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## Government-Sponsored Enterprises: Reality Catches Up to Public Administration Theory

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*Fannie Mae and Freddie Mac are insolvent and in government hands. Political forces led many lawmakers to neglect warnings from public administration academics and practitioners about the vulnerabilities of government-sponsored enterprises (GSEs). Private ownership combined with government backing let the two companies dominate their markets and the political process. GSEs successfully resisted bank-type regulation and capital requirements. The options now include restoring the two GSEs in some form, transforming them into temporary or longer-term wholly owned government corporations, or simply ending them. This article discusses the advantages and drawbacks of each option. Again, the public administration literature provides useful suggestions about organizational alternatives.*

Fannie Mae and Freddie Mac, behemoths of the mortgage finance industry, failed on September 7, 2008, and went into conservatorship under the direction of the federal government. The two companies are government-sponsored enterprises, or GSEs—privately owned companies that benefit from the perception that the government will back their debt obligations and mortgage-backed securities.<sup>1</sup> There are five GSEs: Fannie Mae, Freddie Mac, the Federal Home Loan Bank System, the Farm Credit System, and a small GSE known as Farmer Mac (Stanton 2002). Fannie Mae, Freddie Mac, and Farmer Mac are investor owned. The Farm Credit System and the Federal Home Loan Bank System are cooperatives, owned by their member-borrowers. A sixth GSE, Sallie Mae, which funds student loans, has given up its government sponsorship and

become a completely private investor-owned company (Stanton 2008).

Fannie Mae and Freddie Mac are the two largest government-sponsored enterprises. Together, they fund about \$5.3 trillion in mortgages, or about one-half of the residential mortgage market. Holders of Fannie Mae and Freddie Mac securities include pension funds, commercial banks, mutual funds, and foreign central banks. The systemic risk posed by \$5.3 trillion of securities that the market could not value, even for a brief time, would dwarf the impact of today's credit crunch.

The need for government to provide a stable source of funding to the troubled mortgage market is uppermost in policy makers' minds. How should government best support the mortgage market, both in the

short term and more generally? If the GSEs were replaced by wholly owned government corporations, what would be the benefits and costs of that institutional form compared to GSEs?

Public administration scholars and practitioners have had considerable experience with such questions of organizational design. Indeed, the public administration literature is replete with warnings about the lack of an appropriate accountability framework for the GSEs, especially with respect to their financial safety and soundness.

This article looks first at warnings in the public administration literature about the problems of accountability for GSEs and other government

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There are five GSEs [government-sponsored enterprises]: Fannie Mae, Freddie Mac, the Federal Home Loan Bank System, the Farm Credit System, and a small GSE known as Farmer Mac.... This article looks first at warnings in the public administration literature about the problems of accountability for GSEs and other government instrumentalities. Second, it looks at the effort to create a stronger safety and soundness framework for Fannie Mae and Freddie Mac. Third, the article briefly looks at the causes of failure for the two GSEs....

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instrumentalities. Second, it looks at the effort to create a stronger safety and soundness framework for Fannie Mae and Freddie Mac. Third, the article briefly looks at the causes of failure for the two GSEs and reviews options for providing government support to the mortgage market in the future. Each organizational form has advantages and drawbacks. The article concludes by recommending a return to the wholly owned government corporation as a means of providing support to the mortgage market, especially at times of stress, such as today. Once again, the public administration literature contains many useful suggestions about that institutional form.

### **Accountability of Hybrid Organizations: Warnings from the Public Administration Literature**

Four criteria are helpful in evaluating the quality of agencies and instrumentalities of government that carry out public purposes (Stanton 2003b, 2006):

- Capacity: What is the capacity of the organization, in terms of people, administrative budget, systems, and organization, to carry out its public purposes?
- Flexibility: What flexibility does the organization have, under the law and in practice, to carry out its public purposes?
- Accountability: How well is the organization held accountable for (1) carrying out its public purposes, and (2) its stewardship of public resources?
- Life cycle: As the organization matures, what strengths and shortcomings manifest themselves?

For different organizations, different measures will become more critical than others in understanding strengths and weaknesses. As a general rule, to the extent that weaknesses appear, government departments may have difficulty with the measures of capacity and flexibility, while privately owned instrumentalities may have difficulty with accountability. Numerous organizations of all types have difficulty with life cycle and the ability to remain active, focused, and useful over many years.

Government-sponsored enterprises are privately owned institutions that are free from the budgetary and other constraints imposed on government agencies. As such, they tend to develop significant capacity and flexibility compared to government agencies that serve the same economic sector. A comparison of the mortgage operations of Fannie Mae and Freddie Mac, on the one hand, and the Federal Housing Administration, on the other, displays this pattern.

However, the issue of accountability is salient for GSEs, and for Fannie Mae and Freddie Mac in particular. As private companies operating with

substantial government subsidies, GSEs often grow to dominate their markets (Stanton 2002). As a GSE gains market power, it can use that market power to generate a political constituency among its customers to defend and improve on the status quo. Thus, the *Washington Post* reported on Fannie Mae's use of market power to enlist political support: "Builders, real estate brokers and bankers across the country rely so heavily on Fannie Mae for mortgage funds that they live in fear of offending the firm and routinely defend it in Washington" (Vise 1995). Market power leads to political power; political power, in turn, leads to favorable changes to a GSE's charter to help expand its market power and reduce the effectiveness of any accountability framework that government may seek to apply to the GSEs.

The issue of life cycle is also important for GSEs. Thomas H. Stanton (2007) showed how the rapid growth of GSEs, combined with their dominance of accountability measures, such as government oversight and capital requirements, can lead to flawed business decisions. The current crisis in the mortgage market raises issues of GSE accountability and life cycle with special force.

The public administration literature contains extensive discussion of organizations that carry out public purposes without being part of the federal government itself. Harold Seidman (1988) called these "quasi-government" organizations, while others (e.g., Koppell 2003) have called them "hybrid organizations." Much of this literature focuses on the problem of holding these organizations properly accountable while allowing them the capacity and flexibility for which they were designed. Seidman saw the fundamental question as whether government has the ability to design organizations to carry out complex and varied public purposes without sacrificing public accountability. Surveying the broad range of hybrid organizations, he asked whether there could be "*effective and meaningful* accountability and responsiveness to those officials with political responsibility and through them to the people?" (1975, 83).

Seidman and Musolf (1980) accepted that there are a large number of hybrid organizations and sought to "call attention to the implicit challenge to public accountability which the blurring of the distinction between what is public and what is private poses."

Seidman's colleague, Ronald C. Moe, viewed with alarm the blurring of the distinction between public and private attributes among organizations that carry out public purposes. To Moe, the very mixing of public and private attributes in a single organization ignored fundamental differences in the legal frameworks that apply to public and private organizations. That mixing contributed to government's inability to

impose appropriate accountability on hybrid organizations (Moe 2001, 2004; Moe and Gilmour 1995).

Stanton, another Seidman colleague, took a different tack. He reviewed the institutional antecedents of today's specially chartered government-sponsored enterprises and traced their lineage through the Banks of the United States and the Bank of England, which served Alexander Hamilton as the model for the First Bank of the United States, and more generally to the mercantilist companies chartered by European sovereigns.

Stanton (1991a, 1994) examined the legal literature and case law deriving from the Banks of the United States and found that the principles applicable to commercial banks, and later to thrift institutions, were parallel to those that applied to Fannie Mae and Freddie Mac and other GSEs. This revealed that banks and GSEs shared a common institutional and financial structure, varying in some notable aspects, and that the accountability framework for banks and thrift institutions could and should largely be applied to GSEs, especially with respect to financial safety and soundness (Moe and Stanton 1989; Stanton 1988, 1991a, 1991b).

In its financial effects, particularly the way in which it dampens market discipline, the government's implicit guarantee of GSE obligations is comparable to federal deposit insurance for banks and thrift institutions. The perception of government backing means that investors do not see a need to exercise the usual scrutiny of an institution's creditworthiness when they lend their money by buying GSE obligations or depositing money with a bank, as the case may be. The government must attempt to compensate for the loss of market discipline by creating a regulator with adequate power to examine financial conditions, limit risk, and enforce its requirements. One of the most important requirements is to hold adequate capital so that the institution can deal with periods of financial stress and absorb losses without causing taxpayers to make good on the government's guarantee.

Stanton warned that the history of financial institution failures, including the near failure of Fannie Mae in 1981 and the actual failure of the Farm Credit System, showed that the weak accountability framework for GSEs created a "state of risk."

In the 1990s, it became clear that public administration scholars (Bingman 1992; Mulsolf 1991; Seidman 1998) and government officials (e.g., GAO

1990) appreciated the relevance of the bank-type financial accountability framework. The question then became the one that Seidman had posed years earlier: Does government have the capacity to create the appropriate accountability framework for the GSEs?

### **The Effort to Increase the Accountability of GSEs**

After a three-year legislative struggle led by Representatives J. J. Pickle (D-TX) and Bill Gradison (R-OH) of the powerful House Ways and Means Committee, Congress created a new financial regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), to oversee the largest and most powerful GSEs—Fannie Mae and Freddie Mac. It was immediately recognized that the OFHEO's organization and powers fell well short of the reformers' goals (Bacon 1992; Labaton 1991; Leach 1991). The GSEs, their constituencies, and their authorizing committees were influential enough to prevent the creation of a central regulator for all of the GSEs, as Moe and Stanton (1989) recommended. Also, the new regulator's powers were far weaker than those of the federal bank regulators.

Congressional interest in the accountability of the GSEs waned after the enactment of the 1992 act. The Bill Clinton administration quickly established the OFHEO to regulate the safety and soundness of Fannie Mae and Freddie Mac.

In 2003, Freddie Mac reported on the failure of its internal controls and fired its chief executive officer and top management. In 2004, the GSE regulator conducted a special examination of Fannie Mae and reported that Fannie Mae's internal controls, too, had failed. Fannie Mae then ousted its chief executive and top managers as well. Each company had to restate earnings by billions of dollars (see, e.g., Stanton 2007).

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legislation to try to strengthen the supervision of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. The final legislation, included in the Housing and Economic Recovery Act of 2008 (HERA), represents a great improvement over the 1992 law in terms of creating a new regulator, the Federal Housing Finance Agency, with improved capacity and authority to supervise GSE safety and soundness. However, reflecting the continuing

political influence of the GSEs and their constituents, HERA provides neither the mandate nor the extent of authority over safety and soundness that is available to federal bank and thrift regulators.

### **The Fall of Fannie Mae and Freddie Mac**

The requirement that financial institutions hold a cushion of capital helps to ensure that they may have sufficient financial strength to absorb losses at times of financial stress. The GSEs consistently and successfully fought against having the same capital requirements as commercial banks and other depository institutions. Having higher leverage meant that Fannie Mae and Freddie Mac could give their shareholders returns that, in good times for Fannie and Freddie, ranged above 20 percent a year, and sometimes 30 percent or 40 percent. However, in bad times, leverage works in reverse, and losses quickly run through the thin capital cushion.

The GSEs committed a series of misjudgments that led to their financial demise. Instead of becoming prudent during the housing price bubble, the GSEs disregarded their own risk experts and joined other investors in trying to make money in a market that was about to collapse. The GSEs purchased nontraditional mortgages—that is, those that did not meet the standards for prime mortgages—in large volume (Duhigg, 2008a, 2008b; Freddie Mac 2007, 13; Hilzenrath 2008).

The GSEs also invested heavily in highly rated private-label mortgage securities that failed to meet traditional credit standards. Finally, because the GSEs fund such a large share of home mortgages in the United States, they suffered losses when the general level of housing prices declined and when poor underwriting by other lenders led to foreclosures on homes in the same vicinity as properties on which the GSEs held mortgages.

### **What to Do with Fannie Mae and Freddie Mac**

It now appears, as past losses materialize and are recognized by Fannie Mae and Freddie Mac, that both institutions have lost their entire net worth and will require substantial government support to pay off their obligations. The question then becomes what to do with the two insolvent companies. Once again, as in the concerns expressed by public administration scholars and practitioners before the two GSEs manifested major financial vulnerability, the public administration literature provides useful guidance as to possible next steps.

At this point at least, there appear to be three options with respect to Fannie Mae and Freddie Mac over the long term: (1) continue with investor-owned GSEs (or possibly cooperatives) backed by the perception of an explicit government guarantee, in some form, to

serve the mortgage market; (2) transform the GSEs into wholly owned government corporations backed by the full faith and credit of the U.S. government; or (3) end the investor-owned GSE as an institutional form, possibly using them as short-term wholly owned government corporations to support the mortgage market during the current crisis. Let us consider the advantages and drawbacks of each of these options.

#### ***Continue with the Privately Owned GSE as an Institutional Form***

The advantage of this option is that it preserves Fannie Mae and Freddie Mac, perhaps under new management as a result of conservatorship or receivership, to serve the mortgage market as at present. Moreover, HERA levies fees on the new business that the GSEs undertake, in order to provide an off-budget source of funding for affordable housing and community development. The continuation of GSEs in their current form would provide policy makers with access to a continuing source of off-budget money to fund purposes that otherwise might not be served by the housing market.

This option has two disadvantages. First, in good times, Fannie Mae and Freddie Mac grow rapidly. They currently fund nearly half of the home mortgage market. If government props them up so that they can continue as before, they are likely to fund much more of the market within only a few years. This represents a significant concentration of risk, with consequences that we are now trying to address.

Second, the two GSEs command significant political influence. They used this influence to ensure that they do not have the same capital standards or government supervision as other firms in the mortgage market, such as banks and thrifts. If they continue to use their influence in this way, the taxpayer exposure, especially now that the perception of government backing is explicit rather than implicit, could be even greater in the future than it is today.

The literature contains several variations on the current GSE theme. The government could regulate Fannie Mae and Freddie Mac as public utilities (Seiler 1999), or it could charter multiple GSEs and thereby reduce the monopoly market power of today's Fannie Mae and Freddie Mac (Stanton 2001), or the government could attempt to reduce the risk of the GSEs by requiring them to fund mortgages through securitization rather than through their huge portfolios and by increasing their capital requirements.

Another option would be to replace the investor-owned GSEs with multiple cooperatives, owned, as are the Federal Home Loan Banks, by lenders that serve the primary market. Both the Federal Home Loan Bank System and the Farm Credit System,

another cooperative GSE, have had significant problems with capacity and accountability. The Farm Credit System has operated with an improved structure for capacity and accountability since it failed in the 1980s. (For a discussion of the investor versus cooperative GSE models, see Stanton 2002.) It is consideration of the life cycle

of GSEs that makes this option, or its variations, unwise. Shareholder-owned GSEs have a continuing incentive, once the current crisis has passed, to satisfy shareholders by increasing leverage and continuing their substantial growth. Over the years, the GSEs have been able to use their influence to fend off statutory and regulatory accountability that would bring them to parity, in terms of capital and supervision, with banks and thrifts. The pressure of shareholders to take more risks to maximize profits for themselves or their cooperative owners, as the case may be, can be significant.

***Transform the GSEs into Wholly Owned Government Corporations (and Ultimately a Single Corporation)***

Because Fannie Mae and Freddie Mac are insolvent, and their liabilities exceed their assets, it is appropriate to place them into receivership and remove shareholders from the ownership structure. The government then could shrink the holdings of the two companies and operate Fannie Mae and Freddie Mac as a single wholly owned government corporation under federal management.

The wholly owned government corporation would resemble Ginnie Mae, a government agency that deals in government mortgages, but would guarantee pools of conventional loans. It would not hold loans in portfolio. Conventional loans are not guaranteed or insured by the government and instead may be backed by private mortgage insurance. Operating the former GSEs as a government corporation could help assure the housing market that mortgages will be funded at a reasonable cost. Taxpayer protections would come from sound underwriting standards and risk sharing with the private sector. The new corporation could also set protective standards for brokers and other originators that seek to benefit from the facility. New mortgages in particular, based on appraisals that reflect declining home values, may be good long-term investments.

The benefit of this option is that it cleanly removes shareholders and current management from the equation and allows the government to pump federally backed funds into the mortgage market on a prudent basis. The wholly owned government corporation is an institutional form with contours that are well

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understood (e.g., GAO 1995; NAPA 1981; OMB 1995).

One argument for this approach relates to the way in which the U.S. Treasury's infusion of capital, starting on September 7, 2008, creates the perception of an explicit federal guarantee for the GSEs. With taxpayers now clearly exposed to the financial

risk of GSE operations, it makes sense to let the benefits of GSE operations flow to taxpayers as well. Operating the two enterprises as a single financially self-sustaining government agency, comparable to Ginnie Mae for government mortgages, would allow the government to earn a surplus and use that surplus for public purposes.

The largest drawback of this option relates to organizational capacity: Recent events would seem to demonstrate that it is difficult to manage any organization, public or private, that funds a trillion dollars of mortgages or more. Life cycle is also an issue. After some years, the government corporations could "ossify," that is, begin to display some of the kinds of bureaucratic infirmities that the Federal Housing Administration, for example, has manifested in recent years.

To some extent, the public administration literature provides guidance about addressing the life cycle issue. Harold Seidman, Alan Dean, and Thomas H. Stanton worked with the late Senator Paul Simon (D-IL) to fashion S. 2095, the Government Corporation and Government Sponsored Enterprise Standards Act, which Senators Simon and David Pryor (D-AR) introduced on September 19, 1996, in the 104th Congress. That act was intended to provide a template for policy makers who might seek to introduce legislation to create a new government corporation or GSE. One section of that act provides that the charter for a new government corporation should sunset after 10 years. While the Congress would retain the option to renew the charter, the sunset would give policy makers an opportunity periodically to review life cycle issues and management quality.

This option is attractive because it would align the returns to taxpayers with the risk of a perceived explicit guarantee and would allow the federal government to support the mortgage market and also generate a stream of income with which to fund public purposes. For example, under this option, the government could continue to fund an affordable housing trust fund, if that is what policy makers desire.

***End the Investor-Owned GSE as an Institutional Form (Privatization)***

The GSEs helped the financial sector solve a specific problem—that federal and state laws largely limited

the geographic territories that could be served by banks and thrifts. The GSEs were able to overcome these market imperfections by raising funds in money center areas and providing mortgage money in other parts of the country. Those geographic restrictions on banks and thrifts have now largely been ended. The GSEs turned from vehicles to improve market efficiency into vehicles for delivering a modest federal subsidy based on the perception of taxpayer backing of GSE debt obligations and mortgage-backed securities. The Congressional Budget Office (1996) has pointed out that GSE managers, with their fiduciary responsibility to serve shareholders first, were able to siphon off a large part of the federal subsidy for shareholders rather than the mortgage markets.

The technical aspects of privatization can be managed. The major advantage of the privatization option is that it would end the concentration of financial risk in two large companies and diversify the sources of mortgage money across many other institutions. The major disadvantage of this option is that, at times such as now, the federal government needs to support the mortgage market. Also, it may not always be attractive for banks and other financial institutions to fund 30-year fixed-rate mortgages, although 15-year fixed-rate mortgages should be possible. If 30-year fixed-rate mortgages were no longer available through a GSE, a wholly owned government corporation could be used to reduce the impact of this change, for example, by providing funding for 30-year fixed-rate mortgages to first-time home buyers (see GAO 1996).

One variation on the privatization option deserves careful consideration. This would be to end Fannie Mae and Freddie Mac as investor-owned companies with perceived federal backing and instead create an alternative type of temporary support for today's troubled mortgage market in the form of two wholly owned government corporations. Thus, the government could turn today's Fannie Mae and Freddie Mac into separate wholly owned government corporations. However, in contrast to the earlier option, the government would end those corporations at some specified time—say, five years from now, when the mortgage market stabilizes once again. Because of the short time frame for this alternative, there might not be time to consolidate the operations of the two companies into a single government corporation. The benefits could be substantial:

- They could fund mortgages in a manner targeted to meet pressing public purposes, as the Barack Obama administration defines them.
- They could begin to provide essential consumer protections for borrowers, such as Alex Pollock's one-page mortgage disclosure form (Pollock 2008), borrower counseling, and increased pre-foreclosure loss mitigation services.

- They could begin to devise and impose requirements that primary lenders and other participants in the mortgage process have appropriate financial strength and capability and accountability and engage in appropriate risk sharing before they are allowed to do business with the two companies. Implementation of some of these requirements may need to be deferred until when the housing and mortgage markets return to some semblance of stability.
- They could help adapt their automated underwriting systems, and perhaps other systems and capabilities, for use by other federal agencies, starting with the Federal Housing Administration and perhaps Ginnie Mae and the direct loan program for home owners (part of the disaster loan program) of the Small Business Administration.

In short, the government could turn the insolvency of Fannie Mae and Freddie Mac into an opportunity to begin to upgrade the quality of federal support for the delivery of credit by federal agencies. The companies, once they are charged with serving public purposes rather than a mix of public and private objectives, could support the housing market and fashion important consumer protections and rules of conduct for the participants in that market.

This approach deals both with the capacity and life cycle disadvantages that otherwise can accompany the creation of wholly owned government corporations. A five-year sunset would allow the wholly owned government corporations to support the mortgage market at a critical time. The experience of the Resolution Trust Corporation indicates that a temporary government corporation can develop the capacity to deal with complex financial issues. It does this by attracting high-quality talent who might not contemplate a longer-term career in government. The Resolution Trust Corporation was impressive in the way that it evolved constant improvements in its approach to its mission (Stanton 2003b).

Even though Congress could allow one or both of the government corporations to sunset at the end of their charter terms, this is not a forgone conclusion. If they do sunset, the model of the wholly owned government corporation would remain available if needed to provide government support for the mortgage market in the event of any future crisis.

### **Conclusion: The Wholly Owned Government Corporation Is the Superior Organizational Design to Serve the Current Needs of the Mortgage Market**

At this writing, it appears that a consensus is emerging that the status quo cannot continue. The concentration of risk in only two companies, with shareholder-driven incentives to increase growth and maintain higher leverage than other institutions in the market,

is increasingly seen as unsustainable (e.g., *Washington Post* 2008).

Transforming Fannie Mae and Freddie Mac into wholly owned government corporations, shrinking their holdings, and potentially combining them into a single agency would be one way for policy makers to provide government support for the mortgage market in these troubled times while removing the GSE, which has become a significant source of market instability. This flexible use would not be possible if shareholders remain the subject of fiduciary responsibility in the governance structure of Fannie Mae and Freddie Mac.

One alternative would be to sunset the new government corporations after five years or so, when the market has stabilized; another choice is to consolidate the operations of the two organizations and allow the government corporation to continue for longer, perhaps with a renewable 10-year charter. Political forces led many lawmakers to neglect warnings from public administration academics and practitioners with respect to the GSEs and their design elements, strengths, and vulnerabilities; in making the decision about whether and how to create one or more government corporations, policy makers would be well advised this time to consult the recognized body of public administration knowledge for guidance as it explores organizational alternatives.

## Notes

1. More formally, a government-sponsored enterprise is a government-chartered, privately owned, and privately controlled institution that, while lacking an express government guarantee, benefits from the perception that the government stands behind its financial obligations (see Moe and Stanton 1989). This definition is consistent with the definition that Congress enacted in amendments to the Congressional Budget Act of 1974, codified at 2 U.S.C. Section 622 (8). The Treasury purchase of stock in Fannie Mae and Freddie Mac on September 7, 2008, and its commitment to infuse up to \$200 billion into the companies as needed, make the perception of GSE backing explicit rather than implicit, as it had been before the companies were taken into conservatorship.

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