huge bonus. However, it wouldn't be fair to conclude this commentary without mentioning that this seemingly smooth process occurred over an entire semester and was packed with crucial ingredients, such as frustration, fleeting relief, and procrastination. Regardless, taking just two writing courses at BU helped me refine my writing process, and I hope this recount of my personal experience is helpful, cogent, and coherent enough to justify its length to you, the (hopefully) kind and (without a doubt) good-looking reader.

— Aneesh Acharya

Aneesh Acharya

Rampant Corruption Plagues Washington: Why Fannie and Freddie Are Not Completely to Blame for the Credit Crisis[1]

"Housing finance," ex-Treasury Secretary John Snow commented in 2003, "is so important to our national economy that we need a strong, world-class regulatory agency to oversee the prudential operations."[2] This call for stronger regulation went relatively unheard, however. As political infighting dogged priceless Congressional session time, regulatory matters were simply further delayed. As proven over the past few months especially, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, better known as Fannie Mae and Freddie Mac, suffered massively from bipartisan politics. What Snow, and others who shared his point of view, perhaps did not foresee is that what began as a domestic economic slump has now evolved into a global financial crisis of massive proportions. However, Fannie Mae, Freddie Mac, other government-sponsored enterprises (GSEs), and large investment banks did not cause the current crisis by themselves. Politicians were involved in the vicious circle that caused the capitulation of the credit market; they clearly stood to benefit from large donations, or else change would have occurred. Although it is easy and perhaps understandable to place the blame squarely upon GSEs like Fannie and Freddie, reducing corruption in politics is just as crucial a strategy as financial regulation for ensuring that this crisis does not recur.

First, some key background information can set up the context for the recent failures of Fannie Mae and Freddie Mac. On June 27, 1934, as one of several measures taken to combat the Great Depression, the National Housing Act was enacted. This historic moment paved the way for the creation of the National Mortgage Association of Washington in

1938, which later became the Federal National Mortgage Association.[3] The initial intent behind Fannie Mae's creation was to encourage the growth of a secondary mortgage market, which could stabilize the primary mortgage market and maintain credit flow to private business, homebuyers, and other individuals in American society. This GSE, which began as an arm of the federal government used to exert some influence upon the secondary mortgage market, eventually became a crucial component in enabling citizens to participate in a large aspect of the American dream: homeownership.

However, Fannie Mae's role in the American economy has warped since then. The deregulation of Fannie Mae began thirty years after its inauguration, when, in 1968, a Congress mandate split and privatized the corporation. As a result, the Government National Mortgage Association (Ginnie Mae) was created, taking a few of the responsibilities of the pre-1968 Fannie Mae. Nevertheless, the new, privately owned Fannie Mae still held most of its original responsibilities and powers. A major cause for Fannie Mae, as well as other GSEs, growing beyond control can be attributed to the new role that it was given. Although it was privatized and then traded on the New York Stock Exchange, it still essentially possessed the U.S. Treasury as a financier.[4] Fannie Mae grew rapidly and consistently in the years leading up to the turn of the century. The greed established by this expansion is one of many causes of the corruption that occurred as the millennium ended.

From the moment Congress partially privatized them, Fannie Mae and Freddie Mac grew with breathtaking speed. They retained their ability to borrow money from the government at low interest rates, and then reap the income from higher interest rate loans for mortgages. In 2005, Alan Greenspan, the Federal Reserve Chairman at the time, proclaimed that the GSE business model hinged on "a big, fat gap."[5] By declaring this, Greenspan was referring to the gap between the cost of funds and earnings. The cost of funding has a low interest rate due to the perceived government backing that GSEs have, and the large earnings are generated from their sizable portfolios. Although this does not immediately seem to be a large enough profit margin to really spur on such growth, these interest rates had grown far apart during the early 2000s in the American housing boom. The housing boom was just one of the few causes that allowed Fannie and Freddie to grow so wildly.

From this note it can be argued that Fannie Mae, and to a lesser extent, Freddie Mac, used two major mechanisms to preserve their dominance of the secondary mortgage market: they maintained highly pervasive lobbying networks and a firm stance that they enabled a rapidly-growing housing market. Their major concern throughout the years leading up to their recent capitulations was ensuring that the government did not end their special statuses. As a result, both companies spent millions of dollars to gain political leverage. In 1999, Franklin Raines, the CEO of Fannie said, "We manage our political risk with the same intensity that we manage our credit and interest rate risks."[6] They accomplished this through a variety of means, including giving high-paying positions to government officials. At Fannie Mae, chief executives had clauses written in their contracts that listed their severance benefits if they left specifically for a federal position.

As a result, GSEs pose a massive risk to taxpayers. When asked about the "special benefits" Fannie receives over the rest of the housing-finance industry during a congressional hearing in 2001, Fannie's CFO Tim Howard responded, "We are given different opportunities from those which our competition's been given."[7] Fannie and Freddie have ties to the U.S. Treasury, which essentially guarantee they will not be allowed to fail. This system makes taxpayers not only their customers, but also their financiers, since a government rescue is funded by taxpayer money. This fact, coupled with the multi-trillion dollar portfolios that each GSE holds, poses an interesting dilemma: if Fannie and Freddie survive, they will continue to profit from American citizens, whereas if they fail, they would take rescue funds also from the citizens.

On the other hand, Fannie and Freddie catered to politicians to bolster their enhanced statuses through their network of highly developed lobbyists. Fannie Mae possessed an intricate bipartisan network of lobbyists, which it used to suppress any unfavorable legislation. In the fall of 1999, as President Clinton's term was ending, officials within his administration, for the first time in history, made public comments warning about the risks that Fannie and Freddie could pose. Lawrence Summers, the Treasury Secretary of the administration, warned, "Debates about systemic risk should also now include government-sponsored enterprises, which are large and growing rapidly."[8] These comments failed to spark sufficient Congressional action, and Fannie and Freddie were allowed to grow unabashedly.

As a strategy to protect the powers that enabled them to grow to such an astonishing level, Fannie Mae and Freddie Mac leveraged much of their power and influence in Washington politics. In 2005, Fannie Mae and Freddie Mac together spent about $23 million on lobbying, during a period of time when Congress was considering legislation that would tighten oversight. Annys Shin, a staff writer for *The Washington Post*, gives more accurate numbers for the amount of money spent by these two corporations: "Freddie Mac spent $12.6 million on lobbying, down from $15.44 million in 2004 but still enough to place it 11th among corporations that have so far filed . . . Fannie Mae was 15th."[9] Even with such high spending, Fannie Mae's spending increased almost $2 million from 2004 to 2005, rising from $8.78 million to $10.1 million.[10] According to reports released by the corporation, Fannie did indeed reduce spending on outside lobbyists by roughly 24%, but in-house lobbying costs increased by about 67%.[11] Critics have long argued that Fannie and Freddie have lobbied too much against tighter regulation, favoring stockholders rather than the majority of American citizens.

In addition, Fannie Mae and Freddie Mac donated generously to the political campaigns of favorable candidates. In 2008 alone, Fannie and Freddie donated about $4.8 million to Congress members. Although Barack Obama bucked the trend, most of the top recipients were members of the Senate Banking, Housing, and Urban Affairs Committee, from both major political parties.[12] The large donation that Obama's campaign received can be accounted for considering that Raines worked on his campaign. Fannie and Freddie lobbied both parties in order to get the most influence. They also lobbied representatives in the appropriate regulatory groups of Congress. By doing so, they created strong bipartisanship and tension between the two parties. It is ironic to note that by campaigning both parties, they also polarized them to each other.

Fannie Mae's unique ability to hinder threatening legislation was enabled by corruption in Washington politics. Politicians were directly or indirectly influenced by money, and this is what ultimately prevented the necessary oversight from being implemented. Although a few corrupt politicians did benefit in the short-term, this fraudulent behavior was the root cause of the recent near-collapse of the entire financial system. This is not to say that there were no attempts to enact legislation that would have put some restrictions on how recklessly the GSEs would have been able to act. There were politicians who did try to act in the best interest of their constituents, but they were suppressed through many tactics used by lobbyists employed by both Fannie Mae and Freddie Mac.

For example, one freshly exposed lobbying scandal showed that, in 2005, Freddie Mac secretly paid a Republican consulting firm about $2 million to put an end to potential legislation that would have regulated Fannie Mae. The legislation, put forth by a Republican Senator, Chuck Hagel, would have overhauled the regulatory system currently in place.[13] At the time, most Republican senators supported the bill. Unknown to Hagel and the senators who supported his plan, DCI, the consulting firm, was undermining his efforts by targeting and convincing various Republican senators to drop support for Hagel's bill. In the end, there was not enough Republican support to warrant even bringing it to the floor for a vote, since Democrats were all against the bill due to the divisive politics that plagued, and continue to plague, Washington. Hagel and his supporters wrote to the Senate majority leader, Bill Frist, saying, "If effective regulatory reform legislation . . . is not enacted this year, American taxpayers will continue to be exposed to the enormous risk that Fannie Mae and Freddie Mac pose to the . . . financial system and the economy as a whole."[14] This statement proved to be ominously accurate, as retrospective observation proves.

Furthermore, in March of 2000, Gary Gensler, an undersecretary of the Treasury, testified in favor of a bill that would have imposed tighter regulations upon Fannie and Freddie. David Hilzenrath, a staff writer for *The Washington Post*, wrote that, "Gensler and other Treasury officials feared that the companies had grown so large that, if they stumbled, the damage to the U.S. economy could be staggering." However, at this point, a Fannie Mae spokesperson announced that Gensler's remarks had cost 206,000 Americans the chance to buy homes. As expected, the Treasury folded under public pressure, the bill was rejected, and as a result, the companies continued to grow. This idea that Fannie and Freddie were inexplicably linked to homeownership began to permeate throughout Washington. Gradually, the GSEs became impervious to even the mildest of regulations.[15]

Just a few months ago, the federal government seized control of both Fannie and Freddie in an attempt to stabilize the secondary mortgage market. The cost to the taxpayers will now run up to at least $700 billion. Because of their quasi-government status, which gave them the advantages of being a private corporation as well as those associated with government institutions, both corporations were able to forge close political ties with the institutions designed to control them. This conflict of interest meant that regulation remained loose, so that Fannie and Freddie's shareholders reaped the rewards. Hilzenrath writes that, ". . . the companies were protected by the belief . . . that their success was inseparable from the expansion of homeownership in America."[16] Political spin was used to drive this unfounded belief that restrictions placed upon Fannie or Freddie would equal restrictions placed upon American homebuyers.

Fannie Mae and Freddie Mac have become very easy scapegoats for the current global credit crisis, and while they have played a major role in the financial meltdown, it is critical to recognize the large role corrupt politics also played in bringing the global economy into recession. Fannie and Freddie are capitalist corporations and can be expected to try and manipulate every law to their own advantage. Even though this is an extremely cynical view of Fannie and Freddie, given their historic role and founding mission statements, there is still no reason for lobbyists having as much influence in Washington politics as they clearly have had in the decades leading up to this year. Politicians derive power from their constituents, and the corruption that was widespread throughout Congress represents a failure to even adequately represent the desires of these constituents. They acted selfishly and will be remembered for their contributions to the largest-scale recession since the Great Depression. While one crucial component of recovery is the implementation of a strong regulatory agency to oversee the actions of enablers like Fannie and Freddie, strong political action must also be taken to remove the persuasive powers of lobbyists. Legislation must be passed to rid politics of lobbying, at least to the degree it is today. Bribery and graft have replaced feelings of nationalism and integrity throughout much of Washington, and this represents a major area that cries out for swift reform.

Notes

1. Earlier versions of this paper were presented in: "Greed Unleashed: How Fannie Mae Derailed the American Economy," for WR150 A2, Boston University, November 2008.

2. U.S. Department of the Treasury. *Secretary Snow's GSE Testimony before House Financial Services Committee* (Washington, DC: The Office of Public Affairs, 2003).

3. U.S. Department of Housing and Urban Development. *Federal National Mortgage Association Charter Act* (Washington, D.C.: Government Printing Office, 1954).

4. Ginnie Mae, "About Ginnie Mae," (Washington, DC: Ginnie Mae, n.d.), http://www.ginniemae.gov/about/history.asp?subTitle=About (accessed November 6, 2008).

5. Roumell Asset Management, LLC, "Quarterly Update," (Chevy Chase, MD: Roumell Asset Management, LLC, April 29, 2005), http://www.roumellasset.com/update_050429.htm (accessed November 28, 2008).

6. Binyamin Applebaum, Carol D. Leonnig, and David S. Hilzenrath, "How Washington Failed to Rein In Fannie, Freddie," *The Washington Post*, September 14, 2008, http://www.washingtonpost.com/wpdyn/content/article/2008/09/13/AR2008091302638_pf.html (accessed November 29, 2008).

7. Kathleen Day and David S. Hilzenrath, "Futures of Fannie's CEO, CFO Unclear As Directors Meet," *The Washington Post*, December 17, 2004, http://www.washingtonpost.com/wp-dyn/articles/A6119-2004Dec16.html (accessed November 5, 2008).

8. Department of Treasury. *Toward a 21st Century Financial Regulatory System* (Washington, DC: Office of Public Affairs, 1999).

9. Annys Shin, "Fannie, Freddie Keep Up Lobbying," *The Washington Post*, February 20, 2006, http://www.washingtonpost.com/wpdyn/content/article/2006/02/19/AR2006021900874.html (accessed November 29, 2008).

10. Open Secrets.org, "Fannie Mae," (Washington, DC: The Center for Responsive Politics, n.d.), http://www.opensecrets.org/lobby/clientsum.php?lname=Fannie+Mae&year=2005 (accessed December 10, 2008).

11. Shin, "Fannie, Freddie Keep Up Lobbying."

12. Open Secrets.org, "Update: Fannie Mae and Freddie Mac Invest in Lawmakers," (Washington, DC: The Center for Responsive Politics, n.d.), http://www.opensecrets.org/news/2008/09/update-fannie-mae-and-freddie.html (accessed December 10, 2008).

13. The Libertarian Party, "Investigate Fannie Mae, Freddie Mac Lobbying, Says Bob Barr," (Washington, DC: Libertarian National Committee, October 20, 2008), http://www.lp.org/news/press-releases/investigate-fannie-mae-freddie-mac-lobbying-says-bob-barr (accessed November 29, 2008).

14. Associated Press, "Freddie Mac paid $2m to thwart regulation," *The Boston Globe*, October 20, 2008, http://www.boston.com/business/articles/2008/10/20/freddie_mac_

paid_2m_to_thwart_regulation/ (accessed November 29, 2008).

15. Applebaum, Leonnig, and Hilzenrath, "How Washington Failed to Rein In Fannie, Freddie."

16. Ibid.

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