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Congress Says 'No' to Fannie Mae/Freddie Mac CEO Pay Hike; Misses Big Picture

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If there is an issue that has united popular indignation, Left and Right alike, excessive executive compensation surely ranks near or at the top. But the bipartisan opposition to recent pay increases for the CEOs of mortgage conduits Fannie Mae and Freddie Mac, while understandable, misses the larger point. Several months ago, these companies, which account for nearly half the nation's outstanding home mortgage debt and which since September 2008 have operated as wards of the government, announced plans to raise annual CEO pay from $600,000 to $4 million. Their overseer, the Federal Housing Finance Agency, approved the hikes. Congress has responded with bills to roll them back. Passage and presidential signature are virtually assured. Yet what lawmakers *should* be doing is allowing these firms to compete, unsubsidized, in the market.

National Legal and Policy Center has visited the travails of these two companies many times over the last few years. The Washington, D.C.-based Federal National Mortgage Association ("Fannie Mae") and the McLean, Va.-based Federal Home Loan Mortgage Corporation ("Freddie Mac"), founded, respectively, in 1968 and 1970, account for roughly $5 trillion, or close to half, of all outstanding residential mortgage debt in this country (actually, Fannie Mae began as a government agency in 1938, but was re-chartered by Congress as a corporation 30 years later). In recent years, they have bought anywhere from 50 percent to 70 percent of newly-underwritten mortgages. These publicly-traded companies are known as "secondary mortgage lenders." That is, they do not originate mortgage loans, but instead buy them from institutions that originate them (e.g., banks, savings & loan associations) and eventually package them as bond offerings, known as "mortgage-backed securities," to outside investors. Fannie Mae and Freddie Mac are what link Main Street and Wall Street. Their job is expanding mortgage lending liquidity. When functioning properly, this arrangement is of great benefit to the supply and demand side. Banks and thrift institutions, having received cash in exchange for unloading long-term debt, gain flexibility in how they manage assets. Investors realize a steady and lucrative stream of income. And borrowers see a reduction in their interest rates of anywhere from 20 to 50 basis points.

But things don't necessarily go according to script. From their earliest years, Fannie Mae and Freddie Mac have operated as "Government-Sponsored Enterprises," or GSEs. This gives them several advantages over competitors, including a granting of a $2.25 billion line of credit with the U.S. Treasury (caps in recent years dramatically rising and then being removed altogether) and exemption from state and local taxes. This implicit "too big to fail" federal backing was a key element of a national housing policy that long has promoted

homeownership. On one level, this arrangement has succeeded. Roughly two-thirds of all U.S. households are homeowners. But there has been a downside. And its full effects were not realized until less than a decade ago. Armed with GSE status, Fannie Mae and Freddie Mac became an industry duopoly whose top executives and lobbyists enjoyed an unusually cozy relationship with Congress and a series of administrations. Rather than challenge increasingly stringent mandates, they went along, as the money was too good to resist. Yet the mandates were largely responsible for an eventual credit collapse and a sharp upswing in foreclosures.

Back in 1992, Congress, as part of broad housing and community development legislation, laid the groundwork for an expanded role for Fannie Mae and Freddie Mac. The law created a regulator for these corporations, the Office of Federal Housing Enterprise Oversight (OFHEO), part of the U.S. Department of Housing and Urban Development. The law imposed tighter capital standards on the two companies, and at the same time, laid the groundwork for requirements for Fannie Mae/Freddie Mac to reserve a minimum share of purchases of loans going to low-income (i.e., high-risk) borrowers. This quota-driven approach was driven heavily by black and Hispanic civil rights and community activists, and their allies in Congress, who long had been claiming that the financial services industry had been "redlining" minority communities. The industry preferred to see new opportunities for growth rather than the possibility of severe undercapitalization. Cato Institute Senior Fellow Johan Norberg, in his 2009 book, *Financial Fiasco: How America's Infatuation with Homeownership and Easy Money Created the Economic Crisis* (Cato), explained:

President (George W.) Bush's aim was to create an "ownership society" where citizens would be in control of their own lives and wealth through ownership, which would promote both independence and responsibility. But that did not just mean free markets based on private-property rights – it was the expression of a willingness to use the levers of government to treat ownership more favorably than other contractual relationships in the marketplace. One of Bush's key objectives was to increase the proportion of homeownership, and two of his best friends in that endeavor were Fannie and Freddie.

The growth in housing production and mortgage lending, already well underway since the mid-Nineties, accelerated. Underneath the prosperity was a time bomb in danger of detonating. As more loans went to borrowers who could not (or would not) repay them, Fannie Mae and Freddie Mac – and by implication, bondholders and taxpayers – were exposed. By the end of 2007, the sum of their loans and guaranteed mortgage-backed securities were roughly equal to the national debt. High-risk "subprime" loans now constituted about one-fifth of their combined liability. So long as housing prices were rising, this wasn't a problem because property values were the primary source of collateral. But in the event of a fall, the reverberations throughout capital markets, here and abroad, could be calamitous.

The price bubble, needless to say, burst. Signs of trouble became evident during 2007. And they would hit with hurricane force in 2008. Fannie Mae and Freddie Mac, operating with only $1.20 for every $100 in guaranteed bonds, faced a meltdown if they failed to satisfy bondholder claims. The entire economy would be in peril. Congress responded in July 2008 with legislation, the Housing and Economic Recovery Act, which among other things, created

a new GSE regulator, the Federal Housing Finance Agency (FHFA), to replace OFHEO. President Bush quickly signed the law. But the liquidity crisis would worsen. The investment house of Bear Stearns already had gone under. Merrill Lynch, Lehman Brothers and American International Group (AIG) were on the precipice of eventual collapse. That September, the FHFA, with the strong backing of the Treasury Department and the Federal Reserve Board, seized Fannie Mae and Freddie Mac and placed them under emergency temporary conservatorship.

The GSEs remained corporations, but more in name than in fact. These were now de facto government agencies. Keeping them solvent, at least on the government's terms, required Treasury Department loan bailouts eventually totaling a combined $187.5 billion. The terms of repayment were punitive. Fannie Mae and Freddie Mac had to hand over shares of senior preferred stock and warrants to their benefactors representing 79.9 percent of equity – and with no opportunity to buy back the shares. Moreover, they had to pay the government a 10 percent annual dividend. Yet around 2011, as the companies were paying back their debts, the unexpected happened: The housing market was coming back. Lenders, having greatly tightened credit standards since 2008 in the face of rising defaults and foreclosures on a scale not seen since the Great Depression, now, if ever so cautiously, were loosening them. Business at Fannie Mae/Freddie Mac was picking up as well.

The Treasury Department had taken note. In August 2012, in an effort to hasten debt collection, the department suddenly changed the terms of repayment. It issued a so-called "sweep" rule forcing Fannie Mae/Freddie Mac to surrender future profits. In the department's own words, the sweep represented "every dollar of profit that each firm earns going forward." The action, which superseded the "10 percent" rule, was a blatant breach of contract. Shareholders of already-depressed company stock, unable to realize a return, filed a series of class-action lawsuits. What made the regulation even more unjustifiable was that the balance sheets of Fannie Mae and Freddie Mac were improving. The companies were coming close to repaying what they had borrowed – and then some. By the close of the Second Quarter 2014, the two corporations had forwarded to the Treasury a combined $213.1 billion, more than $25 billion beyond the amount borrowed. Through Second Quarter 2015, this figure had risen to $239 billion. Yet rather than return the corporations to the market with a "You're on your own" admonition, the federal government has chosen to lock up profits in perpetuity. Fannie Mae and Freddie Mac now aren't as much companies as they are government-milked cash cows.

The government's capture of secondary mortgage lending has extended to executive compensation. Part of the bailouts stipulated that Fannie Mae and Freddie Mac CEOs would be paid maximum of $600,000. At the time, the requirement made sense. By the close of 2008, the corporations not only were sustaining enormous losses, but also were still reeling from accounting scandals of a half-decade earlier. Back in 2003, not long after Freddie Mac had received a clean bill of health from OFHEO, the company faced had to deal with revelations that it had hidden almost $7 billion in profits from the previous three years. Suspicious regulators also probed Fannie Mae's accounts, concluding that the company deliberately had overstated profits by $9 billion, a sum which they later lowered to $6.3 billion. Some of this money had gone for outsized executive compensation to former company chieftains. Fannie Mae CEO Franklin Raines was forced out in December 2004;

Freddie Mac CEO Richard Syron was terminated by the Federal Housing Finance Agency in September 2008 as part of the conservatorship agreement.

Syron, relatively new to Freddie Mac, did pretty well for himself, receiving $19 million in 2007 alone in cash, stock and other compensation despite growing possibilities of a financial meltdown. The case of Franklin Raines, who had served as director of the Office of Management and Budget under President Clinton during September 1996-May 1998 (and immediately before that, Fannie Mae vice chairman), was particularly galling. Highly paid during his tenure – he had received total compensation in excess of $20 million in 2003 – he then received an out-of-this-world retirement package. Raines' Form 8-K, filed December 27, 2004 with the Securities and Exchange Commission, indicated he was entitled to the following:

- deferred compensation of $8.7 million.
- stock options worth $5.5 million, and potentially millions more.
- "performance share payouts" through 2006, potentially worth millions more.
- a monthly pension of $114,393 for the rest of his life, and for the life of his spouse should she survive him.
- free medical and dental coverage for the rest of his life, as well as for his wife for the rest of her life, and his children until age 21.
- free life insurance in the amount of $5 million until age 60, and $2.5 million thereafter.
- a cash bonus for 2004.

Raines had snagged this golden parachute even while SEC investigators were poring through company accounting irregularities. As a final touch, Raines stated: "By my early retirement, I have made myself accountable." This gesture moved National Legal and Policy President Peter Flaherty to remark in a press release: "Let me get this straight. Raines apparently cooks the books, brings disgrace to the company, and imperils Fannie Mae's standing with regulators, the Congress and administration. So for his punishment he is made wealthy for the rest of his life?" Flaherty added: "It is like Enron and Tyco never happened. I cannot even fathom the level of arrogance and self-delusion necessary for Raines to claim he's been made accountable for his mistakes."

Eventually, in an April 2008 settlement with the SEC and OFHEO, Fannie Mae agreed to pay a $400 million civil fine and revise its accounting practices. As for Franklin Raines, he and two other former Fannie Mae executives, J. Timothy Howard and Leanne Spencer, were hit with civil charges in 2006 by OFHEO. The agency sought $110 million in penalties and $115 million in returned bonuses. Eventually, the trio settled out of court. While admitting to no wrongdoing, they agreed to pay fines totaling $3 million. Raines, for his part, agreed to donate his company stock options to charity. Yet the settlement wasn't as onerous as it seemed. Fannie Mae insurance policies covered the $3 million in fines. And Raines' stock options, valued at $15.6 million when issued, now were virtually worthless anyway.

By the time of the September 2008 federal takeover, financial industry golden parachutes had lost their luster. Under heavy pressure from Congress, especially Sen. Charles Schumer, D-N.Y., the Federal Housing Finance Agency nixed severance packages for departing Fannie Mae CEO Daniel Mudd and Freddie Mac CEO Richard Syron worth a combined $24

million. "The agency, serving as conservator, determined that under applicable statute and regulation, the enterprises should not make such payments to these individuals," noted FHFA in a prepared statement. Both major presidential candidates, Barack Obama and John McCain, also denounced the deals.

The recent announcement by the GSEs to boost the annual pay of its top officials from $600,000 to $4 million attests to the staying power of this resentment. According to SEC filings on July 1, current Fannie Mae CEO Timothy Mayopoulos and Freddie Mac CEO Donald Layton each would receive $4 million a year in compensation. Federal Housing Finance Agency Director Mel Watt, after soliciting proposals for promoting CEO retention, had approved them in May. Watt remarked: "The plan defers significant compensation to ensure retention, is based on performance, does not include a bonus, and is consistent with FHFA's statutory responsibilities to ensure safety and soundness and a liquid national housing finance market. The plan also positions each CEO's compensation well below the 25th percentile, one of the requirements set by FHFA in recognition of the fact that the enterprises are in conservatorship."

Lawmakers on Capitol Hill, having gotten word of FHFA approval, were outraged. They quickly responded with legislation to rescind the pay increases. On September 15, the full Senate, led by David Vitter, R-La., and Elizabeth Warren, D-Mass., unanimously approved a bill, the Equity in Government Compensation Act of 2015 (S.236), limiting Fannie Mae and Freddie Mac CEO annual pay to $600,000. The House Financial Services Committee in late July already had passed an identical measure (H.R. 2243) introduced by Rep. Ed Royce, R-Calif., by a 57-1 vote. Senator Vitter explained his position this way: "Giving massive taxpayer-funded pay raises to Fannie Mae and Freddie Mac isn't just out of touch – it's downright offensive." President Obama and the Treasury Department each strongly support the legislation.

On the surface, the outrage is justified. Fannie Mae and Freddie Mac, for years having lowered standards of mortgage risk assessment to reach "underserved" populations and compensated top brass in a lavish fashion, tempted fate. And after being placed under conservatorship, they chose to receive large loan bailouts. Yet the larger story is underneath the surface. What is truly "downright offensive" is that the Treasury Department continues to force Fannie Mae and Freddie Mac to hand over quarterly profits in perpetuity. These companies are legally imprisoned by an arrangement that is neither needed nor wanted. Yes, they borrowed $187.5 billion. *But they have repaid nearly $240 billion.* For some reason, this latter figure is not high enough for their release from further servitude.

Congress has the power to pass legislation returning the companies to the private sector. Yet lawmakers, far from using that power, have leaned toward shutting them down. In 2013, Sens. Bob Corker, R-Tenn., and Mark Warner, D-Va., proposed legislation to liquidate Fannie Mae/Freddie Mac over a five-year period. The following year, fleshing out that plan, Sens. Tim Johnson, D-S.D., and Mike Crapo, R-Idaho, also proposed liquidating these corporations over five years. They also called for replacing them with a federally-chartered insurance corporation that ironically could leave taxpayers exposed at least as much as before. A 2013 House bill, sponsored by Rep. Jeb Hensarling, R-Tex., also sought to terminate Fannie Mae and Freddie Mac, but at least did not include federal guarantees for investors. None of the

bills went anywhere because Republicans and Democrats, though sharing the view that Fannie Mae and Freddie Mac needed to go, could not come to terms over how a replacement system should operate.

The saga of Fannie Mae and Freddie Mac should serve as a fair warning to those who believe that public bailouts, even "successful" ones, are needed to prop up risky business enterprises. Conservatorship per se has not been the problem here. The government assumed key management functions of these companies in September 2008 to protect the nation's credit system from collapse. But the nearly $200 billion in emergency loans accompanying conservatorship has been more trouble than it is worth. The government, though fully repaid, continues to treat Fannie Mae and Freddie Mac as deadbeat debtors. Equally to the point, even if it had set the companies free upon repayment, the fact of the bailouts has raised the expectation of future bailouts. And this is what enabled the sorts of behavior that led to financial recklessness in the first place.

There is no sound reason why Fannie Mae and Freddie Mac can't be returned to the market – this time without special guarantees insulating them from competition. Limiting executive pay is an inevitable fact of life with conservatorship in force. Yet the challenge is to eliminate conservatorship, not perpetuate it. And that means freeing Fannie Mae and Freddie Mac from "affordable housing" mandates that prompted their leaders to significantly lower standards of risk assessment. Very few people, in and out of Washington, seem to understand as much.