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The Financial Crisis on Trial

The SEC fingers the government-backed mortgage buyers, not Wall Street greed.

By PETER J. WALLISON

The Securities and Exchange Commission's lawsuits against six top executives of Fannie Mae and Freddie Mac, announced last week, are a seminal event.

For the first time in a government report, the complaint has made it clear that the two government-sponsored enterprises (GSEs) played a major role in creating the demand for low-quality mortgages before the 2008 financial crisis. More importantly, the SEC is saying that Fannie and Freddie—the largest buyers and securitizers of subprime and other low-quality mortgages—hid the size of their purchases from the market. Through these alleged acts of securities fraud, they did not just mislead investors; they deprived analysts, risk managers, rating agencies and even financial regulators of vital data about market risks that could have prevented the crisis.

The lawsuit necessarily focuses on 2006 and 2007, the years that are still within the statute of limitations. But according to the SEC complaint, the behavior went on for many years: "Since the 1990s, Freddie Mac internally categorized loans as subprime or subprime-like as part of its loan acquisition program," while its senior officials continued to state publicly that it had little or no exposure to subprime loans.

The GSEs began acquiring large numbers of subprime and other low-quality loans in the mid-1990s, as they tried to comply with the government's affordable-housing requirements—quotas for mortgage purchases imposed by the Department of Housing and Urban Development (HUD) under legislation enacted by Congress in 1992.

These quotas initially required that, of all the loans bought by Fannie and Freddie in any year, 30% had to have been made to borrowers earning at or below the median income in their communities. The quotas, however, would increase—they rose to 40% in 1996, 50% in 2000, and 55% in 2007. HUD also added and raised quotas for "special affordable" loans that were to be made to borrowers with low or very low incomes (in some cases a mere 60% of the area median income).

It is certainly possible to find prime mortgages among borrowers whose incomes are below the median, but this becomes more difficult as the quota percentages increase. Indeed, by 2000 Fannie and Freddie were offering to buy zero-down payment loans and buying large numbers of subprime mortgages in order to meet the HUD quotas.

According to the SEC, for example, Fannie failed to disclose a low-quality loan known as an Expanded Approval (EA) mortgage—even though these loans had
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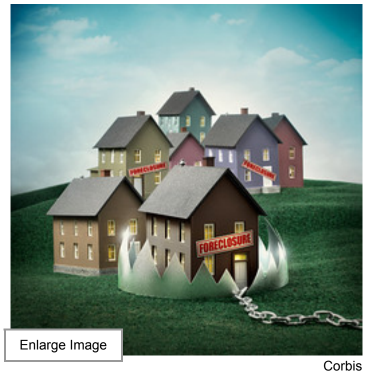

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(90 days past due, and almost certainly going to foreclosure) in Fannie's book. Those EA loans—as then-Chairman Daniel Mudd told the House Financial Services Committee in April 2007—"helped us meet our HUD affordable housing requirements."

Meeting these quotas made Fannie and Freddie important factors in the financial crisis. Relying on the research of my colleague Edward Pinto at the American Enterprise Institute, I stated in my dissent from the majority report of the Financial Crisis Inquiry Commission that there were approximately 27 million subprime and other risky mortgages outstanding on June 30, 2008, and a lion's share was on Fannie and Freddie's books. That has now been largely confirmed by the SEC's data.

The SEC also charges that Fannie and Freddie's disclosures grossly understated the number of subprime and other risky loans they were holding or securitizing. For example, Freddie's Information Statement and Annual Report to Stockholders, in March 2006, reported that for 2005 and 2004 the company's exposure to subprime loans was "not significant." According to the SEC complaint, subprime mortgages at this point constituted 10% of Freddie's exposures.

Similarly, Fannie held over $94 billion in EA loans in 2007, according to the SEC—"11 times greater than the 0.3% ($8.3 billion)" in subprime loans Fannie disclosed for that year. (According to an SEC press release, both GSEs have agreed with the commission's "Statement of Facts" about their disclosure failures, without admitting or denying liability. They also agreed to cooperate with the commission's litigation against the former executives.)

Fannie and Freddie were the dominant players in the U.S. mortgage markets, by far the largest buyers of mortgages and mortgage-backed securities of all kinds. Statements by these two firms that their exposure to subprime mortgages was "not significant" or ".03 percent" would be read by analysts and other mortgage market participants as strong indications that relatively few subprime and other low-quality mortgages were outstanding.

My own research, as a member of the Financial Crisis Inquiry Commission (and a dissenter from its majority report), did not turn up any analyst report or other public statement before the 2008 crisis that came close to estimating the actual number of subprime or other low-quality mortgages outstanding.

These failures to disclose subprime holdings meant that banks and other financial institutions, risk managers, analysts, rating agencies and even regulators may well have underestimated the risks of continuing to acquire, hold and distribute mortgages and mortgage-backed securities. Thus, when the bubble deflated in 2007, the financial system, and particularly the largest financial institutions, were primed for immense losses.

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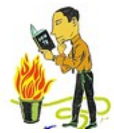

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