

# The Life Cycle of the Government-Sponsored Enterprise: Lessons for Design and Accountability

## Perspectives on Performance and Accountability in Public Administration

*The federal government uses government-sponsored enterprises (GSEs) to allocate credit to sectors such as housing and agriculture that are considered to deserve special support. The GSEs illustrate the importance of life cycle in the design and accountability of federal agencies and instrumentalities. Four case studies are presented here. In general, market and political dominance and rapid growth are inherent in GSE design. Dominance means inadequate feedback, which can foster poor management and financial risk. Government lacks an exit strategy for GSEs that have outlived their usefulness. Government should systematically review the organizational structure, accountability, and design of all agencies and instrumentalities, both at inception and over their life cycles.*

The United States has had sufficient experience with government agencies and instrumentalities that it is often possible to foresee likely developments as each type of organization matures. Sometimes the legislation creating an agency or instrumentality may contain compromises at the outset that become manifest only later. Even though the impact of its life cycle lies in the future, it may be possible to predict beforehand some of the critical implications of a flawed organizational design. Zegart (1999) and Comarow (2004) provide useful examples.

In other cases, as Bernstein (1955) explored for regulatory commissions, a historical pattern can be discerned and analyzed. If life-cycle issues cannot be addressed through appropriate design at an organization's inception, the question then becomes how to anticipate and mitigate potential flaws before they cause avoidable harm.

The government-sponsored enterprise (GSE) provides a useful case study of the implications of life cycle for organizational development. When GSEs begin, they may be useful in correcting market imperfections that are adequately addressed by existing institutions. However, their statutory benefits turn most GSEs into large institutions that dominate their markets. Unlike government instrumentalities in the 18th and 19th

centuries that operated under renewable charters, government currently lacks an exit strategy for GSEs that have outlived their usefulness.

### The Government-Sponsored Enterprise as an Organizational Type

Government-sponsored enterprises are specially chartered financial institutions. The federal government uses them to allocate credit to sectors such as housing and agriculture that are considered to deserve special treatment. The GSE may be defined as a government-chartered, privately owned, and privately controlled institution that lacks an express government guarantee but benefits from the perception that the government stands behind its financial obligations (Moe and Stanton 1989). In return for tax benefits, regulatory exemptions, and reduced borrowing costs (thanks to the perception of the government's implied guarantee), the GSE is confined by its charter to serving specified market segments through a limited range of authorized services.

Three of the GSEs are among the largest financial institutions in the nation. Fannie Mae and Freddie Mac each fund \$1.5 trillion–\$2.5 trillion of home mortgages. The Federal Home Loan Bank System, a trillion-dollar group of 12 cooperative institutions, provides inexpensive funds to commercial banks and thrift institutions that own the individual Home Loan Banks. Even smaller GSEs are multibillion-dollar financial institutions. The Farm Credit System and a small GSE known as Farmer Mac provide loans to agricultural borrowers. A sixth GSE, Sallie Mae, which funds student loans, has given up its government sponsorship and become a completely private company.

This analysis of the GSE life cycle might be summarized as follows:

- Thanks to government backing, which is unavailable to their competitors to the same extent, as well as other special benefits, GSEs often grow rapidly into huge institutions and dominate their markets.

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- These GSEs can often call on powerful constituencies to protect them politically and to enact favorable legislation to further expand their franchises and diminish government control. However, GSEs face the continuing prospect of political risk—the chance that an unusual combination of economic or political factors could facilitate the enactment of unfavorable legislation.
- Because of their government backing, most GSEs receive only minimal feedback from the markets; because of their political power, they often receive only minimal feedback from the political process.
- When GSEs grow rapidly, they may depend on people, systems, and processes that remain from the time when the institution was smaller and less complex.
- Rapid growth and limited feedback mean that GSE officers and directors may bask in a favorable environment, even though they have outrun their organizational capabilities and internal controls.

The core argument here is that the combination of market and political dominance, on one hand, and rapid growth, on the other, are inherent characteristics of the GSE structure. There are ways to mitigate these structural failings, but the continuing political power of the larger GSEs—especially Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System and their constituents—makes reform difficult now that they have achieved such market dominance.

If GSEs are to thrive in the future, they need to be supervised by regulators with the mandate and capacity to provide effective feedback before problems get out of control.

Structural limitations, such as portfolio size limits for Fannie Mae and Freddie Mac, can also help to mitigate some of the more serious concerns about risks to the financial system if such a huge institution ever failed. Here, too, the political power of the GSEs comes into play in helping to persuade Congress to avoid setting structural limits at levels that might be financially prudent and comparable to limits (such as capital requirements) that the law imposes on other financial institutions. Let us consider here the life cycles of four of the GSEs: the Farm Credit System, Sallie Mae, and Fannie Mae, and Freddie Mac. (A review of the history and activities of the GSEs, including those not covered here, can be found in Stanton 2002).

### The Case of the Farm Credit System

The federal government created the Farm Credit System as a cooperative, owned by its farmer borrowers, to provide credit for the agricultural sector. After weathering a difficult beginning and the travails of the

Great Depression, the system grew rapidly. At its peak (in terms of market share) in 1982, the Farm Credit System held 34 percent of total farm debt outstanding. At that time, the system's regulator was an extension of the system itself. Special regulatory accounting allowed the system to price loans to its owner-borrowers at prices significantly below those that borrowers could obtain from rural commercial banks. This could not be sustained, however, especially in the face of a serious agricultural downturn.

The Farm Credit System announced in 1985 that it could not meet its obligations. In 1987, the government created a new off-budget federal organization, the Farm Credit System Assistance Corporation, to funnel federally backed funds to the Farm Credit System and its owner-borrowers. At the insistence of the U.S. Treasury Department, the bailout legislation also included statutory changes to create an arm's-length regulator with powers similar to those of the federal bank regulators.

The Farm Credit System continues to grow rapidly today. It has a market share of 31 percent of total farm sector debt, somewhat below the 40 percent share of commercial banks. The system is beginning to perceive the constraints of its charter restrictions and thus is seeking expanded authority. However, especially since the 1987 bailout, commercial banks have manifested a stronger political presence with respect to the system. They seek to block further expansion of the system's authorized powers.

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From a life-cycle perspective, the Farm Credit System, until its financial failure in 1985, manifested a combination of market penetration, growth, and political influence that rendered the GSE impervious to important feedback that might have helped the institution stave off failure. Today, the Farm Credit System contin-

ues to grow but faces increasing constraints from the limits of its statutory authority and the opposition of a commercial banking industry that is politically stronger with respect to the Farm Credit System than it was before the collapse.

### The Case of Sallie Mae

The federal government chartered Sallie Mae in 1972 as part of an effort to provide government funding for the recently established federal student loan program. Student loans were small and costly to service in small numbers. Banks tended to offer student loans to their customers primarily as a way to build consumer loyalty for other financial products. Sallie Mae offered an

opportunity to create a specialized financial institution that could purchase large volumes of student loans and develop profitable economies of scale.

Like other GSEs, Sallie Mae was able to use its statutory advantages to grow rapidly, more than doubling in size every five years from 1975 to 1995. By the late 1980s, Sallie Mae dominated the student loan market, holding some 27 percent of federally guaranteed student loans, compared to the second dominant firm, Citibank, which held only 4 percent. By 1994, Sallie Mae's market share had grown to 34 percent.

In the early 1990s, an unusual confluence of factors came together to turn political risk into a serious threat to the company. The Clinton administration came into office and launched an initiative to create a new federal direct loan program for students. For years, policy makers had expressed concern about the extreme profits that Sallie Mae derived from its public purpose of serving the student loan market. Analysts and policy makers had also objected to the complicated structure and high cost of the guaranteed student loan program, compared to the prospect of a direct loan program operated through schools and funded by low-cost borrowing from the U.S. Treasury.

Despite its political strength, in August 1993, Sallie Mae suffered serious legislative defeat. The 1993 Omnibus Budget Reconciliation Act authorized a new federal direct loan program that would compete with the existing federal guaranteed loan program. As the nation's largest holder of student loans, Sallie Mae was affected much more than other companies. The act also levied a special fee on Sallie Mae, measured as percentage of the student loans that Sallie Mae held in portfolio. The fee largely offset Sallie Mae's funding advantage from its GSE status in the debt markets.

Sallie Mae decided to give up government sponsorship. In return, the company, operating as a non-GSE private company, could expand its business activities without regard to the statutory limits that had been imposed on Sallie Mae as a GSE. One major benefit of GSE status, lower funding costs, had already been neutralized by the offset fee. Sallie Mae rolled out its privatization proposal in 1994 and achieved success with enactment of the Student Loan Marketing Association Reorganization Act in 1996. The company argued that it had come to the end of its useful life cycle as a GSE:

In creating the various GSEs, Congress did not contemplate the need at some point to unwind or terminate their federal charters. However, Congress did not assume the perpetual existence (and continual expansion) of individual GSEs in the context of changing social and economic priorities. The missing element in the GSE concept is the notion of a life cycle for government sponsorship. GSEs are *created* to increase the flow of funds to socially desirable activities. If successful, they grow and *mature* as the market develops. At some point, the private sector may be able to meet the funding needs of the particular market segment. If so, a *sunset* may be appropriate. (Sallie Mae 1994, 13–14)

In 2004, Sallie Mae completed the transition and became a completely private company without government sponsorship. The company retained the economies of scale and market dominance that it had achieved as a GSE and captured 27 percent of the federal student loan market, despite creation of the federal direct student loan program, which today lags Sallie Mae in market share.

### The Case of Fannie Mae and Freddie Mac

The life cycles of Fannie Mae (the Federal National Mortgage Association) and Freddie Mac (the Federal Home Loan Mortgage Corporation) are instructive because they show—like the experience of the Farm Credit System—how government subsidies foster rapid growth and a dampening of feedback that can mask problems until they become major threats to the GSE itself.

Taken together, Fannie Mae and Freddie Mac have roughly doubled in size every five years since Freddie Mac was chartered in 1970 (see table 1). This is the result of a combination of lower funding costs and tax and regulatory advantages that are not comparably available to their financial competitors. The unique nature of congressionally chartered GSEs distinguishes them from commercial banks, for example, which face competition from myriad other institutions that benefit from comparable powers under the same general charter. The statutory charters of Fannie Mae and Freddie Mac are unique and unavailable to other competitors. The two GSEs have been extremely profitable, with returns on equity averaging well over 20 percent for many years (OFHEO 2006a, 6, 24).

**Table 1** Growth of Fannie Mae and Freddie Mac, 1975–2005 (Mortgage Holdings plus Mortgage-Backed Securities Outstanding)

1975	1980	1985	1990	1995	2000	2005
\$ 37.3 billion	\$ 77.6 billion	\$ 263 billion	\$ 740 billion	\$ 1.3 trillion	\$2.3 trillion	\$ 4.0 trillion

Source: Office of Federal Housing Enterprise Oversight (2006a, tables 4 and 14).

As the GSEs have grown, former Treasury secretary John Snow, Comptroller General David M. Walker, former Congressional Budget Office director Douglas Holtz-Eakin, and Federal Reserve chairmen Alan Greenspan and Ben Bernanke have warned about the possibility of financial failure at a GSE spreading to the many holders of GSE obligations, such as commercial banks and foreign central banks. This is what is known as systemic risk, which is the possibility that a failure at one institution could cause market turmoil that then spreads to other institutions in the financial system, with potentially serious effects for the performance of the U.S. economy.

Compared to other financial institutions, Fannie Mae and Freddie Mac hold huge portfolios of mortgages and other assets that they fund at high leverage. If a problem occurred—say, because of changing interest rates—the value of the GSE portfolios could fall dramatically. This happened to Fannie Mae in the early 1980s when the GSE nearly failed, along with many savings and loan institutions that were similarly vulnerable to changing interest rates. If a GSE suddenly lacks the funds to pay off the holders of its debt obligations, there could be ripple effects through the financial system, especially for commercial banks that hold large amounts of GSE securities. At the end of fiscal year 2003, the financial institutions insured by the Federal Deposit Insurance Corporation held more than \$1 trillion of GSE-related securities, amounting to substantially more than their shareholder capital.

The GSEs—especially the largest GSEs, Fannie Mae and Freddie Mac—are politically powerful. Yale professor Jonathan G. S. Koppell makes this point about “hybrid organizations,” his term for instrumentalities that mix governmental and private characteristics, generally: “Designers of future hybrids should not be surprised if hybrid organizations acquire unusual political influence due to their unique combination of public- and private-sector advantages” (2003, 121).

The GSEs develop and maintain their political power in order to survive and thrive. In contrast to other firms that may exercise influence over parts of the political process, but are chartered under general corporation laws that are available to their competitors, the GSE operates under special authorizing legislation that determines how it comes into existence and outlines its permitted powers, the extent of its special tax and regulatory and other privileges, whether other institutions will receive similar charters, powers, and privileges, the powers of its regulator, and what happens if the GSE fails. As in the case of Sallie Mae at the beginning of the Clinton administration, if political risk materializes, it can impair a company’s future as a GSE.

The failure of internal controls at Fannie Mae and Freddie Mac that became manifest in 2003–04 had deeper causes than mere poor management or poor government supervision. The elements of effective supervision of Fannie Mae and Freddie Mac have been understood for many years (see, e.g., Stanton 1991; Walker 2004). However, in good part thanks to the political strength of the GSEs themselves, Congress has regularly balked at enacting such legislation. The GSE, as a hybrid that combines government backing with private ownership and control, involves a concentration of political power that can allow the GSE to obtain a favorable accountability framework and then prevail over its regulator.

As a GSE gains market power, it can use this 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 the GSE’s charter that help expand its market power and reduce the effectiveness of government supervision. Indeed, the statutory framework of Fannie Mae and Freddie Mac arguably gave the government more supervisory control when each company was chartered as a GSE, in 1968 and 1970, respectively, than the government possessed when Fannie Mae and Freddie Mac discovered the failure of their internal controls a few years ago.

The GSEs are active participants in the process of influencing policy makers, especially those who are in a position to affect their charter legislation. On April 19, 2006, Freddie Mac paid a record fine to the Federal Election Commission to settle charges that the company had violated federal law by using company resources to hold some \$ 1.7 million in fund-raisers, many involving the then-chairman of the House Financial Services Committee. That committee is responsible for the legislation that created both Fannie Mae and Freddie Mac and had been considering legislation to address their shortcomings.

## **Current Problems at Fannie Mae and Freddie Mac**

### **Freddie Mac**

Freddie Mac changed accounting firms in 2002. The company had been using Arthur Andersen for many years, but when Andersen got into trouble in the Enron debacle, Freddie Mac decided to change to a firm without that taint. The new auditor, PricewaterhouseCoopers, found that Freddie Mac had been

engaging in numerous accounting practices that were not in conformance with generally accepted accounting principles (GAAP).

In January 2003, Freddie Mac announced that it would need to restate its financial results for 2002, 2001, and possibly 2000. In June 2003, Freddie Mac announced the termination, resignation, and retirement of the three principal officers of the company. Pursuant to a consent order with its regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), the board retained an outside law firm, Baker Botts LLP, to investigate. In July, Baker Botts reported numerous irregularities to the board of directors.

In December 2003, OFHEO published an extensive *Report on the Special Examination of Freddie Mac* (OFHEO 2003). Its findings included the following:

- The size of the bonus pool for Freddie Mac's senior executives was tied, in part, to meeting or exceeding annual specified earnings per share (EPS) targets. Actions to shift extra earnings to future periods helped ensure the achievement of future EPS goals and the related bonuses.
- The company constrained resources needed for accounting and internal controls. Senior management treated the accounting and financial reporting parts of the company like "second class citizens" (OFHEO 2003, 139).
- Freddie Mac circumvented prevailing public disclosure standards in order to obfuscate particular policies and specific capital market and accounting transactions.

On April 20, 2006, Freddie Mac settled lawsuits with shareholders for \$410 million. These suits stemmed from internal control failures and accounting misstatements that forced the company to restate earnings by \$5 billion from 2000 to 2002. Freddie Mac ousted its chairman and chief executive officer, its president and chief operating officer, its chief financial officer, and its general counsel, among other top officials. Since 2004, the company has replaced virtually all senior managers—more than two dozen positions. The company paid a civil penalty of \$125 million to OFHEO and agreed to take corrective measures specified by that agency.

### **Fannie Mae**

Misconduct at Freddie Mac prompted OFHEO to launch a special examination of Fannie Mae. In September 2004, OFHEO produced an interim report on numerous irregularities. That month, pursuant to an agreement with OFHEO, a board of directors' special review committee retained former U.S. senator Warren Rudman and his law firm, Paul, Weiss, Rifkind, Wharton & Garrison LLP, to investigate. On February 23, 2006, Senator Rudman and his firm reported that it had found numerous improprieties, substantiating

OFHEO's findings. The 616-page Rudman Report (Paul, Weiss, Rifkind, Wharton & Garrison 2006), plus another 2,000 pages of appended documents, found the following:

- Fannie Mae had "a culture of arrogance" (443). "Management created an environment that was not conducive to open discussion and exchange of views" (438). The culture discouraged dissenting views, criticism, and bad news. Internally, employees felt uncomfortable telling senior management what it didn't want to hear. Externally, the company maintained an acrimonious relationship with OFHEO, its regulator.
- The achievement of EPS-driven goals was "inextricably linked" to achieving management's maximum bonus pools.
- The company violated GAAP in numerous important ways.
- There were staff shortages and Fannie Mae lacked senior officials with the requisite expertise and experience in key parts of the company. The head of internal audit had no experience or formal training as an auditor; the controller was not a certified public accountant.

Following the release of the Rudman Report, OFHEO issued its final *Report of the Special Examination of Fannie Mae* (OFHEO 2006b). The 340-page report found the following:

- Fannie Mae was engaged in numerous acts of misconduct involving more than a dozen different forms of accounting manipulation and violations of GAAP.
- Senior managers sought to hit ambitious EPS targets that were linked to their own compensation. Fannie Mae's chief executive officer, Franklin Raines, received compensation of \$90 million during 1998-2003; of that amount, more than \$52 million was directly linked to achieving EPS targets.
- Fannie Mae attempted to apply pressure from Capitol Hill to thwart the special examination report. Documents released by OFHEO described Fannie Mae's implementation of a strategy of "opposing, circumscribing, and constraining OFHEO" (OFHEO 2006a, 36-276).

Fannie Mae estimated that it had overstated its earnings by billions of dollars. It allowed its chairman and chief executive officer to retire with a generous compensation package and ousted its chief financial officer and other top officials of the company. Fannie Mae signed settlement agreements with OFHEO and the Securities and Exchange Commission (SEC) that included a \$400 million fine, growth limits, and extensive remedial actions to enhance the safe and sound operation of the GSE. Both the SEC and the U.S. Department of Justice continue to investigate.

The SEC forced Fannie Mae to restate its financial results for 2002 through mid-2004; this was extremely costly. It resulted in “losses of tens of billions of dollars in market capitalization for Fannie Mae shareholders, and expenses for the restatement process, regulatory examinations, investigations, and litigation that the Enterprise has recently estimated will exceed \$1.3 billion in 2005 and 2006 alone” (OFHEO 2006a, 1).

### **Underlying Reasons for the Problems at Fannie Mae and Freddie Mac**

These reports raise significant issues concerning the accountability and performance of government-sponsored enterprises. Two issues stand out: (1) a large GSE’s ability to dominate its environment, and (2) the wisdom of government support for GSEs in forms that result in a life cycle of rapid growth to the extent that the companies outgrow the capabilities of their people and systems.

#### **Dominance of the Environment**

Consider the defense presented by Franklin Raines, Fannie Mae’s ousted chief executive. The Rudman Report included a long letter from the law firm representing Raines, part of which contended that he had been misinformed about events at his company:

[T]his matter involves allegations that accounting professionals misapplied accounting standards and that Fannie Mae’s management and Board of Directors relied upon these erroneous judgments in connection with financial disclosure, after the judgments were, or appeared to have been, endorsed by internal auditors, outside auditors, and regulators. (Downey 2005)

This defense assumes that Fannie Mae’s executive was entitled to rely on favorable reports of internal auditors, the company’s external accounting firms, and OFHEO, among others. In fact, because of Fannie Mae’s policies, each of these actors was affected by resource constraints, distorted incentives, and limited capacity to render independent judgments.

As the Rudman Report explains in great detail, Fannie Mae’s internal audit organization was deprived of resources. This was motivated, at least in part, by a desire to promote the corporate goal of increasing EPS, and by Fannie Mae’s corporate culture, which discouraged the presentation of bad news. The capabilities of the company’s longtime external accountant appear to have been shaped by similar resource incapacity and susceptibility to the corporate culture in which it had worked for many years.

Then there is OFHEO, the regulator. Thanks to the lobbying power of Fannie Mae and Freddie Mac,

OFHEO was created as an institution that lacked the capacity needed to do its job (Bacon 1992). The OFHEO was limited by the appropriations process and had a budget that was much smaller, compared to its responsibilities, than the budgets of the federal bank regulators.

Whenever OFHEO tried to do its job well, as in the *Special Examination Report on Fannie Mae*, it felt political pressure. Fannie Mae lobbyists generated a congressional request for the inspector general of the Department of Housing and Urban Development to investigate OFHEO’s conduct in the special examination. Between October 2002 and June 2004, there were three other congressional requests for investigations of OFHEO. Fannie Mae lobbyists also tried to use the appropriations process to force a change in the leadership of the agency. They convinced the Senate Appropriations Subcommittee to try to withhold \$10 million from OFHEO’s appropriation until a new director could be appointed. Until Freddie Mac’s board acted in 2003, OFHEO’s examinations completely missed the failures of internal controls at the two GSEs.

In short, Raines defended himself by stating that he had relied on affirmations from organizations whose behavior had been shaped by the power of Fannie Mae and its centralized leadership structure. As one financial commentator wrote, “If, in the parlance of modern business, controlling one’s environment is the name of the game, maybe Fannie controlled its environment too well, getting congenial answers until it was too late” (Connor 2006).

The ability to control their environments, in turn, permitted the management of both GSEs to stress EPS as the critical measure of performance, without fear of contradiction. This led to deprivation of adequate staff and systems in key organizations within the two GSEs. Given the immense resources at the company’s disposal, the constraints on staff and systems at Fannie Mae are striking. In 2003, the last year of Raines’s program to double EPS in five years, the company’s net income was reported as \$7.9 billion, and return on equity for that year was 49.9 percent (OFHEO 2006a, 6).

The same parsimony existed at Freddie Mac during the same period. The OFHEO reported that, just as it would later find at Fannie Mae, stringent resource constraints had led to ineffective business units: “Simply stated, the quality and quantity of accounting expertise was too weak to assure proper accounting of the increasingly complicated transactions and strategies being pursued by Freddie Mac” (2003, 13).

## Rapid Growth

This relates to the second issue. Government-sponsored enterprises receive numerous tax, regulatory, and other benefits, including statutory authority to operate at high leverage, which may enable them to thrive and take market share from competitors. As table 1 shows, Fannie Mae and Freddie Mac grew rapidly, both in their portfolio businesses and in the outstanding mortgage-backed securities that they guaranteed.

Both the Rudman Report and the OFHEO report on Freddie Mac documented how officials rose within both organizations and reached major positions that were inappropriate for such large and complex organizations. The Rudman Report shows, for example, how Fannie Mae promoted an internal candidate to become senior vice president for internal audit even though he had had no prior training or experience as an auditor. At Freddie Mac, the chief financial officer, also promoted from within, “had little knowledge of GAAP, financial accounting, or disclosure rules” (OFHEO 2003, 91).

In other words, although senior officers and directors at both GSEs were riding high, Fannie Mae and Freddie Mac were outgrowing their internal controls and the capabilities of their managers and systems. This raises the question, not yet answered, of the capabilities of other parts of the companies.

## Where Do We Go from Here?

### Improving Organizational Design

Once life cycle issues are understood, they can be addressed both in the design and in the supervision of a GSE. Sidney D. Goldberg and Harold Seidman (1953) set forth a template for policy makers to use when considering the statutory framework for creating new wholly owned government corporations. Senators Paul Simon and David Pryor (U.S. Senate 1996), relying on work of Harold Seidman, Alan Dean, and Thomas Stanton, introduced legislation to provide such templates for wholly owned government corporations and GSEs.

Such templates seek to address major life cycle issues and strengthen the quality of organizations that policy makers may wish to establish. The idea of a template is to suggest an appropriate framework that policy makers can adapt to the particular circumstances of new organizations and the legislative process from which they emerge.

For a GSE, it is important to build an exit strategy into the organization’s initial design. The Office of Management and Budget, for example, has stated that “GSEs should only be created with a clearly

articulated ‘exit strategy’ and an express sunset date in their charter” (1995, 14–15).

Alex J. Pollock (2005) points out that such a sunset was a feature of charters of instrumentalities that government chartered in early years of the Republic. Most notable were the First and Second Banks of the United States, the lineal ancestors of today’s GSEs, which operated under a 20-year sunset provision. However, GSE charter acts do not include such fixed terms.

### Implementing an Exit Strategy

If there is no sunset date in a GSE charter, then the option remains of trying to remove government sponsorship at a later date. The U.S. Treasury Department (1995) articulated this position in urging removal of government sponsorship from Sallie Mae:

The Treasury has for a number of years, in Democratic and Republican Administrations, believed that it is appropriate to wean a GSE from government sponsorship once the GSE becomes economically viable and successfully fulfills the purpose for which it was created with Federal sponsorship, or when the purpose for which it was created ceases to exist.

As the case of Sallie Mae shows, the political strength of a GSE can make privatization difficult except on the most favorable terms to GSE shareholders. This relates to what the Treasury has called “the tension between profit and public purpose” that is inherent in the GSE as an organizational type:

When creating a GSE, Congress defines the problem (i.e., the market imperfection) it seeks to overcome, provides benefits (subsidies), and imposes limitations on the GSE. But if Congress wishes to revise those decisions in response to changing public needs, it no longer has the same freedom of action. In addition to the usual constraints of the legislative process, it must contend with the private interests of the GSE and its shareholders. Congress must consider, and legislate, any such changes through a process in which the GSEs are significant participants. As a private company, the GSE will act to fulfill its fiduciary responsibilities by promoting and protecting the interests of its shareholders. (1996, 81)

## Conclusion: Larger Lessons about the Design and Supervision of Government-Sponsored Enterprises

Koppell (2003) anticipates that hybrid organizations such as GSEs will become even more significant in coming years than they are today. Because the GSE is a mechanism for delivering a federal subsidy outside

the federal budget, the GSE would seem to be an instrument that is of continuing interest to policy makers.

The fundamental lesson of the life cycle of the GSEs reviewed here is that the GSE does not offer a free lunch. In creating a GSE, or in permitting it to expand its scale and scope, policy makers make a trade-off. They receive access to an off-budget vehicle that can help funnel government subsidies to preferred purposes. In return, the government takes on risk—in some cases, substantial risk. The savings and loan debacle stands as a warning that—as in the case of Hurricane Katrina with respect to natural disasters—policy makers cannot play the odds forever; high impact events can and do materialize. The current GSEs must be structured to limit financial risk and ensure effective accountability and supervision, or the potential cost of an off-budget subsidy can become very high.

What does effective accountability mean? First, feedback is essential for effective operations. Though many organizations strive for autonomy in their environments, appropriately designed organizations should balance the need for flexibility against requirements for accountability. Many examples exist, in both the private and public sectors, of how too much autonomy can lead to subsequent failure. The details of effective financial supervision are well known, especially from the experiences of the federal bank regulators. The GSEs themselves should have a stake in being supervised by a capable independent regulator.

Second, private actors generally are more nimble than government. Government backing of private organizations causes special vulnerability to flaws in structure and accountability. Once problems emerge, as in the savings and loan debacle or with Fannie Mae and Freddie Mac in 2003–04, policy makers find it difficult to act effectively. At the design stage, policy makers should understand and address the potential costs of creating hybrid organizations.

Third, in the financial sector, the agility of private actors means that risk will migrate to areas where government is least equipped to deal with it (Stanton 2002, xii). Thus, in the aftermath of the savings and loan debacle, when the supervision of thrift institutions was strengthened, hundreds of billions of dollars of mortgages, and the attendant risks, shifted to the GSEs, where supervision was much weaker. This private sector agility tends to exacerbate design flaws in hybrid organizations. Especially in the financial

services arena, legislation tends to lag developments in the marketplace, often substantially.

Fourth, given evidence of design flaws that manifest themselves at considerable cost from time to time, the federal government should establish processes to regularly assess organizational structures of agencies and instrumentalities to anticipate and mitigate the likelihood of un-

pected failures.

In the 1960s and early 1970s, the Executive Office of the President included an Office of Management and Organization, housed first in the Bureau of the Budget and then in the new Office of Management and Budget, with responsibility for improving management and organization of government organizations and programs. That office worked on enhancing the institutional capacity of the presidency and, by extension, the rest of the executive branch. One of its functions was to review the way federal agencies and instrumentalities were organized and to propose improvements. As Ronald Moe (2006) has argued and testified, the Executive Office needs to restore such an office. Government-sponsored enterprises are only the most recent examples of organizations with structural shortcomings that, if left unchecked, can weaken or even bring down institutions. As with most issues of salience in the political process, corrective measures (such as portfolio limits on GSEs) are best proposed early, before constituencies become locked into rigid positions.

The GSEs should be red flags for policy makers, not only about financial vulnerabilities but also to highlight the need for government systematically to review organizational structure, accountability, and design across its agencies and instrumentalities.

That Fannie Mae and Freddie Mac could stumble so badly without causing failures in other parts of the financial system was a rare benefit; feedback is indeed valuable, and policy makers would be wise to heed it before flaws in these or other institutions manifest themselves in more costly ways.

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