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Cause and Effect

SEC Lawsuit Against Fannie Mae and Freddie Mac Demonstrates Why Wall Street Caused the Bush Era Housing and Financial Crises

By David Min
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Introduction

The Securities and Exchange Commission late last year announced it was suing former senior executives at Fannie Mae and Freddie Mac, the government-backed mortgage companies that have helped to finance about half of all home mortgages in our nation in recent decades.[1] The reason: allegedly failing to disclose their exposure to "subprime-like" mortgages between December of 2006 and August of 2008.

Conservatives seeking to absolve Wall Street of its blame for causing the housing and financial crises of the past few years—the roots of which stretch much further back than December of 2006—have implausibly seized on this SEC announcement, inaccurately claiming that it supports their arguments that federal affordable housing policies caused the financial crisis. But these attempts to blame the government for Wall Street's mistakes continue to stretch the facts to support a blatantly ideological narrative that has increasingly become known as the "Big Lie" of the financial crisis.[2]

Indeed, the SEC's allegations actually contradict the argument that Fannie and Freddie, which at the time were so-called government-sponsored entities before falling into federal conservatorship in August of 2008, created the subprime mortgage bubble. And the SEC charges certainly do not support the extreme and factually baseless argument that federal affordable housing goals caused the financial crisis.

To understand the actual role of Fannie and Freddie in the financial crisis just go to the final report by the Financial Crisis Inquiry Commission:

> *These government-sponsored enterprises had a deeply flawed business model as publicly traded corporations with the implicit backing of and subsidies from the federal government and with a public mission… In 2005 and 2006, they decided to ramp up*

their purchase and guarantee of risky mortgages, just as the housing market was peaking… They suffered from many of the same failures of corporate governance and risk management as… other financial firms…

We conclude that these two entities contributed to the crisis, but were not a primary cause… The GSEs participated in the expansion of subprime and other risky mortgages, but they followed rather than led Wall Street and other lenders in the rush for fool's gold.[3]

In short, Fannie and Freddie were poorly designed public-private enterprises, with regulatory oversight that was insufficient to stem misbehavior and badly misaligned incentives that led them to acquire risky loans at the height of the housing bubble in a foolish attempt to maximize short-term profits. These flaws, along with the collapse of the housing bubble created by Wall Street securitization, caused Fannie and Freddie to incur major losses that the taxpayers are paying for today.

Some conservatives, most prominently Peter Wallison and Edward Pinto of the American Enterprise Institute, have seized on these taxpayer losses in an attempt to push the tired and now thoroughly refuted argument that Fannie and Freddie—driven by federal affordable housing requirements—caused the housing and financial crises. As the SEC makes clear, this argument is bunk.

This issue brief will look in detail at the SEC's allegations to demonstrate they strongly support the Financial Crisis Inquiry Commission's findings about the role of Fannie and Freddie, and prove false the factually unsupported argument that federal affordable housing policies created the housing bubble. Briefly, though, here are the facts:

- **Fannie and Freddie did not cause the housing and financial crises because the timing is all wrong.** The SEC's complaints allege that Fannie and Freddie executives, in response to market share lost to Wall Street's securitization of subprime mortgages, dramatically increased their exposure to "subprime-like" mortgages from December 2006 to August 2008. But by December 2006, the subprime mortgage boom was already well underway and the housing bubble was beginning to show signs of popping.

- **The SEC charges make clear that affordable housing policies were not a factor.** Fannie and Freddie's decisions to add more subprime-like risk to their loan was not due to affordable housing policies but rather to a desire to regain market share and profits lost to Wall Street, as the SEC's complaint makes clear. Indeed, the overwhelming majority of loans labeled as subprime-like would not have qualified for the affordable housing goals of Fannie and Freddie.

- **Fannie and Freddie's subprime mortgage exposure still lacking.** The SEC alleges that Fannie and Freddie did not disclose their exposure to certain "subprime-like" mortgages, but the amount the agency claims were not accounted for—roughly $300 billion—is nowhere near the $1.19 trillion in subprime-like mortgages that conservatives seeking to blame Fannie and Freddie for the subprime mortgage bubble claim these two companies failed to disclose.

- **Delinquency rates show the disparity between subprime and subprime-like mortgages.** The delinquency rate data make clear that Wall Street was primarily responsible for the origination of risky mortgages over the past decade. Most of the "subprime-like" mortgages identified by the SEC in the portfolios of Fannie and Freddie defaulted at rates similar to the national average for all mortgage loans of 9.11 percent. This rate is far lower than the 28.1 percent delinquency rate for mortgages defined by the industry as subprime. Overall, Fannie and Freddie loans experienced a delinquency rate of 5.9 percent, compared to a delinquency rate of 26.8 percent for mortgages originated for Wall Street securitization.

- **Other financial markets also experienced bubble-bust cycles.** The argument that federal affordable housing policies, primarily operating through Fannie and Freddie, caused the global financial crisis, fails to explain why bubble-bust cycles occurred in other financial markets. Commercial real estate, which is not subject to federal affordable housing policies, experienced a bubble-bust cycle that was virtually identical to (and even more pronounced than) the bubble-bust cycle experienced in residential real estate. Similar boom-bust cycles occurred in student loans, auto loans, and credit cards. And of course, there were contemporaneous housing bubbles in other countries such as the United Kingdom, Australia, and Ireland—none of which were governed by U.S. affordable housing policies.

In short, the allegations in the SEC's complaints clearly support the conclusion reached by the Financial Crisis Inquiry Commission and every other reputable analysis of the causes of the financial crisis: Wall Street created the subprime mortgage bubble, and Fannie and Freddie belatedly dived in, motivated not by their affordable housing goals but rather by the desire to regain market share and profits lost to Wall Street. So let's now turn to the facts in more detail.

What the SEC is actually alleging

The SEC's complaints against executives of Fannie Mae and Freddie Mac hinge around the question of what a "subprime" loan is. The SEC essentially argues that Fannie and Freddie's disclosures of their exposure to subprime mortgages, which used the industry's definition of "subprime," were misleading, insofar as they failed to include certain categories of "subprime-like" loans.[4]

The SEC's complaints have given fuel to those who claim that Fannie and Freddie were primarily responsible for the financial crisis. Peter Wallison and Edward Pinto of the

American Enterprise Institute were quick to claim that the SEC's allegations that Fannie and Freddie were holding significant amounts of subprime-like mortgages proved their larger argument that Fannie and Freddie caused the explosion in subprime lending.

It should be noted that the SEC's complaints have been heavily criticized.[5] And notably, Fannie Mae has continued to disclose subprime mortgages using the same methodology that the SEC's complaints allege is fraudulent, as blogger David Fiderer points out, a potential sign that the SEC's case may face some long odds. But even if we assume that the SEC's allegations are completely proven, a closer look at these claims shows that Wallison and Pinto are still wrong, as I demonstrate below.

The timing is wrong

Perhaps the most obvious way in which the SEC's allegations contradict the claim that Fannie and Freddie caused the subprime mortgage bubble is the timeframe they cover, which is the period from December 2006 to August 2008.[6] The SEC's complaints make clear that Fannie and Freddie accumulated the bulk of their "subprime-like" mortgages subsequent to December 2006, which was of course long after the boom in subprime mortgage lending had occurred, and right around the time when the housing bubble was beginning to deflate.

As the Financial Crisis Inquiry Commission and many others have observed, this subprime mortgage boom was driven primarily by a massive surge in Wall Street securitization, often referred to as "private-label" securitization to distinguish it from the government-backed securitization done by Fannie and Freddie. Private-label securitization grew tremendously in market share during the early- to mid-2000s, from about 10 percent of all loans in 2003 to nearly 40 percent of all loans by 2006.[7] This growth in Wall Street's mortgage securitization coincided almost exactly with the growth of the housing bubble.

SEC's complaints make clear that affordable housing policies were not a factor

The argument that Fannie and Freddie were primarily to blame for the subprime mortgage boom is part of a broader misinformed argument that federal affordable housing policies, rather than market failures, caused the housing bubble and financial crisis. The SEC's complaints lay bare the deficiencies of this argument, as they make clear that not only did Fannie and Freddie's forays into "subprime-like" loans occur after the subprime mortgage bubble had formed, but they were in fact driven by the same factors that motivated Wall Street to create the subprime mortgage bubble in the first place: a desire to maximize market share and short-term profits.

As the SEC notes, in the early 2000s, Fannie and Freddie lost significant market share to Wall Street securitization:

> *In or about the early 2000s, Freddie Mac and [Fannie Mae] began to lose market share in mortgage loan securitizations to new competitors, including Wall Street banks. Mortgage originations had shifted from traditional fixed-rate loans to higher risk loan products with features such as adjustable rates ("ARMs"), interest-only payments, and reduced documentation requirements.*
>
> *By 2005, the Freddie Mac and Fannie Mae combined share of the market for mortgage securitizations had fallen to approximately 42 percent from a high of nearly 60 percent in 2000…* [8]

As the SEC documents in great detail, it was in response to this lost market share and in an attempt to bolster flagging profits that Fannie and Freddie each made a conscious decision to acquire more subprime-like loans.

> *Freddie Mac responded to this loss of market share by broadening its credit risk parameters to purchase and guarantee increasingly risky mortgages.*[9]
>
> *In response [to the loss in market share to Wall Street securitization], Fannie Mae's board of directors instructed [Fannie Mae] to adjust its business plan to gain back market share.*[10]

Notably, and contrary to the claims of those arguing that the government was to blame, the SEC's complaint makes clear that affordable housing policies had absolutely nothing to do with these decisions. The SEC's allegations contradict the claim that Fannie and Freddie were primarily responsible for the subprime mortgage bubble, and strongly support the broadly accepted conclusion, reached by the Financial Crisis Inquiry Commission and every other serious analysis of the financial crisis, that Wall Street created the subprime mortgage boom, with Fannie and Freddie belatedly jumping in to try to increase their short-term profits and regain lost market share.

Fannie and Freddie's subprime mortgage exposure still lacking

Another major flaw in the argument that the affordable housing goals of Fannie Mae and Freddie Mac caused the mortgage crisis is the relative paucity of subprime mortgages attributable to these two companies. As I have noted in the past, countless analyses of the financial crisis have been undertaken, and the overwhelming consensus has been that while Fannie and Freddie eventually accumulated significant exposure to subprime mortgages this was not large enough to blame them for the subprime mortgage boom. [11]

The main proponents of the argument that affordable housing policies, rather than deregulation of the financial sector, were the primary cause of the financial crisis have been former Financial Crisis Inquiry Commission Commissioner Peter Wallison, who refused to endorse the findings of the other members of the commission, and former mortgage consultant Ed Pinto, both currently employed by the conservative American Enterprise Institute. As I have previously documented, Wallison and Pinto rely on an extraordinarily expansive definition of "subprime" mortgages—one that no one else uses—to reach their conclusion that federal affordable housing policies were responsible for the subprime mortgage bubble.[12]

Under the sweeping definition used by Wallison and Pinto, 27 million home loans—approximately half of all outstanding U.S. mortgages—would qualify as "subprime" mortgages. By way of comparison, the nonpartisan Government Accountability Office estimates that there were only 4.58 million subprime loans outstanding at the height of the boom.[13]

Wallison and Pinto claim that the SEC lawsuit shows their expansive definition of "subprime" mortgages is justified, insofar as the SEC alleges that Fannie and Freddie had significant exposure to subprime-like loans that they did not disclose as subprime. But a quick look at the numbers shows that the SEC's allegations contradict, rather than support, the claims made by Wallison and Pinto.

The SEC alleges that Fannie Mae and Freddie Mac failed to disclose approximately $300 billion in subprime-like loans[14] that they should have categorized as subprime.[15] This is of course a significant amount, but remains exponentially lower than the amount alleged by Wallison and Pinto, who preposterously claim that Fannie and Freddie failed to disclose $1.19 trillion in subprime mortgage holdings.[16] Even if we assume the SEC's allegations are completely proven, the fact remains that Wallison and Pinto cannot justify their outrageously high estimates of subprime loans held by Fannie and Freddie, which have been a mainstay of conservative claims that these two entities were at the heart of subprime mortgage lending.

The upshot: Fannie and Freddie did not accumulate even a small fraction of the subprime-like loans claimed by Wallison, Pinto, and their ideological allies. In fact, Wall Street securitization was responsible for about three-fourths of all subprime mortgages (with banks, insurance companies, and other private actors being responsible for most of the rest).[17]

Delinquency rates show the disparity between subprime and subprime-like

Another crucial point to be made is that the "subprime-like" loans accumulated by Fannie and Freddie do not resemble actual subprime loans—those defined by the industry as subprime—from the perspective of risk, as evidenced by their relative performance rates. As

I have noted in the past, most of the Fannie and Freddie loans characterized as subprime-like by Pinto and Wallison actually have performed approximately the same as the national average delinquency rate for all mortgages of 9.11 percent.[18] Conversely, mortgages defined by the industry as subprime have experienced a 28.3 percent delinquency rate.[19]

The bottom line: the average delinquency rate for all loans originated for Wall Street securitization—prime, subprime, or subprime-like—is 26.8 percent. By way of comparison, Fannie and Freddie loans originated over the same period have defaulted at a rate of only 5.9 percent.[20]

The delinquency rate is perhaps the best gauge of which mortgage products caused the housing and financial crises. That's why former Federal Housing Finance Agency Director James Lockhart says objectively that Wall Street securitization was primarily responsible for the mortgage delinquencies we have experienced to date.[21] Despite accounting for only 13 percent of all outstanding mortgages, Wall Street securitization was responsible for 42 percent of all serious delinquencies. Conversely, Fannie and Freddie, which accounted for 57 percent of outstanding mortgages, were responsible for only 22 percent of all serious delinquencies.

In other words, even if we accept the SEC's contention that Fannie and Freddie should have called some additional portion of their loans "subprime," it is clear that these Fannie and Freddie "subprime" loans are exponentially safer than loans defined as "subprime" within the industry.

Other financial markets also experienced bubble-bust cycles

As I have noted previously, the argument that federal affordable housing policies, primarily operating through Fannie Mae and Freddie Mac, caused the U.S. housing bubble simply fails to explain the spate of parallel bubbles that occurred in markets where there were no such affordable housing policies.[22] Commercial real estate experienced a contemporaneous bubble-bust cycle, suffering a peak-to-trough price decline of 45 percent, which was actually considerably worse than the 33 percent peak-to-trough decline in the U.S. housing sector. The United States saw similar surges in credit liquidity in student loans, auto loans, and credit cards.

Moreover, as the majority and minority of the Financial Crisis Inquiry Commission (with the notable exception of Wallison) observed, the United States was not the only country to experience a housing bubble during this period. The United Kingdom, Australia, and Ireland were among the many countries that also experienced housing bubbles at around the same time. This shows that poorly regulated new forms of finance created asset bubbles around the world, including the U.S. housing bubble, because U.S. affordable housing policies did not cause similar crises in housing markets around the world.

Conclusion

It will likely be several years before the SEC's allegations against Fannie and Freddie are either proven or disproven in a court of law. But even if we assume that all of the arguments put forth by the SEC are true, it is clear that they support the widely held conclusion—reached by the Financial Crisis Inquiry Commission, the Government Accountability Office, and virtually all other serious analyses—that Wall Street caused the recent housing and financial crises.

Unfortunately, a small band of disproportionately influential ideologues on the right continues to try to rewrite history, pushing ahead with their now thoroughly discredited argument that federal affordable housing policies caused the financial crisis, without any regard for the truth of the matter. This disregard for facts extends to their politicized misuse of the SEC's complaints against Fannie and Freddie executives.

These arguments that Fannie and Freddie played a central role in subprime mortgage lending are simply attempts to distract our attention from the central role of Wall Street in the financial crisis, which was enabled by a grand experiment of relaxing the regulation of the financial sector. We painfully relearned the lessons taught to us in the pre-New Deal era, when extreme bubble-bust cycles were commonplace, occurring every five years to seven years: laxly regulated financial markets inevitably lead to major financial crises, which are extraordinarily costly for economic growth and jobs.

This issue brief sets the record straight about the most recent financial bubble-bust cycle so that we do not repeat the mistake yet again.

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Endnotes

1 Securities and Exchange Commission, "SEC Charges Former Fannie Mae and Freddie Mac Executives with Fraud," Press release, December 16, 2011, available at http://www.sec.gov/news/press/2011/2011-267.htm.

2 *See, e.g.*, Barry Ritholtz, "What Caused the Financial Crisis? The Big Lie Goes Viral," The Washington Post, October 31, 2011, available at http://www.washingtonpost.com/business/what-caused-the-financial-crisis-the-big-lie-goes-viral/2011/10/31/gIQAXlSOqM_story.html.

3 Financial Crisis Inquiry Commission, "The Financial Crisis Inquiry Report," available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf, p. xxvi.

4 As the SEC, Fannie and Freddie all acknowledge, there is no uniform definition for subprime loans across the mortgage industry. The mortgage industry typically uses "subprime" designations provided by the originating lender, who generally labels a loan subprime based on the presence of multiple risk characteristics. Wallison and Pinto have argued that this industry definition of subprime is lacking, and that a better definition of subprime is one in which any single risk characteristic is present, particularly when the borrower has a less-than-pristine credit score. But as the staff of the Financial Crisis Inquiry Commission has found, the lender designation of a loan as "subprime" was far more correlated with the loan's actual riskiness than a borrower's credit score (the metric used by Wallison and Pinto), as loans labeled "subprime" by the industry "performed much worse than those the market labeled prime, even when they were in the same grouping of [credit scores]." Financial Crisis Inquiry Commission, "The Mortgage Crisis" (2010), available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/2010-0407-PSR_-_The_Mortgage_Crisis.pdf, pp. 20-23.

5 *See, e.g.*, Joe Nocera, "An Inconvenient Truth," The New York Times, available at http://www.nytimes.com/2011/12/20/opinion/nocera-an-inconvenient-truth.html; Bethany McLean, "A Tale of Two SEC Cases," Reuters, January 17, 2012, available at http://blogs.reuters.com/bethany-mclean/2012/01/17/a-tale-of-two-sec-cases; Jonathan Weil, "SEC's Fannie, Freddie Lawsuits Miss the Enablers," Bloomberg, December 22, 2011, available at http://www.bloomberg.com/news/2011-12-22/sec-s-fannie-freddie-suits-miss-the-enablers-commentary-by-jonathan-weil.html.

6 In the case of Fannie Mae, the "Relevant Period" covered by the SEC's complaint is from December 6, 2006 to August 8, 2008. *See* Complaint, SEC v. *Daniel H. Mudd et al.*, 11 Civ. 9202, p. 1, available at http://www.sec.gov/litigation/complaints/2011/comp-pr2011-267-fanniemae.pdf. In the case of Freddie Mac, the "Relevant Period" covered by the SEC's complaint is from March 23, 2007 to August 6, 2008. *See* Complaint, *SEC v. Richard F. Syron et al.*, 11 Civ. 9201, p. 1, available at http://www.sec.gov/litigation/complaints/2011/comp-pr2011-267-freddiemac.pdf.

7 Financial Crisis Inquiry Commission, "Securitization and the Mortgage Crisis" (2010), available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/2010-0407-Preliminary_Staff_Report_-_Securitization_and_the_Mortgage_Crisis.pdf, pp. 10-11.

8 *SEC v. Richard F. Syron et al.*, p 14.

9 Ibid.

10 *SEC v. Daniel H. Mudd et al.*, p. 41.

11 David Min, "Why Wallison Is Wrong about the Genesis of the U.S. Housing Crisis" (Washington: Center for American Progress, 2011), available at http://www.americanprogress.org/issues/2011/07/wallison.html.

12 David Min, "Faulty Conclusions Based on Shoddy Foundations" (Washington: Center for American Progress, 2011) available at http://www.americanprogress.org/issues/2011/02/pdf/pinto.pdf.

13 Government Accountability Office, "Nonprime Mortgages: Analysis of Loan Performance, Factors Associated with Defaults, and Data Sources," Report to the Joint Economic Committee, United States Congress (2010), available at http://www.gao.gov/new.items/d10805.pdf.

14 The SEC also alleged that Fannie and Freddie had reduced documentation loans that they should have disclosed as Alt-A. As has been well documented, however, the acquisition of Alt-A loans generally makes it more difficult for the enterprises to reach their affordable housing goals. *See*, e.g., John C. Weicher, "The Affordable Housing Goals, Homeownership and Risk: Some Lessons from Past Efforts to Regulate the GSEs," available at http://research.stlouisfed.org/conferences/gse/Weicher.pdf, pp. 11-12. As such, the inclusion of Alt-A and other reduced documentation loans is not appropriate in determining the impact of the affordable housing goals.

15 Specifically, the SEC has alleged that Fannie Mae did not disclose $57.1 billion in subprime-like mortgages, including $43.3 billion in "Expanded Approval" loans and $13.8 billion in "My Community Mortgage" loans. *SEC v. Daniel H. Mudd et al.*, p. 26. The SEC claims that Freddie Mac did not disclose $244 billion in subprime-like loans. *SEC v. Richard F. Syron et al.*, p. 43. Together, this totals $301.1 billion in subprime-like loans that the SEC claims were not disclosed by Fannie and Freddie.

16 Wallison and Pinto claim that Fannie did not disclose $741.7 billion in subprime-like loans and that Freddie did not disclose $445 billion in subprime like loans. Specifically, they claim that Fannie had $1.011 trillion in "high risk" loans, a category that includes subprime-like loans and Alt-A loans. Edward J. Pinto, "Sizing Total Federal Government and Federal Agency Contributions to Subprime and Alt-A Loans in U.S. First Mortgage Market as of 6.30.08," available at http://fcic.law.stanford.edu/documents/view/1406, pp. 5-7. Wallison and Pinto claim that Freddie Mac had $635 billion in undisclosed "high risk" loans. Pinto, "Sizing Total Federal Government and Federal Agency Contributions," pp. 8-10. Subtracting out the $261.3 billion in Alt-A loans disclosed by Fannie and the $190 billion in Alt-A loans disclosed by Freddie, that leaves us with $741.7 billion and $445 billion in subprime-like loans that Wallison and Pinto claim are held by Fannie Mae and Freddie Mac, respectively.

17 Federal Reserve Bank of San Francisco, "The Subprime Mortgage Market: National and Twelfth District Developments" (2007) Annual Report, available at http://www.frbsf.org/publications/federalreserve/annual/2007/subprime.pdf, p. 10.

18 Min, "Why Wallison Is Wrong about the Genesis of the U.S. Housing Crisis," pp. 8-9.

19 Mortgage Bankers Association, "National Delinquency Survey, 2nd Quarter 2010; Freddie Mac, Second Quarter 2010 Financial Results Supplement. These figures represent serious (90+ day and foreclosures) delinquency rates as of June 30, 2010.

20 Federal Housing Finance Agency, "Data on the Risk Characteristics and Performance of Single-Family Mortgages Originated from 2001 through 2008 and Financed in the Secondary Market" (2010), available at http://www.fhfa.gov/webfiles/16711/RiskChars9132010.pdf, p. 27. These figures represent serious (90+ day and foreclosures) delinquency rates as of June 30, 2010.

21 James B. Lockhart, "The Roles of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks in Stabilizing the Mortgage Market," Speech to the National Association of Real Estate Editors, Washington, D.C., June 18, 2009, available at http://www.fhfa.gov/webfiles/2919/Lockhart_Speech_to_National_Association_of_Real_Estate_Editors-06-18-09.pdf, p. 21.These delinquency figures are as of March 31, 2009.

22 David Min, "For the Last Time, Fannie and Freddie Didn't Cause the Housing Crisis," *The Atlantic*, December 16, 2011, available at http://www.theatlantic.com/business/archive/2011/12/for-the-last-time-fannie-and-freddie-didnt-cause-the-housing-crisis/250121/.