[Fannie Mae's Last Stand](#) by **Bethany McLean** February 2009 (doc formatting added here)

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Many believe the government-backed mortgage giants known as Fannie Mae and Freddie Mac were major culprits in the economic meltdown. But, for decades, Fannie Mae had been under siege from powerful enemies, who resented its privileged status, its hard-driving C.E.O.'s, and its huge profits. Surveying Fannie's deeply dysfunctional relationships with Congress, the White House, and Wall Street, the author tells of the long, vicious war—involving most of Washington's top players—that helped propel one of the world's most successful companies off a cliff.

"The chairman of the universe."
"Washington, D.C.'s Medici."
"The face of the Washington national establishment."
"One of the most powerful men in the United States."

All those phrases were used to describe a man you may never have heard of: **Jim Johnson**, the C.E.O. of mortgage giant Fannie Mae in the 1990s. Fannie was then one of the largest, most profitable companies in the world, with a stock-market value of more than $70 billion and more earnings per employee than any other company in America. (By comparison, G.M. at its peak, in 2000, was worth only $56 billion.) On one level, Johnson, now 65 years old, was just another businessman with a lot of money and multi-million-dollar houses in desirable locations from D.C. to Sun Valley, Idaho, to Palm Desert, California. Chairman of D.C.'s premier arts venue, the Kennedy Center, and one of its top think tanks, the Brookings Institution, Johnson was out "wearing white-tie and black-tie every night," says Bill Maloni, Fannie's former chief lobbyist. "Everyone wanted a little bit of Jim."

But Johnson was also a political force, because the company he ran had a public mission—literally. It had been chartered by Congress to help homeownership. Johnson liked to paraphrase the old motto about General Motors: "What's good for American housing is good for Fannie Mae," he'd say. Accordingly, he built Fannie into what former congressman Jim Leach, a Republican from Iowa and longtime Fannie gadfly, calls "the greatest, most sophisticated lobbying operation in the modern history of finance."

He may be right. John McCain was embarrassed last summer by revelations that his campaign manager, Rick Davis, had served as the president of the Homeownership Alliance, an advocacy group for Fannie and Freddie Mac, Fannie's smaller brother. The "revolving door," as people call it, between the Hill and Fannie and Freddie spun so quickly that it's actually more surprising when someone isn't on the list than when they are. Rahm Emanuel served on Freddie's board! Right-wing godfather Grover Norquist lobbied for Fannie! Newt Gingrich was a consultant for Freddie, and Ralph Reed was a consultant for Fannie!

The Princeton-educated son of a Minnesota state legislator, Johnson has silver hair and round tortoiseshell glasses, which give him a warm appearance that is belied by the hard planes of his face. Indeed, he was "very warm, very nice," in the words of one former Fannie executive, but also "very hard-ass." In 1996, Richard Baker, a Republican representative from Louisiana, complained that the preface to a Treasury Department report on Fannie had been watered down to make it friendlier to the company. Rumors flew that this had been accomplished after Johnson, or someone else high up in the company, had simply made a call to Treasury Secretary Robert Rubin or President Bill Clinton, both of whom were Johnson's personal friends. (Johnson and Clinton had met at a 1969 gathering on Martha's Vineyard.) Johnson has denied calling either man, and has said that he and Rubin had a policy while Rubin was Treasury secretary that they would not discuss business. But, under Johnson, Fannie Mae had a reputation for never losing a fight. "The old political reality was that we always won, we took no prisoners, and we faced little organized political opposition" is how Daniel Mudd, son of journalist Roger Mudd and Fannie's last real C.E.O., later described Fannie's golden years.

On December 15, 1998, Jim Johnson's retirement dinner was held at the National Museum for Women in the Arts. That seems to have been the second choice—according to The Washington Post, the gala was supposed to have been in the U.S. State Department's Benjamin Franklin Room, which could be used by outsiders only if a government official requested it. The Post began making calls after it got hold of an invitation, at which point State Department lawyers pulled the plug. But the dinner was grand in any event. Rubin spoke, as did comedian Bill Cosby and Fannie board member Bill Daley, the brother of Chicago's current mayor.

The press reported Johnson's compensation in his final year as around $7 million, but an internal Fannie Mae analysis (which assumed a high stock price) said that the real number was closer to $21 million. Plus, he got perks that could add up to half a million a year: a consulting agreement, two support-staff employees paid for by Fannie Mae, a car, and partial payment for a driver.

There were rumors that Johnson was angling to become Treasury secretary. Instead, in 1999, he became one of the first outside directors of the investment bank Goldman Sachs, where Rubin had been C.E.O., and where current Treasury secretary Henry Paulson presided at the time. Johnson became the head of the compensation committee, making him the closest thing Hank Paulson had to a boss.

Flash forward to just 10 years later. On Friday, September 5, 2008, Treasury Secretary Paulson sat in a conference room at an obscure government agency known as the Federal Housing Finance Agency (F.H.F.A.), which had been charged with regulating Fannie and Freddie. Next to Paulson sat Jim Lockhart, the director of F.H.F.A. On Lockhart's other side was Ben Bernanke, chairman of the Federal Reserve. Across the table sat Dan Mudd, who had become Fannie's C.E.O. in late 2004. By the summer of 2008, Fannie and Freddie owned or guaranteed $5.2 trillion of American mortgages, roughly half the $12 trillion total. Just six weeks before the September 5 meeting, Lockhart had said publicly that Fannie Mae's capital was "well in excess" of what it needed to survive the mortgage storm that was engulfing the nation. But at the meeting he announced that the company's capital was, in fact, insufficient. The government officials told Mudd that his company had to give its consent to something called conservatorship, which meant that the government would take it over, pretty much wiping out shareholders—not because Fannie needed capital at that moment, but because they believed Fannie would need it in the future. Mudd was out. The message to Fannie executives, says one person who was in the room, was crystal clear: "If you oppose us, we will fight publicly and fight hard, and do not think that your share price will do well with all of the forces of the government arrayed against you."

There was also a threat that F.H.F.A. would make life very unpleasant for both the board and management if they didn't agree to the government's terms, says another Fannie executive. "That's really not true—there were no threats," claims Lockhart, although he adds, "We were very firm." Steve Ashley, former chairman of Fannie's board, asked what the government wanted Fannie to do that it wasn't already doing. The Fannie team didn't feel that any good answers were given.

A lot of people assume they already know the story of Fannie's fall from grace. In a narrative that has been repeated incessantly in op-eds and on cable TV, there were good guys and bad guys. The good guys were the Republicans, who had tried to rein in Fannie and Freddie (which was also put into conservatorship that same day), and the bad guys were the Democrats, who wanted to put people into houses they couldn't afford with subprime mortgages, and Fannie itself, which took advantage of its supposed mission to enrich its executives at the expense of taxpayers. Some even argue that Fannie and Freddie—"the toxic twins," former Connecticut Republican representative Chris Shays called them—are to blame for the entire economic meltdown. They were "the match that started this forest fire," according to John McCain. On October 21, a group of House Republicans wrote to Attorney General Michael Mukasey, requesting that the Justice Department appoint a special counsel to investigate Fannie and Freddie executives. (The F.B.I. is investigating both Fannie and Freddie.) Jim Johnson, by last June the vetter of vice-presidential candidates for Barack Obama, had to resign the post due to allegations that he had gotten more than $7 million of loans—some at favorable rates—from scandal-ridden Countrywide Financial, a major Fannie Mae customer whose former C.E.O., Angelo Mozilo, was a friend of Johnson's. (Johnson said at the time that he received no special favors.)

But there's a very different—albeit equally radical—version of reality. In this version, which is told by former Fannie executives and shareholders, Fannie was shot, not because it had to be, but because it could be. "The weekend massacre" is how one former Freddie lobbyist describes the events of the September 5 weekend. "My view is [the Bush] administration said we've got four months to remove this thorn in our side," says Tim **Howard**, who was **Fannie's chief financial officer from 1990 to 2004**. "There will never be another time. We've got to do it now."

It is worth noting that thus far the government has put not a dime into Fannie and only $13.8 billion into Freddie—which is a drop in the bucket compared to the taxpayer dollars that have gone to some other firms, such as the $45 billion Hank Paulson has handed Citigroup. In this alternative narrative, it was Paulson's rash action of taking over Fannie and Freddie that helped cause the financial meltdown. As famous money manager Bill Miller, the chief investment officer of Legg Mason Capital Management, wrote in a recent letter to his investors: "When the government pre-emptively seized [Fannie and Freddie] not because they needed capital and could not get it, but because the government believed they would run out in the future, then shareholders of every other institution that needed or was perceived to need capital did the only rational thing they could do—sell, in case the government decided to pre-emptively wipe them out as well."

In truth, Fannie was a company with extraordinarily powerful enemies. They spanned the decades, the two parties, and the ideological spectrum, from Reagan budget director David Stockman to Clinton Treasury secretary Larry Summers to President George W. Bush, and from Ralph Nader to former Federal Reserve chairman Alan Greenspan. These enemies, who detested the privileges Fannie got from its congressional charter, had long wanted to drastically curtail the company—or kill it outright. Johnson called the battle a "philosophical dispute with deep roots and many, many branches," and it was, but it was also a personal dispute based on rivalries and jealousies. "The War of the Roses" is how a former Fannie executive describes it.

As in most wars, there is fault on both sides. Although in 2000 the Department of Housing and Urban Development (hud), under Andrew Cuomo, increased the requirements that Fannie and Freddie buy loans made to lower-income people, a dramatic increase came in 2004—under the Bush administration. Some people believe it did so merely in order to pressure the companies into agreeing to new regulation. But Fannie itself isn't a hapless victim, either. In the end, it was Fannie executives who made a business decision to stake their future on risky mortgages that had nothing to do with helping people own homes. The company used its political power to stymie effective regulation, and its extreme aggressiveness and arrogance gave its enemies license to do things they never would have done to a normal company. And, oh, did they ever.

The Vampire Issue

Gary Gensler, the Treasury undersecretary for domestic finance in the final years of the Clinton administration, likes to tell a story about the deal Alexander Hamilton cut with Thomas Jefferson and James Madison back in 1790. Jefferson and Madison agreed that the nation would assume the debt of the states; Hamilton agreed that the capital of the country would not be in New York, but rather on the Potomac. "This was a very wise move," says Gensler, "because for about two centuries it separated the nation's financial capital from its political capital." Then he chuckles a little. "It worked until Fannie Mae and Freddie Mac came along."

The **Federal National Mortgage Association** (Fannie Mae) was founded in **1938**, a creature of F.D.R.'s New Deal. The **Federal Home Loan Mortgage Corp**. (Freddie Mac) came along in **1970**, when the thrift industry decided that Fannie needed a competitor.

Referred to as **Government Sponsored Enterprises**, or **G.S.E.**’s, they were created to help homeownership, but that has never been because they lend money directly to homeowners. Instead, Fannie and Freddie bought mortgages from the local institutions—banks, thrifts, and mortgage originators—that had made them, which relieved those mortgage-makers of both the credit risk (the risk that the homeowner wouldn’t pay) and the interest-rate risk (the risk that the bank would earn less on the mortgage than it paid on its debt). This enabled the mortgage-makers to go out and make more loans.

In addition to having a congressional mandate to aid homeownership, Fannie and Freddie also had shareholders who wanted to see profits, just like Citigroup or General Electric or any publicly traded company. That’s because in 1968 President Lyndon Johnson, who needed money to pay for the Vietnam War, decided to remove Fannie from the government’s balance sheet by having it sell shares to the public. Freddie followed suit in 1989.

And yet, Fannie and Freddie weren’t just like Citigroup or General Electric, or any normal company, because they kept an array of special perks that came with their congressional charters. Among those perks: an exemption from state and local income taxes, presidential appointees on their boards of directors, and a line of credit with the U.S. Treasury. This last was by far the most important, because the line of credit—eventually $2.25 billion for each company—implied to many investors that the full faith and credit of the U.S. government stood behind Fannie and Freddie. Officially, everyone denied that that was the case, but this “double game”—as Rick Carnell, the Treasury undersecretary for domestic finance in the 1990s, called it—enabled the companies to raise money at a cost that was just a smidgen higher than that of the government itself, thereby providing them with an enormous competitive advantage over ordinary financial institutions.

As the mortgage market evolved, and finance grew more sophisticated, Fannie and Freddie came to make their money in two ways. One was supposedly conservative: they were paid a small fee by the mortgage-makers to guarantee that the homeowner wouldn’t default. And for most of their history, they wouldn’t buy just any loans, but rather loans that conformed to certain size limits (thereby excluding so-called jumbo loans, more than $417,000) and fairly strict credit standards. Then they repackaged these loans into what are known as mortgage-backed securities, and sold them to other investors. The new investors were willing to take the interest-rate risk, but didn’t have to worry about evaluating each and every homeowner’s ability to pay—a task of enormous proportions—because Fannie and Freddie guaranteed that. Today, this is the $3.7 trillion in mortgages Fannie and Freddie guarantee.

UStax payers

The other way Fannie and Freddie made money was when they began to repurchase their own mortgage-backed securities, and to buy similar securities that were created by Wall Street without the G.S.E. guarantee, and hold them in a portfolio. Then Fannie and Freddie pocketed the difference—what Greenspan called “the big fat gap”—between what the mortgages yielded and the companies’ own cost of borrowing funds. This was an immensely profitable business: Wall Street analysts estimated that it provided up to three-fourths of Fannie’s and Freddie’s earnings, and today the portfolio business comprises most of the $1.5 trillion in mortgages that Fannie and Freddie own.

This second way of making money became the source of great controversy. Critics, most notably Alan Greenspan, argued that the portfolio wasn’t worth any risk at all because it did nothing to put people in homes and existed only to make money for the companies’ executives and shareholders. He and other critics didn’t want just to modify Fannie’s and Freddie’s business. They wanted to drastically curtail it—or, better yet, wipe out the two G.S.E.’s altogether. And so it was only human nature that Fannie and Freddie fought back—hard. Or, as former Fannie chief lobbyist Bill Maloni, whose Friday-night poker games for Washington power players were the stuff of legend, wrote on a blog, “One fact of the GSE world is that you will be slaughtered either for being a sheep or a wolf, and I’d much rather meet my fate as a predator than as a lamb chop provider.”

Maloni and his bosses felt that they couldn’t lose any battle, no matter how small. “You punch my brother in the face, I’ll burn down your house” was one Fannie Mae saying. Another was “It’s better to throw one brick too many than one brick too few.”

But Fannie, no matter how aggressive it was, could never stop the criticism. Within Fannie, people called the desire to shrink them or kill them the “vampire issue”—because Fannie could never make it go away.

Jim Johnson had come to Fannie in 1990. His predecessor, David Maxwell, had been on the tennis team at Yale and was “the kind of man who sends only handwritten notes,” recalls Maloni. But Maxwell was also a tough cookie who knew how to get what he wanted. When he left, in 1991—with a $19.5 million retirement package—a humorous going-away video showed corporate cars leaving Fannie’s offices with body bags in the trunks.

Maxwell had met Johnson at a small Washington dinner party in 1985. Johnson was a partner at Shearson Lehman, where he’d landed after he and Richard Holbrooke (who would go on to become ambassador to the U.N. under President Clinton) sold a consulting firm they’d founded to the investment bank. Johnson’s world encompassed both business and politics. He had worked on the campaigns of Eugene McCarthy and George McGovern, and then served in the Carter administration as Walter Mondale’s executive assistant (and later the chair of his presidential campaign), during which time he married Mondale’s press secretary, Maxine Isaacs, now a lecturer at the Harvard Kennedy School. When Maxwell retired, he chose Johnson as his successor over protests from President George H. W. Bush’s people, who claimed Johnson was a partisan Democrat.

It was Johnson who “took the seeds that David Maxwell sowed and [grew] them far beyond what David Maxwell dreamed,” as Countrywide chief Angelo Mozilo later told a reporter. Like Maxwell, Johnson cut a charming, suave figure in society, but under his Minnesota-nice exterior was the heart of a born fighter. “In daily life, he’d say things like ‘We’re going to cut them off at the knees,’” says a former Fannie executive.

A key test for Johnson came early in his tenure, when Congress began work on **how best to regulate Fannie** and Freddie. The resulting legislation, which **allowed the G.S.E.'s to hold lower amounts of capital** than other financial institutions, was what one analyst later called Johnson's "finest moment." Fannie lobbied relentlessly, using a letter from former Fed chairman **Paul Volcker**, who said that if Fannie reached its proposed capital standards it would be able to maintain its solvency.

Fannie's allies in Congress also made sure that the new regulator—which was known as the **Office of Federal Housing Enterprise Oversight** (**ofheo**) until its name was changed to the **F.H.F.A.** in the summer of 2008—was **placed inside hud, which had no experience regulating a financial-services company**, and that ofheo, unlike any other regulator, would be subject to the appropriations process, meaning its funding was at the mercy of politicians—politicians who often took their cues from Fannie.

Not surprisingly, ofheo was a notoriously weak regulator. For almost three years, from February 1997 to September 1999, the agency didn't even have a director. "The goal of [Fannie's] senior management was straightforward: to force ofheo to rely on [Fannie itself] for information and expertise to such a degree that Fannie Mae would essentially be regulated only by itself," wrote ofheo in a report years later.

Johnson also addressed Fannie's other big problem, which was that **homeowners and politicians never really understood what it did.** "There's nothing in the homeowner's life called Fannie Mae," he'd say. So he had to show homeowners that the company was indispensable. The cornerstones of his strategy were the Fannie Mae Foundation and the Partnership Offices. *In 1994, Fannie began opening offices in congressional districts around the country. They issued thousands of press releases, which usually featured a local politician prominently assisting Fannie in some good housing-related deed.*

In 1995, Johnson seeded the Fannie Mae Foundation with $350 million in Fannie stock. In the ensuing years, the foundation gave away millions of dollars to organizations ranging from the Cold Climate Housing Research Center, in Fairbanks, Alaska, to the Congressional Hispanic Caucus Institute. All of this, along with the alliances Johnson built with others in housing, including **homebuilders** and **real-estate agents**, helps explain all the outcry today about Fannie's and Freddie's lobbying dollars—$170 million over the past decade, or just a little less than what the American Medical Association spent, according to the Associated Press. But that misses the point. It's like counting only one arm on a giant octopus. "They ran a battle plan that would make Patton proud. It was 24-7 and never anything left to chance," says former congressman and Fannie antagonist **Richard Baker** today.

Despite what right-wing critics now charge, however, Fannie and Freddie weren't big risktakers, even after the **1992 legislation in which Congress also mandated that they had to buy a certain number of mortgages made to people with lower incomes.** Critics now charge that this was when Fannie began to engage in risky lending practices. But, in reality, Fannie was extremely careful about the credit risks it took. Johnson was a master at announcing plans that sounded very grand—such as the trillion-dollar initiative, in which Fannie would buy a trillion dollars' worth of mortgages to help housing—but didn't really cost much. "About 98 percent were done at market rates [i.e., mortgages they would have bought anyway]," says a former employee. "We were giving away a little at the edge of the big machine." Or, as Maloni puts it, Johnson could say to a member of Congress, "'Have you seen our initiative for the handicapped?' It might have only been for a few dozen loans, but our intent mattered." Johnson would tell people that "the [congressional] housing goals had no teeth." Indeed, during those years, Fannie and Freddie faced harsh criticism that they did less—not more—to support affordable housing than private lenders did.

This wasn't because Fannie people were cynical about affordable housing. Quite the contrary: many referred to themselves as "housers," which is slang for those who believe that better housing is the cure to all of society's ills. But the company's leaders knew that they couldn't afford to make many unsafe loans, because any sign of financial weakness would be grist for their critics.

If the 1990s were a golden time for Fannie's political power, they were for its financial power as well. Fannie's market valuation grew from $10.5 billion at the beginning of the decade to more than $70 billion by the end. On Wall Street, Fannie and Freddie were big business—all those mortgage-backed securities and all that debt to fund their growth were sold through Wall Street firms—and "people dealt with them as if they were sovereign credits," says one former banker. There was even talk, in those days of no federal deficit, that Fannie and Freddie debt would become the substitute for U.S. Treasuries.

The **G.S.E.'s also became the place for ex-politicians to work.** The Washington Monthly once declared that after he left the White House, Bill Clinton should go to Fannie because "scoring an executive post at Fannie Mae is recognized around establishment Washington as the equivalent of winning the lottery." After all, where else could you make Wall Street–type money with no financial skills? And where else could you make so much money as a lobbyist?

In retrospect, this was a balancing act that was almost destined to fail. As Fannie and Freddie got bigger and more powerful, they struck even more fear into the hearts of those who resented their size and power. "We became dominant so quickly that we scared people," says former Fannie chief financial officer Tim **Howard** today. And as a former top lobbyist for Fannie says, "A company like Fannie Mae, which has defined itself in Washington through its public mission, but which also has very well-paid executives, will have a hard time staying in the sweet spot."

Profits of Doom

Every winter, Fannie Mae held a conference for Wall Street analysts and major investors. One year, right before Johnson retired, the theme song was a customized version of the song "The Best Is Yet to Come," popularized by Frank Sinatra. Fannie Mae executives dressed up in top hats and tails to perform it. Frank Raines, who took over from Johnson as C.E.O., told investors that "the future's so bright that I'm willing to set as a goal that our earnings per share will double over the next five years." A report by the research firm Sanford Bernstein noted that the combined assets of Fannie Mae and Freddie Mac exceeded, in dollar terms, the G.D.P. of any nation except the U.S., Japan, and Germany.

When Franklin Delano Raines was named Johnson's successor, he became the first African-American C.E.O. of a Fortune 500 company. Born in 1949 in Seattle to blue-collar parents—his mother cleaned offices at Boeing and his father was a custodian at the Seattle Parks Department—Raines went to Harvard, where he joined both the Young Democrats and the Young Republicans, and was named a Rhodes scholar. He interned in the Nixon White House and then served in the Carter administration, before leaving government to become a partner at the investment bank Lazard Frères. After 11 years at Lazard, Raines was spending four days a week on the road. He left, without his next move planned, in order to spend more time with his three young children. In 1991, when Johnson offered him the vice-chairmanship of Fannie Mae, Raines said yes—Fannie's offices were just a mile and a half from Raines's seven-bedroom Colonial home in Virginia.

In 1996, President Clinton lured Raines away from Fannie by appointing him the director of the Office of Management and Budget. Raines asked Clinton how long the job would last, and Clinton replied, "Until you balance the budget." **Within two years Raines produced the first balanced budget the U.S. had seen in 30 years.** Later, he would be amazed to find himself painted as a partisan Democrat, because, during his time at O.M.B., Democrats had been angered by what they saw as his support for Republican fiscal policies. In 1995, Raines was appointed to the board of Boeing, where his mother had scrubbed floors. In 1998 he returned to Fannie Mae. At the time, there was talk that one day he would become the **first black president** of the United States.

There is no one who says that Franklin Raines isn't incredibly smart. But praise for Raines's intelligence is often accompanied by criticism of his interpersonal skills. "He's very introverted," says one former executive. "He cannot lower himself to make nice to people he considers intellectually inferior." "Frank hurt himself," says another. "He lacks a certain understanding of how to best position the other person so that you get what you want."

Inside Fannie, there was also skepticism about the promise Raines made to Wall Street to double Fannie's earnings from $3.23 per share in 1998 to $6.46 per share in 2003. "All the V.P.'s in the company looked at each other and said, 'How is that going to happen?"' says a former executive. The promise, combined with the lure of financial rewards, created an unhealthy pressure throughout the company. In 2000 the head of Fannie's office of auditing gave a speech to the company's internal auditors. "By now, every one of you must have 6.46 branded in your brains," he said. "You must be able to say it in your sleep, you must be able to recite it forwards and backwards, you must have a raging fire in your belly that burns away all doubts, you must live, breathe, and dream 6.46 After all, thanks to Frank, we all have a lot of money riding on it."

Almost immediately in Raines's tenure, the criticism of the G.S.E.'s took on a new ferocity. One of the first salvos was fired by the Clinton Treasury Department under **Larry Summers**, who had replaced Rubin in the summer of 1999. Treasury workers knew that taking on Fannie was akin to political suicide, but "everyone jumped off together," in the words of one former appointee, because they were all so convinced that Fannie and Freddie would eventually fall on top of taxpayers with a crushing thud. **One of Summers's goals was to weaken the perceived ties between the G.S.E.'s and the U.S. government**, which was enabling the G.S.E.'s to take on too much risk. Most notably, on March 22, 2000, in congressional testimony, **Gary Gensler** said that the U.S. Treasury should consider cutting the lines of credit that Fannie and Freddie had with the government.

The response from Fannie Mae was immediate and furious. Tim **Howard** called **Gensler's comments** "inept" and "irresponsible." Fannie even tried to get the White House to distance itself from the Treasury, according to one person.
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What has **never been disclosed before** is that, even before Gensler's comments, and through the summer of 2000, Treasury held a series of meetings—some in a room just down the hall from Summers's office—with Fannie's top executives, in which Fannie tried to get Treasury to sign off publicly on a set of initiatives Fannie had devised in the hopes of appeasing its critics. Both sides describe Fannie's strategy in the same way: keep your friends close and your enemies closer. But the negotiations came to nothing. One explanation is that the chemistry between Summers and Raines was "horrible," in the words of one former executive. "The two of them were so alike," says this person. "They were both arrogant, stubborn sons of bitches, and they both viewed themselves as the smartest guy in the room."

Another explanation is that Summers realized that if Treasury supported Fannie in any public way it would only strengthen its apparent ties to the U.S. government, so he backed off. "Treasury was too smart," Howard says now. "**Larry wouldn't bite**."

But perhaps the best explanation is that there just wasn't a deal to be cut. Treasury officials simply didn't believe Fannie's arguments. As for Fannie, "you have to have some level of trust that they're not trying to do you in, and there wasn't that level of trust," says another former Fannie executive.

As the critics became more vehement, Fannie's responses became ever tougher. Its customers, including major banks, who were terrified of its rapid growth and Raines's grand plans, set up a group called FM Watch, which began its own anti-G.S.E. lobbying effort. Fannie responded by comparing FM Watch to Slobodan Milošević, the Serb dictator who was charged with crimes against humanity for his role in the Balkan wars. "I think Frank was scared that he couldn't be as tough as Jim, and so he overcompensated," says a former executive.

Operation "Noriega"

When George W. Bush ran for president, part of the Republican Party platform was that "**homeownership is central to the American Dream**." Those words were manna for Fannie and Freddie. And **Bush appointed people** to their boards, including Yale **classmate Victor Ashe** and campaign **donor Manuel Justiz**. ("It is a great honor to be appointed by the President to serve on the board of a company with such an important housing mission," wrote the Bush appointees in a letter to ofheo in late 2001.) In 2002, Karl Rove invited Raines to Bush's economic summit in Waco. Raines still keeps a "Doonesbury" cartoon on his wall that features an admiring Bush saying, "Franklin can tell you … "

Perhaps most notably, after a 2002 event in Atlanta in which **Bush** announced his efforts **to help 5.5 million black** and Hispanic families buy homes before the end of the decade, both Raines and Freddie C.E.O. Leland Brendsel flew back with him on Air Force One.

Then the Bush administration's attitude changed dramatically. Both sides point to the same catalyst: **Enron.** "It was as if someone flipped a switch," **Raines says today.** A former Bush-administration official says that the last thing the president wanted was to be at the center of another corporate scandal, and if you were looking for likely candidates, how could you miss Fannie and Freddie, with their longtime critics and thin capitalization? **Raines, for his part, thought that the administration wanted to deflect the criticism it got for its ties to Enron by pointing at what it could claim was a Democratic scandal in the making.** In 2003, Bush's chief of staff Andrew Card was put in charge of a policy-review group. Soon thereafter, **Bush pulled his presidential appointees from the G.S.E.'s boards.**

And then there was Fed chairman Alan **Greenspan**. He was friendly with Raines, had regular lunches with him, and came to the grand Christmas **parties at Raines's home**—but he never got past his **deep suspicion of the G.S.E.'s**. To wit: the **portfolio business** was a ticking time bomb, and who needed Fannie and Freddie anyway? Big banks, which were supposedly subject to the discipline of the market, were better holders of mortgage risks than the G.S.E.'s.

Although it didn't happen immediately, Greenspan's thinking on the G.S.E.'s soon came to dominate the Bush administration's thinking on them. "[Greenspan and the Bush administration] weren't interested in having a strong regulator," says **Howard** today. "They were interested in constraining Fannie and Freddie. Obviously, Fannie and Freddie weren't going to agree to that." So someone had to win, and someone had to lose.

The fight became both nasty and personal in early 2004, when Raines sent what one person calls a "**fuck you**" letter to **Andrew Card**. This came about after the **homebuilders** complained to Raines that Card had told them Raines had agreed to regulatory compromises the homebuilders didn't want. After that the White House took on Fannie and Freddie in an organized, orchestrated way that was akin to how Fannie itself had long operated. Some of those on the inside jokingly referred to their assault as "Noriega"—as in Manuel Noriega, the former Panamanian dictator and drug kingpin whom the U.S. military blasted with loud, incessant rock music during its attempt to get him to leave a Vatican compound and surrender.

Congressman **Barney Frank**, a Massachusetts Democrat and **longtime supporter of the G.S.E.'s,** told a Wall Street analyst that "the [Bush] administration is engaged in a strategy of political attacks on the G.S.E.'s, designed to pressure them into accepting the administration's regulatory-reform bill by depressing their stock prices."

But the best weapon the G.S.E.'s opponents could have had was handed to them by Freddie Mac itself. **On June 9, 2003, Freddie's entire top management team was ousted** after the company confessed to needing to re-state its earnings for the past three years. They had understated—not overstated, but understated—earnings in order to produce the smoothly growing earnings that investors most valued.

Just days before **Freddie announced its accounting error**, ofheo had signed off on Freddie's management and internal controls. This very public mistake was a huge black eye—a "humiliating experience," in the words of **Steve Blumenthal, then ofheo's deputy director**—for an agency that was already smarting from years of perceived and real condescension.

Not that anyone would have guessed that ofheo's director at the time, **Armando Falcon**, was a guy to take on the G.S.E. machine. A Texas Democrat who was appointed by Clinton to head ofheo in 1999, Falcon had been raised near San Antonio by a father who was an aircraft mechanic. On the surface, he seemed like a shy, gentle soul—but he was far more politically savvy and ambitious than anyone would have expected. And he had Steve **Blumenthal, a longtime Republican Hill staffer** who viewed himself as a warrior, by his side. Even ofheo's supporters say that Falcon and Blumenthal were emotionally invested in getting Fannie. And even though Falcon is a Democrat, he and the White House both wanted the same thing. In **early 2004**, over Fannie's protests that "there should be no question about our accounting" in the wake of Freddie's problems, **ofheo launched a review** of Fannie's finances.

Fannie fought back in classic Fannie fashion. They tried to get Falcon and Blumenthal fired. Via a staffer who was a longtime friend and poker buddy of Maloni's, **Fannie got Republican senator Kit Bond of Missouri** to launch a counter-investigation into ofheo. The resulting 2004 report from the **hud inspector general (I.G.)** came to some startling conclusions that couldn't be dismissed as politics as usual, however. It claimed that Falcon and Blumenthal's campaign against the G.S.E.'s was both ugly and relentless. It accused ofheo of taking what one source within ofheo called a "publicity-driven approach to oversight" with a "very strong intent to embarrass Fannie Mae." A witness recalled that Blumenthal was "almost gleeful" when Fannie's stock went down. (Blumenthal denied being gleeful, but did say, "You can't hurt them enough to matter.") Even more troubling was that both ofheo's chief accountant, **Wanda DeLeo**, and its chief examiner, **Scott Calhoun**, complained that Falcon and Blumenthal were overstating Fannie's problems or prematurely reporting some of ofheo's findings, partly for political purposes. Another witness, who wanted to remain anonymous, had this way of explaining ofheo's strategy: "Everybody runs for cover if somebody's accusing a company of some impropriety in terms of their accounting. All of a sudden, they don't have any friends anymore."

An online exchange that took place in December 2007 shows how bitter emotions were, and still are, between **Fannie publicist Bill Maloni and Blumenthal**.

Maloni: "A HUD IG in a GOP Administration—with no Dems involved in the process—revealed the game you and your friends were playing.… Why would a regulator turn to guerilla tactics and try and financially injure one of its regulated institutions?"

Blumenthal, who didn't directly answer the question, responded: "It has been my privelege [*sic*] to fight people like you all my life. Corrupt, fundamentally dishonest, cowards.… The HUD IG didn't intimidate me, and a Chevy Chase wanna-be thug doesn't either." (Maloni now lives in Chevy Chase.)

Falcon and Blumenthal accused Fannie's management of seeking to "misapply and ignore accounting principles" in order to meet Wall Street's earning expectations. Although much of this was due to the implementation of a complicated **new accounting rule for derivatives**—one that caused hundreds of other companies to re-state their results as well—Falcon also accused Fannie of improperly deferring $200 million of expenses in 1998 to the following year in order to meet earnings targets and pay management's bonuses. Both the Department of Justice and the S.E.C. opened investigations into possible **accounting fraud at Fannie Mae**.

At a congressional hearing on **October 6, 2004**, **Raines and Falcon faced off**. Falcon defended his work; Raines defended himself and his company. At the end of the hearing, longtime G.S.E. antagonist Richard Baker, the Republican from Louisiana, threw a curveball. More than a year earlier, he had requested information from ofheo on the compensation of Fannie's top executives. He hadn't released it, because Fannie had hired Ken Starr—the former special prosecutor who investigated Bill Clinton—to represent it, and had gone so far as to threaten "criminal proceedings" against anyone who supposedly violated privacy laws to disclose the information. Now Baker had found his moment. He put up a chart showing that 20 of Fannie's top executives—including three lobbyists—had earned more than $1 million in 2002, and 9 had made more than $3 million. Today, Baker says that when he brought the chart out "the whole room blew up. It was the most animated room I'd ever seen in a hearing."

If Fannie had any hope of prevailing, that was demolished on December 15, 2004, when the S.E.C. sided with ofheo and said that Fannie would have to re-state years of earnings, wiping out as much as $9 billion in profits. **Under pressure from the board, which was itself under pressure from ofheo, Raines retired and Howard resigned.**

One and a half years later, on **May 23, 2006**, ofheo issued its final report on Fannie Mae. The agency claimed that Fannie's executives "deliberately and systematically" created earnings "illusions" to hit Fannie's earnings-per-share targets from 1998 through 2004. Fannie agreed to pay the government $400 million. **Christopher Cox**, chairman of the S.E.C., promised to "vigorously pursue" the people responsible for this "extensive financial fraud."

At the end of that year, **ofheo sued Frank Raines, along with Tim Howard and controller Leanne Spencer**, demanding the payment of $100 million in civil fines and returned bonuses that could exceed $115 million. ofheo said that Raines, in particular, had gotten $90 million in total compensation from 1998 to 2003, of which more than $52 million was directly tied to achieving earnings-per-share targets.

But astonishingly, given the extreme rhetoric from ofheo—Falcon even called Fannie a "**government-sponsored Enron**"—no criminal charges were filed against Fannie Mae or any of its executives. And **despite Cox's promises, the S.E.C. never filed civil charges against any Fannie Mae executive**, either. This past spring, ofheo trumpeted the news that the former Fannie executives had paid $31.4 million to settle the charges against them, with Raines agreeing to forgo cash, stock, and other benefits of $24.7 million. But the headline number was an illusion. In Raines's case, the bulk of his settlement consisted of stock options that were so out of the money they would never be worth anything, along with $5.3 million that ofheo called "other benefits," but which Raines says was a "totally made up number." Nor did Raines agree to keep his mouth shut. In fact, he wanted to respond to the settlement by saying that "the process against me began with lies and ended with lies," but was persuaded by his lawyers to say instead that "the process invoked against me by ofheo was **fundamentally unfair**."

Raines "had to settle because something was wrong," says current F.H.F.A. director Jim Lockhart. He adds, "It was not one of my happier days. Over 20 percent of the agency's budget was legal expenses. We were just being eaten up, and [Raines] knew it."

To this day, Raines insists that he was sabotaged by his enemies. He tells friends that he told Clinton, "They spent more time and money investigating me than you!" In 2007, in a civil suit that is still proceeding against Fannie and its former executives, Raines subpoenaed the White House for what his lawyers called "evidence that officials in the most powerful office in the country were part of a plan to influence the political debate about Fannie Mae." (Of course, Raines can afford to be aggressive, because as part of his "retirement," Fannie Mae is paying his legal bills.)

"Frank Raines continues to try to re-write history to protect his reputation, but the history is clear," counters White House deputy press secretary Tony Fratto.

But, in fact, the history isn't perfectly clear. There is no question that Fannie Mae's accounting problems were real, and that under

Raines the company had an unhealthy focus on earnings growth, but, still, one has to wonder about the solidity of the charge that Raines led an Enron-like enterprise. While some believe the lack of prosecution merely reflects the Justice Department's unwillingness to take on a deeply complicated accounting case, others argue that it didn't have a case, because there is a line between aggressive accounting and intentional fraud. And, in fact, an internal Fannie Mae investigation led by former senator Warren Rudman found no evidence that Raines knew the company's accounting policies departed significantly from generally accepted principles. For Fannie Mae, the distinction didn't much matter, because its reputation was tarnished beyond repair.

Despite that, no new legislation for regulation of the G.S.E.'s made it through Congress. While it is true that votes often broke along partisan lines, with the **Democrats siding with Fannie and Freddie**, it's also true that Republicans often broke ranks. In one instance, Senator Bob Bennett, a Republican from Utah, sabotaged a bill by adding an amendment that favored the G.S.E.'s. (**Bennett's son worked for Fannie's partnership office in Utah**.) Congressman Mike Oxley, an Ohio Republican and a recipient of much campaign cash from the G.S.E.'s, also introduced bills that the administration thought were too weak. "I think the administration, for whatever reason, wants to do a lot more than is possible," said Oxley. Says former congressman Richard Baker today, "There were Democrats and Republicans who had reservations.… It was not a partisan thing."

Maybe the truth is that, as one person puts it, "everyone was still scared of Fannie Mae and Freddie Mac." Or maybe the truth is that everyone—not just Democrats, and not just Republicans—was terrified that hurting Fannie and Freddie would, as the G.S.E.'s always said, hurt the housing market. "Everybody had a fear of the unknown," says consultant Bert Ely, another longtime G.S.E. critic.

The End of the Holy War

When Raines was dethroned, the board called **Dan Mudd**, then the company's chief operating officer, at seven a.m., just as Mudd was getting dressed for work, and asked him to step in. Mudd couldn't be more different from Raines and Johnson. He's "not a rock star," as one former Fannie employee puts it, he's not a Democrat, and he's all businessman. (**He ran G.E. Capital Japan** before joining Fannie, in 2000.) A self-deprecating ex-Marine, he was not close to Raines, and he had thought about leaving the company because he didn't like what he called the "arrogant, defiant, my-way Fannie Mae." But he stayed because, as he later said, "I'm not a quitter."

Mudd immediately embarked on a strategy of conciliation with ofheo. He visited members of its staff and Congressman Baker, and he even gave ofheo examiners their own badges so they didn't need a Fannie Mae escort when they were at the company's offices. "I thought for a very long time that it was our fault, because we were heavy-handed, because we had a propaganda machine," he says now. "I thought the only way to solve it was to make it Fannie's problem. It's like having an argument with your spouse. There's no use in being right. You have to find the way forward."

There are some who think Mudd had no choice, and some who are far more critical. Says Maloni, "Dan's attitude is great if you don't live in a jungle where all the other animals are trying to eat you." Even Mudd himself says today, "I thought there were things we could do to be a normal company. I did some, and it turned out they didn't make a difference." It was perhaps telling that during his years as C.E.O., he says, no one in the White House would ever take his calls.

By mid-2006 there was a new actor in this long-running drama: **Hank Paulson**, the former Goldman Sachs C.E.O. who had just become Treasury secretary. Unlike the advisers who surrounded Bush, **Paulson did not believe that the G.S.E.'s were the bogeymen of the financial system**. After all, they had been major clients of his for years, and the ties between Goldman and Fannie ran deep. Nor did Paulson want any part of what he called "the closest thing I've witnessed to a Holy War."

Paulson quickly began to move away from what one observer calls the "extreme rigidity" of the administration's position. Then, on the Tuesday night before the 2006 Thanksgiving weekend, he "threw down the gauntlet to change course on where the administration was going," says someone familiar with the events. He "aggressively argued that the White House should soften its position" and cut a deal for new regulation—which Paulson strongly believed was necessary—with Barney Frank, who had just been named the chairman of the House Financial Services Committee. Bush, who had granted Paulson an unprecedented degree of independence in exchange for his taking the job, soon gave him the authority to change existing policy, according to one inside source.

"I was aghast," says a longtime G.S.E. foe, expressing a common attitude. "Here we were fighting trench warfare with Fannie and Freddie, and Paulson says, 'Let's cut a deal and say we won.' Some of us really did believe they were a house of cards."

That fall, Barney Frank told *The Washington Post* that Paulson had told him he wasn't going to use the Treasury's authority to limit Fannie's and Freddie's ability to raise money by issuing new bonds. The Bush administration had won that right in 2004, and other Treasury officials had been saying the government would use it. With Paulson's backing down from Treasury's position, the White House had lost one of its major clubs against the G.S.E.'s.

At the same time, a critical change was occurring in Fannie's and Freddie's businesses. By the mid-2000s, the mortgage market was radically different than it had been in Fannie's and Freddie's golden years. What we now all know as the **subprime business had taken off**, and a whole new breed of opportunistic lenders, such as IndyMac and Washington Mutual, were selling their mortgages to Wall Street, which churned out its own mortgage-backed securities. These were often referred to as **private-label securities**, or **P.L.S.**'s, because they bypassed Fannie and Freddie and didn't have the G.S.E. imprimatur. As a result, Fannie and

Freddie, which had always been selective as to which mortgages met their criteria for purchase, saw their market share plunge. Shareholders and customers were begging them to dive into this new, highly profitable world.

Although both companies resisted due to their worries about the riskiness of the new products, **eventually senior executives disregarded internal warnings**, because the **lure of big profits** was too great. "We're rushing to get back into the game," Mudd told analysts in the fall of 2006. "We will be there." Both companies did two major things. For their portfolios, **they bought Wall Street's P.L.S.'s.** They also began to guarantee so-called Alt-A mortgages—loans made to people who had better credit scores than a subprime customer's, but who might lack a standard job and pay stub. (These mortgages came to be known as **"liar loans,"** because either the customers or the brokers, or both, were often just making up the information on the applications.) By the spring of 2008, the companies owned a combined $780 billion of the riskiest mortgages, according to the Congressional Budget Office, even though they had bought P.L.S.'s that were rated Triple A by the rating agencies and they thought their Alt-A product was conservative. But they bought in bulk.

The Green Team

For a brief time, in the summer and fall of 2007, it did look as if the G.S.E.'s would be the saviors of the mortgage market. That is, if you didn't look too closely and instead just listened to what congressional Democrats were pushing hard, and what the powers that were, including Paulson, Bernanke, Lockhart, and, yes, even President Bush, started saying. **As the banks that everyone had said could handle mortgage risk better than the G.S.E.'s deserted the market, stumbling under the weight of billions of dollars in losses on subprime mortgages, there wasn't anyone else to turn to.** Even so, "is there anything dumber than the suggestion that the institutions to rescue the U.S. mortgage market are institutions that are leveraged 60 to 1 and only own U.S. mortgages?" asks one G.S.E. opponent.

Not surprisingly, Fannie and Freddie—egged on by Democrats—seized the opportunity to prove how critical they were to the market. By the first quarter of 2008, they were **buying 80 percent of all U.S. mortgages**, roughly double their market share from two years earlier.

To some observers, the most remarkable moment came on March 19, 2008, when ofheo held a press conference to announce a deal that Bob Steel—a former Goldman Sachs partner who had joined the Treasury Department shortly after Paulson—had brokered with Fannie and Freddie. The deal was that the G.S.E.'s, which had already sold a combined $14 billion in preferred stock in late 2007, would raise as much as another $10 billion in capital. In return, new ofheo director Jim Lockhart agreed to *lower* the amount of capital the G.S.E.'s were required to hold, enabling them to acquire another $200 billion in mortgages. Several people who were involved with the discussions say that the theme was that they were all in this together. They say Steel would use the line "We want to come out of this with everyone on the green team." (Possibly Mudd used the phrase first.) Says Lockhart today, "We could not afford them not being able to provide funding to the housing market."

ofheo (with Treasury's support) cut this deal despite the fact that the G.S.E.'s losses from mortgages' going bad were already escalating. By the spring of 2008, the two had reported combined losses of $9.5 billion over the previous year. And **they had just $81 billion in capital, which was 1.5 percent of the $5.2 trillion in mortgages** they owned or guaranteed. In other words, if they had to make good on their promises, they had very little money with which to do so. (Skeptics on the Street believed that ofheo's calculation of Fannie's and Freddie's capital was deeply flawed and made the G.S.E.'s look healthier than they were.)

Fannie's $300 billion Alt-A portfolio accounted for roughly 50 percent of its credit losses. At Freddie, the numbers were similar. Although both companies justified their purchases of risky loans based on their need to meet hud's affordable-housing goals, former Fannie employees say that, while the P.L.S. purchases did aid in meeting the goals (which, given the abusiveness of these loans, is an abomination), the Alt-A loans did not. In other words, Fannie dove into Alt-A not because of its mission but because of its bottom line—and because its executives feared that Fannie would become irrelevant if it continued to say no to this brave new world.

By the summer of 2008, the market was going from bad to worse, and Fannie's and Freddie's stocks were plunging. International banks, which held big chunks of both companies' debt, were panicking, and asking if the U.S. government stood behind the debt. **On July 13, Paulson announced a plan under which Treasury would backstop all of the G.S.E.'s debt and buy equity if needed.** "If you've got a bazooka, and people know you've got it, you may not have to take it out," Paulson told lawmakers.

Said President Bush about Fannie and Freddie, "We must ensure that they can continue providing access to mortgage credit during this time of financial stress."

Said Lockhart, "At a very difficult time in the market, the enterprises have the flexibility and sound operations needed to support their mission." That was when he also said that their capital levels were "well in excess" of federal requirements.

Fannie Mae's Last Stand

by **Bethany McLean** February 2009 (doc formatting added here)

How did we land in a recession? Visit VF.com archive, "**Charting the Road to Ruin**."

Bethany McLean [Wikipedia] is acknowledged as being the first journalist to question Enron's inflated stock price with her article in the March 5, 2001 issue of Fortune magazine entitled, "Is Enron Overpriced?"[1].