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Why Fannie Mae, Freddie Mac Continue To Cost US Taxpayers Billions

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What's Your Reaction?

Of all the companies bailed out by the federal government, mortgage finance giants Fannie Mae and Freddie Mac are shaping up as the deepest money pits. A close look at their past and recent financial filings shows why their losses continue to mount.

Fannie and Freddie effectively became wards of the government in 2008. The Obama administration had promised to reveal its plans for the agencies last month, but Washington's focus on reforming the banking system pushed them to the bottom of the to-do list. Fannie and Freddie aren't mentioned in either the Senate or House financial regulatory reform bills.

Treasury Secretary Timothy Geithner may reveal some of the administration's ideas on Tuesday when he testifies before Congress about Fannie and Freddie. But in general, the companies' troubles have drawn less attention than the rest of the financial industry. For example, unlike bonus announcements made on Wall Street, Fannie and Freddie's recent disclosures of about $40 million in executive compensation and bonuses for 2009 caused little stir on Main Street.

Together the two firms have already tapped $125 billion from government lifelines and the Congressional Budget Office predicts they ultimately will drain $380 billion. That would far exceed the final tabs for rescuing the big banks, the automakers or even insurance behemoth American International Group (AIG).

"These calls on taxpayer funds are troubling to all of us," Edward J. DeMarco, acting director of the Federal Housing Finance Agency, said in a letter to congressional leaders last month.

DeMarco's predecessor at the housing finance agency, Fannie and Freddie's regulator, has acknowledged that taxpayers are unlikely to ever see a full return on their investment.

Why are the two companies in such dire shape, when many large banks have been able to turn a profit even as they take huge losses from their real estate investments?

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Fannie and Freddie's losses largely stem from internal decisions made in 2006 and 2007 that sent the companies on a shopping spree for dubious mortgages, according to regulatory filings, congressional testimony and interviews with economists and former Fannie Mae employees. Fannie and Freddie uncharacteristically collected more than $1 trillion in subprime and other risky mortgages---many of which were branded "alternative," or alt-a, because they did not meet the rules set by Fannie and Freddie.

"It's ironic because the original definition of alt-a mortgages was that it didn't meet Fannie and Freddie's underwriting standards," said Thomas Lawler, a former senior vice president of Fannie Mae who left in 2006 to start a consulting business. "A disturbingly high share of losses were incurred from loans acquired during those dog years."

Chasing Market Share

Fannie's and Freddie's ill-fated decision to hop on the risky mortgage bandwagon was inevitable given their inherently contradictory missions, housing specialists said in interviews.

For 40 years, they functioned as publicly traded companies controlled by shareholders who demand profits. But they also operate under a congressional charter, as government-sponsored enterprises (GSEs), to keep credit flowing in minority and low-income communities. The charter also carried an implicit guarantee that if the companies got into trouble, the taxpayer would bail them out.

To follow their mandates, the companies developed two key lines of business. One is to buy mortgages from lenders, which can then use the money to offer new loans to consumers. Fannie and Freddie bundle the loans, guarantee them against default and sell them as securities to investors such as pension funds. The second line of business is management of their own investment portfolios.

Although both sides of the business helped bring the companies down, last year's losses stemmed largely from the loans they bought and guaranteed in 2006 and 2007. Before 2006, the companies dominated the residential mortgage market, owning or guaranteeing more than half of new mortgages. But after initially resisting the subprime boom, they began losing their control to Wall Street banks. Fannie and Freddie's market share plummeted to 37 percent in 2006.

They decided to rev up their buying and guaranteeing of risky mortgages. This decision restored their market share but also helped destroy the companies.

The riskiness of the 2006 and 2007 loans handled by Fannie and Freddie can be read in the details of their financial filings. Compared to earlier years, the borrowers had lower credit scores yet higher outstanding balances on their mortgages. Both companies became especially fond of the alt-a mortgage. Fannie acquired $135 billion in alt-a mortgages that were originated in 2006 and 2007 alone, more than twice the total in all years before 2005. Ultimately, alt-a loans caused about 40 percent of Fannie's credit losses last year.

Ironically, the alt-a name is short for "alternative to agency," meaning that they were the type of loans that Fannie and Freddie historically refused to buy or guarantee. People who secure alt-a mortgages typically have good credit scores but do not identify their incomes or net worth. Such mortgages are prone to default though technically are not subprime, which allowed Fannie and Freddie to rationalize their purchases.

It's still unclear exactly what drove Fannie and Freddie to prioritize market share over safety. To be sure, the shift came partly in response to a series of federal rules crafted during the Clinton and Bush administrations. The rules, adopted by the Department of Housing and Urban Development, required the companies to promote affordable housing in low-income and minority communities.

But the companies often failed to meet their housing goals between 2005 and 2008, "and without any significant repercussions from their regulators," Dwight Jaffee, a professor at the University of California Berkley's Haas School of Business, said in testimony last month before the Financial Crisis Inquiry Commission.

Fannie and Freddie's drop in standards, Jaffee said, more likely came from a desire to please shareholders. After Fannie got more aggressive in 2007, their stockholders' equity increased six percent to $44 billion.

"The bottom line is that GSE managers long understood that they and their shareholders would benefit from risk-taking as long as the higher risks created higher expected returns," Jaffe said.

Christmas Gift

When alt-a and other risky mortgages entered foreclosure in huge numbers in 2007, Fannie and Freddie were on the hook for many of these loans, which they had sold to investors with a guarantee against default. But the companies lacked sufficient funds to cover their pending payouts.

The Bush administration rescued the companies with the promise of big government lifelines. The Treasury Department also purchased an 80 percent ownership stake in Fannie and Freddie, which promptly entered government conservatorship.

Fannie and Freddie agreed to pay the government a 10 percent dividend each year on funds they draw from their lifeline. So far the companies have paid $6.8 billion to the Treasury Department, even as they continue to take in tens of billions of dollars from Treasury. In essence they are paying Treasury's dividends with money from Treasury, the companies disclosed in regulatory filings last year.

Aside from the bailout, the Federal Reserve has purchased about $1.2 trillion of Fannie and Freddie mortgage securities and corporate bonds. The Treasury Department also has bought about $220 billion of the companies' mortgage securities.

In total, Fannie and Freddie have received direct and indirect federal support worth more than $1.5 trillion.

Yet the companies' financial health has not been improving. At first, the companies were each entitled to a $100

billion government lifeline. The Obama administration later raised the limit to $200 billion.

Then on Christmas Eve, the administration quietly lifted the cap altogether, effectively giving the companies a blank check. It was one of several controversial Fannie and Freddie-related announcements made on the holiday. After Dec. 31, the decisions would have required congressional approval.

Some of the announcements were expected. For example, Fannie said it would need another $15 billion from taxpayers to stay afloat. Freddie hasn't asked for more money since last May, but indicated that it will in "future periods."

Amidst these statements was an even more controversial disclosure: The Treasury Department approved about $42 million in combined cash compensation and bonuses for Fannie and Freddie's top executives.

The payouts drew the ire of some lawmakers.

"We are paying these people bonuses to lose tens of billions of dollars," Rep. Jeb Hensarling (R-Texas) said at a House Financial Services Committee hearing in January. "What people do with their money is their business. What they do with the taxpayer money is our business."

Awarding compensation in cash also contradicts the Obama administration's demands that bank executives pay their employees in stock. The administration notes that Fannie and Freddie's conservatorship agreement prohibits stock-based compensation. The companies' cash payments, the administration said, will be deferred so they will resemble a stock salary. Fannie and Freddie's total compensation, on average, dropped 40 percent in 2009, according to a statement released by the federal housing agency.

Still, Fannie and Freddie's chief executives will each make more than $6 million for their 2009 performance, including a roughly $2.5 million bonus. Lloyd Blankfein, the chief executive of mega bank Goldman Sachs, received a $9 million bonus last year, all in stock. His company turned a record $13.4 billion profit last year.

The latest in a series of Congressional attempts to tax bonuses awarded at bailed out companies targeted Fannie and Freddie's executive compensation. Like its predecessors, the bill has gone nowhere amidst met fierce opposition in the Senate.

Freddie still has not disclosed its final compensation plan so its exact salaries are unknown. None of Freddie's current executives were at the company during the bad years.

But Fannie's chief executive, Michael Williams, served as the company's chief operating officer from 2005 to 2009. The housing agency says that Williams, who will earn $6.6 million for 2009, did not run or oversee the purchasing of mortgages. He also has taken a pay cut since the bailout.

DeMarco, head of the housing agency, defended the payments in recent congressional testimony.

"These new structures are designed to align with taxpayer interests," he told the House financial committee last month. "In my judgment, we have achieved the right balance between enough compensation to acquire and retain quality management, while preventing compensation from exceeding appropriate bounds."

Uncertain Future

While a reform plan for Fannie and Freddie takes a back seat to other government concerns the administration is using the companies to stabilize the housing market, keep credit flowing during tough times and direct its seminal foreclosure rescue initiative. By the end of 2009, Fannie and Freddie have approved more than 40,000 permanent mortgage modifications that lowered interest rates. These actions have drained the companies of precious income.

Restructuring the companies thus poses a dilemma for Washington that so far has proven too thorny to tackle: How to protect taxpayers from Fannie and Freddie's losses while using the companies to protect homeowners from foreclosure.

Some housing experts want to privatize Fannie and Freddie once the economy settles, forcing the government out of the housing finance business altogether. Others suggest turning them into a public utility, like an electric company. More likely, the government will simply return the companies to their pre-bailout status as public-private entities, said Peter Wallison, who follows housing finance for the American Enterprise Institute, a conservative think-tank.

"There aren't any real good answers," said Wallison, though he added that he favors the privatization path because it minimizes the likelihood of future bailouts.

This debate will take center stage Tuesday as the House Financial Services Committee holds a hearing on the future of the companies. Geithner has said that his testimony will offer "broad objectives and principles" for remaking the companies.

In anticipation of the hearing, House Republicans floated a plan last week to phase out the companies over the next few years.

At a hearing in January, Rep. Barney Frank (D-Mass.), chairman of the House committee and a long-time Fannie and Freddie ally, proposed eliminating the companies and starting from scratch. "I believe this committee will be recommending abolishing Fannie Mae and Freddie Mac in their current form," Frank said, "and coming up with a whole new system of housing finance."

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