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Mend, Don't End, Fannie and Freddie

Conservatives blame the mortgage giants (wrongly) for the financial crisis, and both parties want them dead. But to finish the job of financial reform without destroying the housing market and costing taxpayers billions, we need to let them live.

by Bethany McLean (https://washingtonmonthly.com/people/bethany-mclean/)

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It's been almost a decade since the slow-rolling financial crisis, which reached its grand finale in the fall of 2008, got started. But as the response to *The Big Short*, the Academy Award-nominated film about the crisis based on Michael Lewis's book of the same name, shows, there's still a big fight about what actually went wrong. Some on the right wing immediately decried the movie, which focused on Wall Street's greed, for ignoring the problems with government policies encouraging homeownership—specifically, the role of the so-called government-sponsored enterprises (GSEs), the Federal National Mortgage Association and the Federal Home Loan Mortgage Association, better known as Fannie Mae and Freddie Mac.

While most Americans don't know what Fannie and Freddie do, many of us are in an intimate financial relationship with them involving the most important financial instrument in our lives—our mortgage—and the most important asset—our home. The way we finance housing, which makes up some 20 percent of the U.S. GDP, affects anyone who has a stake in our economy.

The idea that these little-understood but critically important companies caused the crisis is just the icing on top of the controversy about Fannie and Freddie, which were created by Congress to serve the dream of the United States as a society of individual homeowners. The two are essentially giant insurance companies. They stamp mortgages made to American homeowners with a guarantee that they'll pay the principal and interest if the homeowner can't. Their stamp makes it possible to package the mortgages backed by homeowners' monthly payments into securities, which are then sold to investors, who otherwise wouldn't want to bet their money that you and I will pay in full and on time. For years,

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although Fannie and Freddie had all the trappings of normal companies—shareholders, boards of directors, stocks that traded on the New York Stock Exchange—they were also, in part, government agencies, with a congressional mandate to foster homeownership. Everyone always believed that if there were a crisis, the government would rescue them. Critics hated their government-granted political and financial power, their structure—wasn't it impossible for them to serve both shareholders and homeowners?—and the very idea that the government needed to be involved in the housing market.

Most people who weren't paying close attention probably date the beginning of the global financial crisis at September 15, 2008, the day Lehman Brothers declared bankruptcy. But a few days earlier, on September 6, the U.S. Treasury put Fannie Mae and Freddie Mac into a status called "conservatorship," a kind of government life support system hooked up because the rapidly swooning mortgage markets had put Fannie and Freddie in mortal peril, and their failure would have caused global economic chaos. The Treasury gave Fannie and Freddie an immediate $200 billion line of credit.

The conservatorship was orchestrated by Hank Paulson, then secretary of the treasury, who told President George W. Bush in a meeting at the Oval Office that it was, in essence, a "time out." According to the rhetoric in Washington at the time, that time out was supposed to end with the death of Fannie and Freddie and the creation of some better, less conflicted, more pure way of financing homeownership. "This is an opportunity to get rid of institutions that shouldn't exist," said Paul Volcker, the revered former chairman of the Federal Reserve, in 2011. Said President Barack Obama in 2013, "I believe that our housing system should operate where there's a limited government role, and private lending should be the backbone of the housing market."

And yet, here we are in 2016, and—surprise!—the companies are still very much with us. The Dodd-Frank Wall Street Reform and Consumer Protection Act, which was supposed to reshape the financial sector and which President Obama signed into law in the summer of 2010, quite deliberately did not deal with Fannie and Freddie. Nothing has happened since then, either. The GSEs remain wards of the government. As the longtime housing analyst Laurie Goodman wrote in a 2014 paper, "The current state of the GSEs can best be summed up in a single word: limbo." It turns out that solving the problem of Fannie and Freddie is the most difficult problem of the financial crisis.

Meanwhile, the mortgage market in the United States has effectively been nationalized, too. In fact, it is precisely the opposite of what President Obama said he wanted. According to Goodman, from 2008 to 2013 the government, mainly in the form of Fannie and Freddie, was the major source of credit for most people who got mortgages in the five years following the crisis. This trend hasn't changed. Goodman

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recently noted that the “private label” market—mortgages packaged into securities by Wall Street, rather than by Fannie and Freddie—which hit $718 billion in 2007, plunged to $59 billion in 2008 and has not been above $64 billion since.

Nor have Fannie and Freddie shrunk. They still have some $5 trillion in securities outstanding. By one important measure, they are in more precarious shape than they were in the run-up to the crisis: thanks to a 2012 amendment to the terms governing their conservatorship, the government is taking almost every penny of profit that the two companies generate, so Fannie and Freddie have not been allowed to rebuild any capital, which could absorb losses in the event of another downturn in the housing market. “The two mortgage funders are effectively federal bureaucracies, stripped of their independence, with basically zero capital, but still dominating the market for mortgage financing,” wrote the conservative pundits Alex Pollock and James Glassman in a recent Politico piece. “We are faced with running this business with really no cushion. It is a challenging situation for us,” Fannie Mae CEO Timothy Mayopoulous said on a conference call in early 2015. “It’s the last unsolved issue of the financial crisis, and the ramifications are enormous for everyone,” says Ryan Israel, a partner at a hedge fund called Pershing Square.

Not only is the issue unresolved, signs of movement toward resolution are few. The omnibus spending bill President Obama signed in December contains a provision effectively preventing the administration from taking any action, and leaving it up to Congress. And the issue has barely been mentioned by any of the 2016 presidential candidates.

This broad silence reflects the genuinely thorny nature of the problem, but also the fact that virtually everyone in Washington supports “solutions” that are ideologically or politically convenient but don’t make sense as policy. Tea Party Republicans favor killing off Fannie and Freddie and replacing them with nothing—a move that will, at best, hand the mortgage market over to the big banks and, at worst, crater the housing sector. The Obama administration and establishment types in both parties support eliminating Freddie and Fannie but replacing them with . . . something else. Something perfect! Something that preserves all the benefits provided by Fannie and Freddie, but eliminates the old controversies and doesn’t create new ones, and, oh, by the way, the money to fund this something will miraculously appear, and Fannie and Freddie’s existing $5 trillion in liabilities will miraculously disappear, without any unpleasant ripples. A third option, which no one in Washington supports openly but all do operationally by their own inaction, is to keep Fannie and Freddie as they are: crippled government cash cows that will have to be bailed out (again) with the next (inevitable) cyclical decline in home prices.

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There is, however, a fourth option: fix the flaws in Fannie and Freddie and let them operate, as they did—effectively—for more than half a century, as the main public-private guarantors of the thirty-year mortgage. This idea might sound sensible to most Americans. But in Washington it is considered, if not completely insane, then at the very least a political nonstarter. Yet it does have some backers, including certain reform-minded financial analysts, think tank scholars, civil rights groups, lobbyists for small banks, and, curiously, a few hedge fund billionaires who bought Fannie and Freddie stock low and stand to make a killing if the companies are revived. While this odd assortment of players isn't getting much of a hearing right now, their idea has one advantage over all the others: it would actually work.

Freddie or not: *Conservatives unfairly scapegoated the two government-sponsored behemoths for the financial crisis.*

It's impossible to understand why Fannie and Freddie are such a difficult problem to solve without going back to long before the financial crisis—even before anyone had thought to invent mortgage-backed securities.

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Homeownership is deeply ingrained in the American psyche, in part because our politicians have always stressed its importance. But for most of the early years of our history, the government wasn't involved. There were huge ups and downs in real estate, and great variability in the cost and the availability of credit. By the 1920s, mortgages were typically three to ten years in length, and required high down payments—sometimes as much as 50 percent. Homeowners often only paid off the interest, not the principal, so the mortgage had to be repaid or refinanced at maturity in one big "balloon" or "bullet" payment. If someone lived on the West Coast, they might pay double the rate of a person on the East Coast, where more lenders were based.

The Depression, which set off a vicious circle of plunging home prices and lack of access to credit, made a historically bad situation seem completely untenable. By the peak of the Depression, the national delinquency rate was 50 percent, according to David Min, an assistant professor of law at the University of California, Irvine, and lenders—primarily mutually owned building-and-loan societies—were failing in large numbers.

And so the government stepped in. After President Franklin D. Roosevelt took office in 1933, Congress passed the National Housing Act, which created the Federal Housing Administration. The FHA offered to insure lenders against defaults on long-term mortgages with low down payments. It was meant to calm everything down by encouraging lenders to lend—after all, the government bore the credit risk—and borrowers to borrow, by offering them certainty about the interest they would owe, and a long time to pay back the money. In 1936, the FHA reported to Congress that "the long term amortized mortgage has gained nation-wide acceptance at uniform lower interest rates in all sections of the United States."

The National Housing Act also included a provision that created privately owned national mortgage associations that would buy the new FHA-insured mortgages from lenders. It wasn't enough for lenders not to have to worry about borrowers defaulting. If they also knew that they could instantly turn their loans into cash, they'd be even more willing to lend. The associations were supposed to be funded by private capital, but in the three years after the new associations were authorized, none were set up. So to demonstrate proof of concept, in 1938 the FHA helped set up a government-owned entity to buy the loans it guaranteed. This entity soon became known as the Federal National Mortgage Association, or FNMA—or Fannie Mae.

In its sponsorship of a congressionally chartered company to help increase homeownership, the United States was, and is, unique. Around the world, the most common mortgage product is a shorter-term adjustable-rate mortgage. Indeed, the rest of the world offers no evidence that you can have a mortgage market like that in the U.S., with long-term, fixed-rate loans, without some sort of system that guarantees risks investors don't want to take.

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For consumers, mortgages are commonplace, even mundane. For investors, they are dangerous—very dangerous. Dick Pratt, who was the first president of Merrill Lynch Mortgage Capital, used to say, "The mortgage is the neutron bomb of financial products." Mortgages come packed with risks, including credit risk (the risk that the homeowner won't pay), interest rate risk (the risk that the lender will earn less on the mortgage than it could get investing its money elsewhere if interest rates rise), and prepayment risk (the risk that a homeowner will pay off a mortgage much earlier than expected, thereby forcing the lender to replace a high-paying asset with a lower-paying one). Of those risks, the one that most investors like the least is credit risk. The longer the term of the mortgage, the more risk there is for the lender. And so it's come to be conventional wisdom that a fixture of American life, the thirty-year fixed-rate fully prepayable mortgage, would not exist for the wide swath of American consumers but for the presence of companies like Fannie and Freddie, which remove the credit risk and disperse the interest rate and prepayment risk to a wide set of investors. The only other country in the world that offers such a product is tiny Denmark.

It wasn't until the 1960s that Fannie was reborn as what it was originally supposed to be—a private company with all the trappings like stock that could be bought and sold. This was done because in 1967, during President Lyndon Johnson's administration, a budgetary commission recommended that the debt of agencies like Fannie Mae be included in the federal budget. Adding to the federal debt was no more palatable then than it is today, and so, in 1968, when Johnson signed the Housing and Urban Development Act, he effectively split Fannie in two. The Government National Mortgage Association, or Ginnie Mae, stayed in the government, and guaranteed the credit on only FHA and Veterans Administration mortgages. Fannie Mae, which sold stock to the public, was allowed to guarantee mortgages made to the great American middle class—and its debt stayed off the government's books. "I was in the government when Fannie Mae was a government-owned institution," Paul Volcker later told the interviewer Charlie Rose. "And it was created to take care of the mortgage market in times of stress. It was privatized for extraneous reasons. It was privatized to get it out of the budget. Ridiculous."

At the same time, no one wanted to risk hurting Fannie's ability to grease the mortgage market. And so the 1968 legislation also gave Fannie some special advantages. One was that the U.S. Treasury was authorized to buy up to $2.25 billion of Fannie's debt, thereby sending a signal that this was no ordinary company, but rather one that had the support of the U.S. government. Thus began what Rick Carnell, an assistant treasury secretary in the Clinton administration, later described as a "double game." What he meant was that while Fannie and Freddie were ostensibly private companies, their debt was viewed by investors as being akin to U.S. treasuries, because everyone believed that, if necessary, the U.S. government would bail them out. This was called an "implicit guarantee," because it wasn't written down anywhere and didn't officially exist.

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In the ensuing decades, Fannie and Freddie (which was created in 1970 at the behest of the savings-and-loan industry, which wanted their own company to which they could sell mortgages) became two of the largest, most powerful companies in the world. What triggered it was a Wall Street invention—a new way of financing homeownership by packaging up mortgages as securities. The Big Short shows how a Salomon Brothers trader named Lewis Ranieri made the once-stodgy business of selling bonds into a sexy, high-octane gusher of profits, and, while this is true, the real story is a bit more complicated. In essence, Ranieri needed Fannie and Freddie's guarantee to make investors willing and able to buy his new securities. For a long time, theirs was a mutually beneficial competition, but it's not as if Wall Street was ever happy about having Fannie and Freddie siphon off some of the profits in the mortgage market. "Wall Street had a love-hate relationship with them," says one mortgage industry veteran.

But Wall Street couldn't do much, because Fannie and Freddie had the ear of politicians who saw how fostering homeownership could help them, and the decade of the 1990s was, at least on the surface, a golden age. Although there was some regulatory pressure, Fannie's political power helped ensure that the regulator was weak and the companies' capital requirements were low. (The companies were also obligated to make sure that certain percentages of the mortgages they guaranteed went to lower- and middle-income homebuyers, a requirement that later became the key source of the controversy over their role in the financial crisis.)

The mortgage market exploded in size, from just under $3 trillion in 1990 to $5.5 trillion by the end of the decade. Fannie and Freddie, by setting the standards for what kinds of mortgages they would guarantee, effectively determined the sort of mortgage that much of the American middle class would get—and, of course, they took a toll, in the form of a guarantee fee, on every mortgage that passed through them. By the end of the 1990s, Fannie Mae had become America's third largest corporation, ranked by assets. Freddie was close behind. The companies were ranked one and two respectively on *Fortune's* list of the most profitable companies per employee. Fannie, in particular, became known as a place where Democratic operatives went to make fortunes.

The profits were not just from the business of stamping mortgages with a guarantee. In addition, Fannie and Freddie began to hold the mortgages as investments on their own balance sheet. Because of that "double game," they could make money on the difference between higher yield of the mortgage portfolio and what their cost of funds was. The "big fat gap" is what Alan Greenspan, the very powerful chairman of the Federal Reserve for almost two decades, who became one of the GSEs' most powerful enemies, took to calling it.

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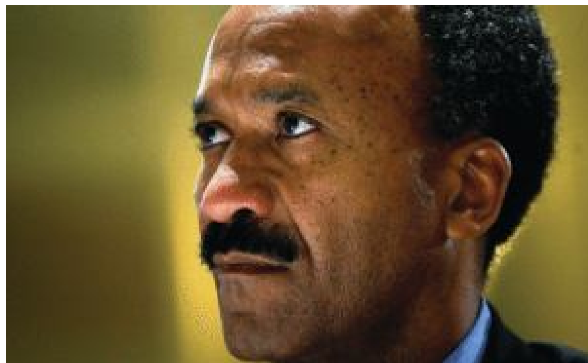
Greenspan wasn't their only enemy. Bill Maloni, Fannie's longtime chief lobbyist, used to call the ideological opposition to the GSEs' very existence the "vampire issue," because it couldn't be killed, try though Fannie might. Economists disliked the hidden subsidy in the form of the implicit guarantee. And increasingly, other players in the mortgage industry—the banks and mortgage insurers—were angry about the extent of the profits that Fannie and Freddie were siphoning off.



The Chairman: Franklin Raines went from balancing Bill Clinton's budget to playing political hardball as head of Fannie Mae.

For most of this period, Fannie and Freddie were able to shut down the opposition to them. Under the leadership of Jim Johnson—whom the *Washington Post* described in a 1998 profile as "one of the most powerful men in the United States," followed by Franklin Raines, a former financier who, as the head of the Office of Management and Budget in the Clinton administration, got great credit for balancing the budget, and who people once thought could be the country's first black president—Fannie Mae developed a reputation for playing political hardball. "Fannie has this grandmotherly image, but they will castrate you, decapitate you, tie you up, and throw you in the Potomac," a congressional source told *International Economy* magazine in the late 1990s. "They are absolutely ruthless." Gene Sperling, who was the director of the National Economic Council in the Clinton administration, used to joke, "If you think a bad thought about Fannie and Freddie, you can hear the fax machine going." When Richard Baker, then the Republican congressman from Louisiana, began trying to get new, tougher regulation of Fannie and Freddie passed, Fannie squelched it.

The political power had a backlash. Even some of those who might have been expected to be on the GSEs' side were offended by what they saw as their abuse of power. "The GSEs brought out a conservative side of me," says Sperling. "The thing that turned me, that made me unwilling to do anything personally for them, is when you see that dynamic where a company is completely dependent on the U.S. government

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for their profit and they spend so much money and time focused on lobbying the U.S. government. It really gets kind of sick." The fact that executives like Raines and Howard made tens of millions of dollars only heightened the anger.

But in 2004, a scandal over the accounting at Freddie, and then Fannie—over the charge, essentially, that Raines, Fannie CFO Tim Howard, and other executives had manipulated their companies' results to please investors—led to the decapitation of the top executives at both companies. The long-standing, slow-burning resentment of the two companies exploded into the open. Fannie's regulator even called Fannie a "government sponsored Enron." And yet Fannie's executives were never criminally charged, and in 2012, after eight years, sixty-seven million pages of documents, and testimony from more than 150 witnesses, a civil suit against Howard, Raines, and another executive ended with the federal judge dismissing all the charges and concluding that there was no evidence that either Raines or Howard had purposefully tried to deceive anyone.

The result was a complete tangle: Fannie and Freddie's stable management was gone; their institutional reputations were badly tarnished; but no one among the GSEs' many critics had the nerve—or the political support—to create anything positive out of the mess. So the GSEs rolled on, deeply wounded, with thin levels of capital and ever-more-onerous requirements to make riskier loans as the mortgage market entered its most dangerous period in history.

The Adviser: Gene Sperling, who worked in the Clinton and Obama administrations, said Fannie and Freddie "brought out the conservative side of me."

By the mid-2000s, so-called subprime lending, which had started in the 1990s, was taking over the industry. The mortgages were sold to Wall Street, not to Fannie and Freddie; within the industry, another term for subprime was "nonconforming," because the mortgages didn't conform to the GSEs' standards.

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As an executive from a major subprime lending company called New Century told Congress in early 2004, subprime lenders were necessary to the economy, because they provided credit to "customers who do not satisfy the stricter credit, documentation, or other underwriting standards prescribed by Fannie Mae and Freddie Mac." He went on to point out that while over 40 percent of New Century's loans were made to borrowers who didn't have to verify their income, Fannie and Freddie "have more stringent income documentation guidelines."

Indeed, as subprime mortgages proliferated, and were sold to Wall Street, Fannie and Freddie were rapidly becoming irrelevant. Their market share fell from 57 percent in 2003 to 37 percent in 2006, according to data gathered by the Financial Crisis Inquiry Commission, which was tasked with investigating the causes of the 2008 financial crisis. A 2005 internal presentation at Fannie Mae noted, with some alarm, "Private label volume [meaning mortgages that were sold to Wall Street, not the GSEs] surpassed Fannie Mae volume for the first time."

If Fannie and Freddie had stuck to their original business—guaranteeing mortgages made to people who (mostly) could pay—there would have been no reason for a bailout. There will always be people, including Frank Raines and Tim Howard, who will insist that if the seasoned executive teams at the GSEs hadn't been ousted just as subprime lending was crescendoing, history would have been different. There is no way, of course, to prove that.

One piece of evidence would seem to point against it, which is that even before the accounting scandals, both Fannie and Freddie had begun acquiring hundreds of billions of Wall Street's private label securities as investments that they would own on their own balance sheets. They did this both because the securities seemed to be a profitable investment at the time, and because—in an incredibly perverse twist enabled by regulators—these loans counted toward the congressionally mandated goals to guarantee loans made to middle- and lower-income people that Fannie and Freddie had to meet.

But it wasn't until after their executive teams were ousted that the GSEs also began guaranteeing supposedly less risky, unconventional mortgages, like so-called stated income loans, in which the borrower simply states her income. They did this because they were under immense pressure from all sides, particularly shareholders, to win back the market share they had lost. In a presentation for a 2005 executive retreat, Tom Lund, who was then the head of Fannie's single-family business, put it this way: "We face two stark choices: stay the course [or] meet the market where the market is."

As the financial crisis gained steam in 2007 and 2008, Fannie and Freddie's regulator continued to tell the market that everything was fine. "The companies are safe and sound, and they will continue to be safe and sound," said Jim Lockhart, the Bush appointee who by then ran the agency that regulated the

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companies, in the spring of 2008.

But at the same time, the government was quietly pressuring the companies to raise capital. Between the start of 2007 and the summer of 2008, Fannie and Freddie sold a combined $22 billion in so-called preferred stock, bringing their total outstanding preferred stock to $34 billion. (Preferred stock pays a dividend like a bond.) The buyers, at least initially, were individual investors in search of dividends, and community banks, who were encouraged to hold GSE securities to bolster their own capital. This preferred stock would turn out to be a huge problem for the government.

By the end of the summer, their stock prices were plummeting, and it was becoming harder for them to sell the debt they needed to fund their operations. On September 5, Paulson pulled what he later called an "ambush." At Freddie, executives were in New York for board meetings when then CEO Dick Syron received what another executive calls a "nasty gram" from Lockhart, taking back all the things the regulator had just said about the company being safe and sound, and instead leveling a host of charges at it. They were told to come to Washington for a meeting at five p.m. on September 5th at the regulator's offices. They had no idea what was coming until they walked into the fourth-floor conference room, where they had all been many times before, and saw not just Lockhart but also Paulson on his left and then Federal Reserve chairman Ben Bernanke on his right. There was a provision in the law that if the directors agreed to conservatorship, they were immune from legal action by shareholders or creditors, making it difficult for them to do anything but agree. The management teams were told to go, and both Fannie and Freddie had to immediately fire all their lobbyists. Paulson later called the decision to take over Fannie and Freddie the "most impactful and the gutsiest thing we did."

In a recent piece in the *New York Times*, Gretchen Morgenson noted that the bailout terms were "draconian" compared to those soon offered to the big banks. The government got the right to take 79.9 percent of the common stock of both Fannie and Freddie. Why not just nationalize them and take 100 percent? "If the U.S. government were to own more than 80 percent of either enterprise, there was a sizable risk that the enterprises would be forced to consolidate onto the government's balance sheet," explained the analyst Laurie Goodman—meaning that the federal government's debt could skyrocket. Although the Treasury would provide no up-front cash, it committed to putting in a great deal of money—up to $200 billion—as needed over time. Fannie and Freddie would have to pay a 10 percent interest rate on any funds the government advanced. Any money the Treasury put in would become senior preferred stock, which would have to be paid before any investor in either the preferred stock that had just been sold or the GSEs' common shares got anything. Although these shares continued to trade, their worth plummeted to pennies.

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Of course, these were the shares that community banks had just been encouraged to buy (while the regulator was saying Fannie and Freddie were safe). The Federal Reserve later estimated that more than 600 depository institutions in the United States were exposed to at least $8 billion in investment losses from these securities, and that at least fifteen failures resulted. "In effect, for the small lenders serving Main Street, it was *let them eat cake,"* wrote the Independent Community Bankers of America in a letter addressed to the *Wall Street Journal's* editorial board. "Treasury's takeover [of the GSEs] is crafted to protect the giant players." What the ICBA meant was that big Wall Street banks had billions of dollars in derivative contracts with the GSEs, so their failure would have ricocheted through the banking sector. But small banks? They could be sacrificed.

Things quickly got worse for the GSEs. During the presidential race between Barack Obama and John McCain, the charge, mostly promulgated by Republicans, that the GSEs were the sole cause of the crisis, and Wall Street just an innocent bystander, first emerged. McCain called Fannie and Freddie "the match that started this forest fire." It got so bad that Freddie employees were told not to wear anything with a corporate logo, and the company offered its top executives twenty-four-hour security protection. In the spring of 2009, Freddie's acting CFO committed suicide.

The appeal of blaming the GSEs was, and is, obvious—it's a way to blame Democrats for the crisis, because, thanks to Johnson, Raines, and others, Fannie was regarded as a Democratic company. And, of course, if the GSEs caused the crisis, and Wall Street is blameless, then no new regulation is needed, and we can repeal the Dodd-Frank financial reform bill.

But that narrative isn't supported by the GSEs' loss of market share as subprime lending took off, or by the loss figures. According to an analysis by the Financial Crisis Inquiry Commission, mortgages turned into securities by Wall Street defaulted at a rate that was almost four times higher than comparable mortgages guaranteed by the GSEs, making it awfully hard to argue that the GSEs led a race to the bottom. Nor is it true that loans made to lower-income borrowers caused the crisis. A study published by the National Bureau of Economic Research in early 2015 found that the wealthiest 40 percent of borrowers obtained 55 percent of the new loans in 2006—the peak year of the bubble—and that over the next three years, they were responsible for nearly 60 percent of delinquencies.

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