

## **Fannie's Illusory Profits Point Directly to CEOs**

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**Editor's Note:** *This article is the third in a four-part series published in November and December on Fannie Mae and Freddie Mac's financial crisis.*

For years, Fannie Mae drew Congressional praise by investing in high risk subprime and alternate documentation loans given to low-income home buyers. Fannie also wanted to increase its market share and satisfy investors who enjoyed the company's large profits. The profits, however, proved to be illusory.

In 2000, Fannie announced its goal to buy \$2 trillion in loans from low-income borrowers by 2010.

According to Inside Mortgage finance, from 2001 to 2004 with Franklin Raines as Fannie's CEO, the company's investment in subprime loans grew from \$160 billion to \$540 billion.

In 2003, Franklin Raines testified before on Fannie's financial condition. Raines told Congress that Fannie was one of the best capitalized financial institutions in the world, especially when considering the inherent risks in its business.

Raines, with the help of Fannie's Chief Financial Officer Timothy Howard, hid Fannie's true condition from the weak oversight of the Office of Federal Housing Enterprise Oversight (OFHEO). Relying solely on financial reports provided by Fannie, in 2003 OFHEO gave Fannie a passing grade on its financial soundness. Fannie was \$7.3 billion short of its capitalization needs.

Raines time as Fannie's CEO ended in 2004. Fannie filed many of its false financial statements while Raines was CEO. The Securities and Exchange Commission (SEC) eventually accused Fannie of fraud and Fannie paid the SEC \$400 million to settle the case. Fannie also agreed to never again hire Raines or Howard.

Regardless, Raines and Howard prospered as Fannie executives. Howard received about \$30.8 million. Raines got \$90 million in salary and bonuses from Fannie during his six years as CEO. Fannie's board of directors based over one-half of Raines' compensation on meeting earning goals gained by fraudulent accounting.

Raines claims Fannie still owes him money. He is suing regulators for a \$3.9 million stock award he claims was wrongfully withheld from him.

Daniel Mudd succeeded Raines as Fannie's CEO in 2004. Given the fraud settlement with the SEC, one would expect Mudd to be more careful with Fannie's accounting and more cautious in buying risky loans. Mudd behaved even more recklessly than Raines.

Mudd quickly gave in to Congressional pressure for Fannie to further increase its buys of risky loans. Senator Jack (D-RI) told Mudd in a 2006 Congressional hearing, "With homes doubling in price every six years...Fannie's mission is of paramount importance. In fact, Fannie ... can do more, a lot more."

Mudd also became concerned about competitors getting more of the subprime market. Lenders demanded Fannie buy more of their riskiest loans or they would bypass Fannie and sell directly to Wall Street.

In response, Fannie bought more than \$230 billion in risky loans between 2005 and 2008, triple what Fannie bought in all the preceding years combined. Fannie also tripled its buys of loans with down payments of less than 10 percent down. According to former Fannie Mae executives, Mudd told employees to "get aggressive on risk-taking or get out of the company." Mudd denies making the statement.

Mudd's aggressive buying practices alarmed some of Fannie's managers. They warned Mudd the company was responsible for too many risky loans. Marc Gott, former director of Fannie's loan servicing department, later said, "We didn't really know what we were buying." Mudd, however, would later tell Congress, "Almost no one expected what was coming. It's not fair to blame us for not predicting the unthinkable".

Meanwhile, Mudd benefited. In his first four years at Fannie, Mudd got \$10 million in compensation.

Eventually, even Fannie's Congressional allies could not ignore the company's financial problems.

In 2006, Congress forced Fannie to audit its books and correct previously filed reports. The huge project cost Fannie \$1 billion and revealed that it overstated profits by \$6.3 billion.

Unbelievably, after completing the audit, Mudd threw Fannie's employees a party at a Washington D.C. hotel featuring Earth, Wind and Fire.

Only Fannie celebrated. For Fannie's investors and many other Americans the party was over.

In January 2007, Mudd outlined management's plan to buy \$11 billion more in subprime and Alt-A mortgages.