American Enterprise Institute for Public Policy Research

AEI

September 2008

Financial Services Outlook

The Last Trillion-Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac

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The government takeover of Fannie Mae and Freddie Mac was necessary because of their massive losses on more than $1 trillion of subprime and Alt-A investments, almost all of which were added to their single-family book of business between 2005 and 2007. The most plausible explanation for the sudden adoption of this disastrous course—disastrous for them and for the U.S. financial markets—is their desire to continue to retain the support of Congress after their accounting scandals in 2003 and 2004 and the challenges to their business model that ensued. Although the strategy worked—Congress did not adopt strong government-sponsored enterprise (GSE) reform legislation until the Republicans demanded it as the price for Senate passage of a housing bill in July 2008—it led inevitably to the government takeover and the enormous junk loan losses still to come.

Now that the federal government has been required to take effective control of Fannie and Freddie and to decide their fate, it is important to understand the reasons for their financial collapse—what went wrong and why. In his statement on September 7 announcing the appointment of a conservator for the two enterprises, Treasury Secretary Henry M. Paulson pointed to their failed business models as the reason for their collapse. This was certainly a contributing element, but not the direct cause. The central problem was their dependence on Congress for continued political support in the wake of their accounting scandals in 2003 and 2004. To curry favor with Congress, they sought substantial increases in their support of affordable housing, primarily by investing in risky and substandard mortgages between 2005 and 2007.

As GSEs, Fannie and Freddie were serving two masters in two different ways. The first was an inherent conflict between their government mission and their private ownership. The government mission required them to keep mortgage interest rates low and to increase their support for affordable housing. Their shareholder ownership, however, required them to fight increases in their capital requirements and regulation that would raise their costs and reduce their risk-taking and profitability. But there were two other parties—Congress and the taxpayers—that also had a stake in the choices that Fannie and Freddie made. Congress got some benefits in the form of political support from the GSEs' ability to hold down mortgage rates, but it garnered even more political benefits from GSE support for affordable housing. The taxpayers got highly attenuated benefits from both affordable housing and lower mortgage rates but ultimately faced enormous liabilities associated with GSE risk-taking. This *Outlook* tells the disheartening story of how the GSEs sold out the taxpayers by taking huge risks on substandard mortgages, primarily to retain congressional support for the weak regulation and special benefits that fueled their high profits and profligate executive compensation. As if that were not enough, in the process, the GSEs' operations promoted a risky subprime mortgage binge in the United States that has caused a worldwide financial crisis.

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