INSIDE TROUBLE: Fannie Mae's stately headquarters belies the turmoil within the building over the past six months.

LIZ LYNCH

Taking Cover

WOUNDED MORTGAGE-INDUSTRY GIANTS FANNIE MAE AND FREDDIE MAC HAVE PULLED BACK THEIR ONCE-VAUNTED LOBBYING OPERATIONS. THEY ARE RELYING ON ALLIES, AND A SOFTER TOUCH, TO TRY TO INFLUENCE CONGRESS.

BY BARA VAIDA

When Jerry Howard heard the news about Fannie Mae last September, the chief executive of the National Association of Home Builders was not worried. Fannie, the giant government-chartered mortgage company, had been accused by its regulator, the Office of Federal Housing Enterprise Oversight, of following lax management practices and of violating accounting rules. But Franklin Raines, Fannie Mae's high-profile and self-assured CEO, was certain that OFHEO's charges were baseless, and he asked the Securities and Exchange Commission to step in and conduct its own investigation.

Howard knew the charismatic Raines and trusted his public assurances—which Raines delivered in sworn congressional testimony two weeks later—that Fannie's balance sheets were fine and that the SEC would issue the agency a clean bill of health. Raines, who was budget director under President Clinton and had long been one of Washington's most influential CEOs, was in a long-running battle with OFHEO's recently departed director, Armando Falcon Jr., and was looking to score a win against the regulator.

Yet three months later, on December 15, the SEC's chief accountant announced that its review supported OFHEO's findings. The SEC concluded that Fannie Mae had indeed violated accounting rules and that it should restate its earnings and revise its previously issued financial statements. As a result, Fannie estimates that it will eventually have to restate its earnings to the tune of $10.8 billion.

Howard was shocked by the SEC's news. "I was disappointed, really disappointed," he said in an interview. As the chief Washington lobbyist for the nation's homebuilders, Howard had spent years wearing out shoe leather on Capitol Hill talking up Fannie Mae and its smaller cousin, government-chartered mortgage company Freddie Mac. In Howard's experience, you could take Raines's word to the bank, and Fannie Mae's enormous political clout—backed up by more than $56 million in spending on lobbying, advocacy, and campaign contributions from 1998 through 2004—had earned it a lot of powerful friends in Washington.

The SEC announcement was also a punch in the gut for the NAHB's 220,000 homebuilders, local and state associations, and home-products companies. Financial problems at Fannie Mae could set off turmoil throughout the entire housing industry.

The December announcement was just the beginning of what would become months of bad news at Fannie Mae's distinctive Williamsburg-style headquarters in upper Northwest D.C. Within days of the company's announcement that it would restate earnings, critics of both Fannie and Freddie began circling like sharks in the water. They seized the moment to press for expanded federal regulation of the embarrassed mortgage giants, seeing a chance to get changes that Fannie's and Freddie's vaunted lobbying operations had stymied.

The House Financial Services Committee this week passed a bill that would create a new regulator with expanded powers to rein in Fannie and Freddie, and the White House is pushing for an even tougher bill in the Senate. Chastened, both Fannie and Freddie are actively supporting regulatory changes; they are objecting quietly, however, to proposals that they think will give their new overseer too much control.

Standing up where Fannie and Freddie no longer can, the homebuilders, along with the National Association of Realtors and other allies, have been aggressively pushing back when legislators have made proposals they think will change Fannie and Freddie in ways that could threaten the nation's housing sector.

"The Realtors and the homebuilders are in a position of playing offense and defense for Fannie and Freddie," said the Mortgage Bankers Association's Kurt Pfotenhauer, senior vice president of government affairs. "So while you don't see [Fannie and Freddie], you still feel their push."

Special Status

As the engines driving the important secondary-mortgage market, Fannie and Freddie, known officially as the Federal National Mortgage Association and the Federal Home Loan Mortgage Corp., hold about $1.5 trillion in residential mortgages and other securities. As government-sponsored enterprises, or GSEs, Fannie and Freddie buy hundreds of billions of dollars in primary mortgages from banks, mortgage companies, and other lenders, thereby pumping money back into the home-financing business and providing liquidity and lower interest rates for middle- and low-income Americans. Fannie and Freddie load their portfolios with mortgages, and then pool those mortgages into a financial product called mortgage-backed securities, which they sell to investors.

In recent years, however, Fannie and Freddie boosted their earnings by holding on to a sizable portion of their mortgages and securities instead of reselling them. As earnings at the two GSEs grew, so too did the paychecks of top executives. In 2003, for instance, Raines received $17 million in compensation, plus stock options valued at about $3 million. The earnings growth may be a key to why Fannie got into trouble over its accounting. OFHEO's September 2004 report charged Fannie with creating "a corporate culture that emphasized stable earnings at the expense of accurate financial disclosures."

In addition, by keeping more mortgages in their portfolios, Fannie and Freddie increased their financial exposure to the threats of borrower defaults and interest-rate hikes.

LIZ LYNCH

Friendly Persuasion:
Fannie and Freddie got help from thousands of real estate agents in May, when the Realtors lobbied Congress.

Their government charters give Fannie and Freddie a unique status. They get no government funds, and the federal government does not legally back their securities, but Fannie and Freddie could, if they ever needed capital, take advantage of a safety net accorded to no other private financial institution in the country—a special line of credit with the U.S. Treasury. This means that under dire circumstances, American taxpayers could be asked to bail out Fannie, or Freddie, or both. This lifeline gives Fannie and Freddie enormous leverage in selling their bonds—they can do so more cheaply than other corporations because of the clout they get from the implicit government backing.

On top of all that, Fannie and Freddie pay no state or local corporate taxes and—unlike all other publicly traded corporations—they are not required to register their debt or the securities they issue with the SEC. In 2002, however, the two companies voluntarily agreed to register their stock and file financial statements with the SEC, making them subject to SEC oversight and enforcement for the first time. Fannie registered its securities with the SEC in mid-2003. Freddie, however, has yet to register its securities, because it is still finalizing its restated earnings.

The SEC's December finding hit Fannie Mae like a bomb. The board soon forced Raines to step down, and other senior executives followed him out the door. More than a year earlier, Freddie Mac, announcing it had misapplied derivatives on its financial statement, had restated its earnings by $5 billion.

The GSEs' critics, which include free-market advocates and some Republican lawmakers, and their competitors, which include commercial banks and mortgage companies, have been emboldened by the accounting problems and are pressing harder than ever for new safety and soundness requirements for both Fannie and Freddie. And on May 19, the pressure mounted even higher when Federal Reserve Board Chairman Alan Greenspan warned in a speech that Fannie and Freddie are "highly leveraged" and thus pose an economic risk to the nation. Just hours after Greenspan's comments, the Bush administration delivered a proposal to the House Financial Services Committee that would allow a new regulator to strictly limit the size of the mortgage assets that Fannie and Freddie could hold on their books.

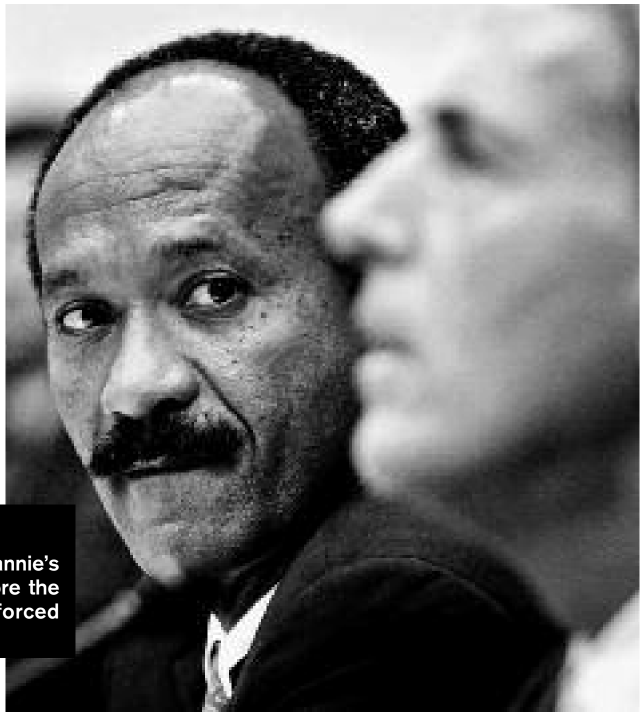
In an interview with *National Journal,* Snow sought to downplay differences between the administration and House Republicans. "Our position has been misperceived some," he said. "We are not for—in fact, I opposed—a legislated cap on the portfolios." *(See related story, p. 1634.)*

However, Snow stressed that it's important to "signal to the markets that these entities 'aren't too big to fail,' which is an inherent part of the problem … that somehow Treasury stands behind them or the government stands behind them."

Until this year, everyone on the Hill understood that Fannie and Freddie could call on their formidable lobbying muscle to stop just about any legislation they didn't like. But the accounting scandals have put the two GSEs on the defensive, forcing them to abandon their former in-your-face tactics and instead rely on friends and allies—such as the homebuilders and the Realtors—to take the lead in trying to water down what they consider onerous legislation.

"Any organization that has gone through the turmoil that they have would find themselves weakened in their ability to communicate with members and lobby on issues," said Sen. John Sununu, R-N.H., a member of the Senate Banking, Housing, and Urban Affairs Committee, and co-sponsor of GSE reform legislation. "Changes in their executives and lobby ranks, and some reduction in the amount being spent on lobbying, has to make a difference."

Sununu also had a warning for Fannie's and Freddie's allies who are resisting tougher regulation. "I wouldn't want to be the person that's trying to step in to discourage Congress from taking action to strengthen the effectiveness of the regulator," he said. "We need to make sure these institutions are strong, safe, and sound—and if the Realtors or homebuilders want to take the other side of that, they are pushing their luck."



REUTERS/LARRY DOWNING

HOT SEAT:
Franklin Raines was Fannie's high-profile CEO before the accounting scandal forced him out of the job.

HARDBALL

On December 15, a group of Senate and House staffers who follow financial issues had gathered after work at the downtown restaurant Shelley's Back Room when they got the news that the SEC had directed Fannie Mae to correct its financial statements. One of the aides who works on GSE reform legislation later recalled, "I thought, 'Oh, my God! Wow!' And then, 'It's a whole new world. How will this all come down?' " The aide, who didn't want to be named, said, "I thought, 'Maybe something will pass this time around,' and then, because I am a constant pessimist, [I thought,] 'I don't know if even the accounting scandal is enough, because Fannie and Freddie have the best friends money can buy.' "

Best friends, indeed. Because protecting their government charters has always been central to Fannie's and Freddie's huge profitability, the companies built two of the most impressive lobbying machines in Washington. Between 1998 and 2004, Fannie Mae and Freddie Mac hired a combined 88 K Street firms, according to the Center for Public Integrity, and employed about a dozen in-house lobbyists—several of whom were former congressional staff members who had worked on GSE issues. Filings at the Senate Office of Public Records show that Fannie and Freddie spent a combined $109 million on lobbying from 1998 to 2004. And during that same period, the two GSEs gave a combined $13.3 million in individual, political action committee, and soft-money donations, according to the Center for Responsive Politics.

The Fannie Mae Foundation and the Freddie Mac Foundation are two additional drivers of the GSEs' advocacy machine. The philanthropic foundations have built relationships with local officials and affordable housing groups, and Fannie and Freddie have tapped those ties whenever they needed support. From 2000 to 2003, the Fannie Mae Foundation handed out $153 million in grants, to thousands of organizations. The Freddie Mac Foundation gave

$64.9 million during that period. “Fannie and Freddie have done a great service for affordable housing, for housing in general,” said Bonnie Caldwell, senior legislative director at the National Low Income Housing Coalition.

The foundations often invite lawmakers to ceremonies celebrating their foundations’ grants—providing lawmakers with photo ops that can boost their re-election campaigns. One Democratic House aide recounted how he called the Fannie Mae Foundation to ask for help for low-income constituents who were facing foreclosure on their home. A Fannie official called back, according to the aide, and said that Fannie would buy the mortgage. “That kind of stuff leaves a nice impression in the brains of lawmakers,” the aide said in an interview.

Congressional staffers told *National Journal* that Fannie Mae’s and Freddie Mac’s multitude of lobbyists would routinely coordinate questions and topics for lawmakers to discuss at hearings, bolstering the appearance of strong support on the Hill for their work. According to others, the GSEs’ lobbyists would attend meetings to advise Hill staff that certain policies under consideration “can’t work,” or would be “harmful to housing.”

“The GSEs were the big gorillas—particularly Fannie,” said Wright Andrews, a banking lobbyist and partner at Butera & Andrews. “No one could take them on.”

And when they felt threatened, the GSEs played hardball. Mike House, a partner at Hogan & Hartson and the executive director of the lobbying coalition FM Policy Focus, felt “vindication … a real sense of satisfaction” when he heard the December 15 bombshell. FM Policy Focus—a group of banks, mortgage insurers, consumer lenders, and others in the home-finance sector—had spent $16.8 million over a five-year period raising questions about Fannie’s and Freddie’s debt and their privileges in the marketplace. Fannie and Freddie and their allies pulled no punches in going after FM Policy Focus, and orchestrated a campaign to discredit the group’s arguments as just sour grapes by competitors. Raines told *National Journal* in 2000 that Fannie Mae viewed the group as “the coalition for higher mortgage costs.”

Fannie Mae tried to peel off lobbyists working on the FM Policy Focus team by offering them more money to switch sides. “Haley [Barbour] would tell the story about how Fannie called him and tried to hire him after we had, and they told him he wouldn’t have to do anything” if he agreed to work for them, House said of ex-lobbyist Barbour, now the Republican governor of Mississippi.

“Or people would come up to us at Christmas parties and say, ‘Oh, you are with those FM guys. How do you like what you are doing to my stock?’ ” said Beneva Schulte, a spokeswoman for FM Policy Focus. Fannie Mae’s press team often chided reporters who quoted FM Policy Focus’s attacks on the GSEs.

One former White House official said that Fannie’s lobbyists were so confident, they simply wouldn’t negotiate. “They would just say, ‘No, that is unworkable,’ ” the official said. “It got to the point where the folks in the White House policy team would ask, ‘Why won’t these guys engage us in an honest intellectual debate?’ Under Raines, their philosophy was, ‘We won’t compromise on anything, because we are Fannie Mae.’ ”

Fannie Mae Senior Vice President for Government and Industry Relations Duane Duncan acknowledges that reputation. “We came across as arrogant and heavy-handed,” he said in an interview. Duncan said the situation is different today, and “it’s been a personal challenge,” he admitted, to represent a company that has “changed a lot from where we were in the years past. So you have to shoot straight with everyone at all times.”

Duncan understands that some on the Hill remain skeptical. “Some people are troubled and want to keep you at a distance,” he said. “When you come back to them with candor and humility, you do your company and yourself a service.”

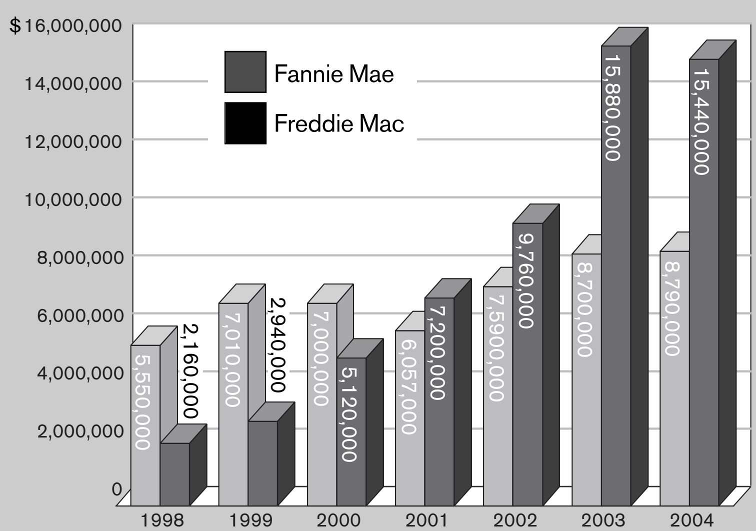
Freddie Mac spokeswoman Sharon McHale disputed that her company’s lobbyists were as aggressive as Fannie’s. Although Freddie spent more on federal lobbying and political campaign donations from 1998 through 2004—$66.3 million for Freddie versus $56.2 million for Fannie—Freddie’s lobbying style was “toned down,” compared with Fannie’s, McHale said.

Lying Low

In the wake of the accounting scandals, the bravado has disappeared. Freddie has cut its lobbying spending by 30 percent this year; Fannie has slashed its lobbying budget by one-third, or about $1 million. The Fannie Mae Foundation said in early May that it was cutting its budget by $20 million, or 22 percent, and that it was eliminating its advocacy campaigns, including television advertising. Not surprisingly, the credibility of the

A Huge Lobbying Tab

Until this year, Fannie Mae and Freddie Mac were among the highest rollers on K Street. The two companies spent a combined $109 million on lobbying in Washington from 1998 to 2004.



SOURCE: Senate Office of Public Records

institutions has taken a hit. “Members are more wary of Fannie and Freddie, given the seriousness of problems that have been announced at both firms,” Sununu said in an interview.

In fact, congressional staffers say they rarely hear from Fannie and Freddie these days, except when the companies respond to their phone calls. Recognizing that legislation to rein them in is almost inevitable, the two GSEs are treading carefully, Hill aides say.

Fannie’s Duncan said it is the company’s strategy to lie low and wait to be asked by lawmakers to discuss Fannie’s positions. “We have clear direction from our board and interim CEO to strike a more conciliatory tone, and we have done that,” he said. “It is a sea change.” Freddie’s McHale concurred that staying below the radar has become the firm’s primary lobbying tactic.

The strategy may well be working. A number of House and Senate aides said they believe that Fannie and Freddie want a bill that will get them past the current controversies. “I feel like, for the first time, they want a bill—so they don’t want to risk pissing people off,” said one House aide. “Instead, they are educating us on the impact of policy.” A Senate aide said, “They aren’t spinning us, or saying, ‘This is a nonstarter,’ or ‘We can’t have that.’ ” And another staffer concludes that Fannie and Freddie “feel so weak to me right now that I think they’d take anything.” Lobbyist Andrews concurs: “Fannie and Freddie have to go underground for a while.”

In Fannie’s case, the company went underground after the SEC found that the mortgage giant had improperly accounted for derivatives—a financial tool for hedging against interest-rate changes—on its balance sheet. Fannie was forced to revise its earnings on its financial statements, and Falcon, former head of OFHEO, expects that straightening out Fannie’s books will take up to three years, according to news reports.

Fannie’s board hired former Sen. Warren Rudman, R-N.H., to conduct an independent accounting investigation, and his report had been expected as early as this month. But because of the complexity of the company’s accounting problems, Rudman has indefinitely postponed releasing his findings. Meanwhile, Fannie’s acting CEO, Daniel Mudd, must report to OFHEO almost daily on the company’s activities, according to a banking lobbyist. In April, Thomas Donilon, Fannie’s top lawyer and its head of congressional and regulatory relations, announced that he was leaving after five years to return to private practice.

In Fannie’s and Freddie’s Shadow

Outside the spotlight is another lobbying effort involving a third government-sponsored enterprise—the Federal Home Loan Bank system, a group of 12 “wholesale” banks that are owned by more than 8,000 community financial institutions around the country.

The FHLBanks, as they are known, provide low-cost funding to regional and commercial banks, credit unions, and insurance companies. Unlike Fannie Mae and Freddie Mac, the FHLBanks don’t sell mortgage-backed securities, and their shares aren’t publicly traded. Instead, financial institutions that buy Home Loan Bank stock are then able to tap the FHLBanks for capital.

“Fannie and Freddie are publicly traded, so their profit motives are different,” said Eric Mondres, vice president and director of government relations for the Federal Home Loan Bank of Atlanta. “Our business model is [more like] a cooperative.”

Some of the Home Loan Banks’ 8,000 members are using the fight over GSE reform legislation as an opportunity to try to free up the FHLBanks to enter new lines of business. The Mortgage Bankers Association, which represents a number of banks that own Home Loan Bank stock, has lobbied for a provision that would allow the FHLBanks to guarantee and issue mortgage-backed securities, for example.

The FHLBanks themselves are divided over that idea. Some, like the Atlanta bank, support it. But Lawrence Parks, senior vice president of external and legislative affairs for the Federal Home Loan Bank of San Francisco, said, “We aren’t favorably disposed to having that authority,” because, he said, it could create regulatory complications.

America’s Community Bankers, a trade association that represents many Home Loan Bank shareholders, has questioned whether new legislative language is necessary, arguing that the FHLBanks’ regulator, the Federal Housing Finance Board, may already have the authority to let the banks enter new lines of business.

Some of the FHLBanks have weathered financial scandals of their own. In December, for example, the Federal Home Loan Bank of Seattle disclosed a 42 percent drop in annual earnings from 2003 to 2004, and acknowledged that it needed to improve its governance, risk management, and financial performance. And the Federal Home Loan Bank of Chicago last year reported that it had misapplied derivatives in its accounting process; the bank subsequently restated its earnings.

In testimony before the Senate Banking, Housing, and Urban Affairs Committee in April, Raymond Christman, president and CEO of the Atlanta bank, said that the FHLBanks have had to take steps to improve internal oversight, but he asserted that their regulatory structure is fundamentally sound. The FHLBanks must adhere to minimum capital standards and must abide by limits on the amount of debt they can hold in their portfolios. They must also set aside 10 percent of their income for investment in affordable-housing programs.

Parks told *National Journal* that the FHLBanks are lobbying Congress to keep regulation of the Home Loan Bank system separate from the oversight of Fannie and Freddie; they base their stance on the regional nature of the Home Loan Banks and their distinct business model. Specifically, Parks said, the FHLBanks want any new federal GSE regulatory agency to have two deputy directors—one to oversee Fannie and Freddie, and one to oversee the FHLBanks. **—B.V.**

Still, Fannie and Freddie haven't completely capitulated. After apologizing for the accounting problems and declaring to Congress that Fannie Mae "welcomes the creation of a new regulator," Mudd testified against several of the proposals circulating on the Hill. One would impose a stricter limit than the current "safety and soundness" standard for determining the level of assets that Fannie could hold in its portfolio. Another is the so-called "bright-line" measure, that would define the specific activities that the GSEs could and could not undertake in the mortgage market, thus potentially forcing them to eliminate current products and services.

The banks and other financial institutions that belong to FM Policy Focus have long complained about "mission creep," as the GSEs moved into offering more and more financial products, such as loan underwriting systems and mortgage advice services. Freddie Mac CEO Richard Syron also testified against the portfolio limit.

Freddie's lobbying team is less hampered, sources say, because the company has pushed out 11 of its top executives and lobbyists, including former Chairman and CEO Leland Brendsel and chief lobbyist R. Mitchell Delk. The company has since hired a new management team and taken a publicly conciliatory approach in its advocacy efforts.

Freddie's new senior vice president of government relations, Timothy McBride, was an assistant to the president and director of White House management and administration under George H.W. Bush, and is married to Anita McBride, chief of staff to first lady Laura Bush. McBride joined Freddie from DaimlerChrysler, where he had been the automaker's vice president of external affairs and public policy. Freddie spokeswoman McHale said that McBride and other company executives "have said they will meet with anyone at any time, and that we want to be as constructive and open with information as possible."

And the GSEs still have friends downtown and on the Hill. The Realtors and the homebuilders obviously have a direct stake in the continued growth of the housing market, which has been partly fueled by low interest rates. Because Fannie and Freddie have been such big players in the market, these groups are worried that a congressional crackdown on the GSEs will stall the housing boom.

The NAHB's Howard, a consummate lobbyist and a football fanatic who enjoys bipartisan respect, played a key role in scuttling Congress's past efforts to tighten regulations on Fannie and Freddie. In the 2004 election cycle, the NAHB's political action committee distributed $2.2 million to federal candidates—two-thirds to Republicans and one-third to Democrats, according to the Center for Responsive Politics. The association also spent at least $1.34 million in lobbying fees in 2004.

Resisting Receivership

For years, Howard said, he worked closely with both Fannie and Freddie to help promote the mortgage lenders' agenda on the Hill. Last year, for example, Congress was considering legislation that would set up a "receivership" mechanism by which, in the event of massive mortgage defaults and the collapse of the GSEs' own portfolios, Fannie and Freddie would be liquidated, rather than bailed out by the government. After visiting Wall Street bond-rating agencies Standard & Poor's, Moody's Investors Service, and Fitch Ratings, Howard spread the word that Fannie's and Freddie's bonds might be downgraded if the legislation passed. The NAHB's' move increased the pressure on lawmakers to oppose the bill.

In early 2005, after the SEC announcement brought Fannie's accounting problems to light, Howard again visited the bond raters—who by then had shifted position and determined that legislation that included a receivership mechanism would *not* be crucial in determining ratings because it doesn't affect Wall Street's perception that the GSEs are backed by the government. S&P Managing Director Michael DeStefano said in April that S&P had come to view receivership as an "administrative tool," Dow Jones News Services reported. Howard said that, based on his talks with the ratings agencies, as well as on congressional testimony from the agencies in February, Wall Street is watching to see how restrictive any new regulations would be before deciding whether to downgrade Fannie's or Freddie's debt. Congress should not limit the GSEs, Howard warned. "We are concerned Congress will overreach."

RICHARD A. BLOOM

Jerry Howard: The CEO of the homebuilders' lobby has been among Fannie's and Freddie's strongest allies.

Most portfolio managers who hold Fannie and Freddie stocks and bonds seem to be betting that Congress's efforts to tighten oversight of the companies will have little impact on the mortgage market, although any restrictions are certain to further slow earnings growth at both companies. "The most [significant] impact on the mortgage market would be if there are restrictions on portfolio size and growth," said Susan Schiff, vice president of Eaton Vance Managed Investments. The problem with strict portfolio limits, said Charles Gabriel, head of Prudential Equity Group's Washington Research Group, is that it could depress the GSEs' growth and hurt their bond ratings. "When you stop growing," he said, "you start dying."

If bond raters indicate that new legislation would lead to a ratings downgrade, Howard said, the NAHB would spend "significant" sums on a public-relations and grassroots campaign to defeat the bill. This would include continuous fly-ins of NAHB members from across the country, he said, adding, "All other issues pale in comparison."

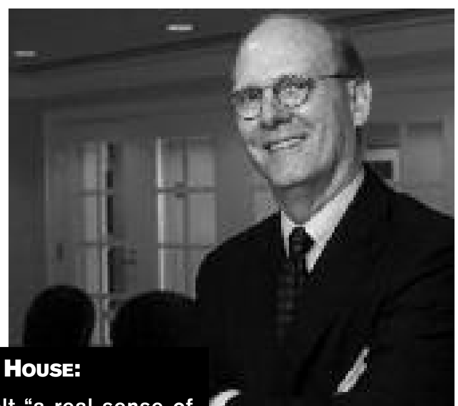
The National Association of Realtors has also come to Fannie's and Freddie's rescue. The NAR's strength is its 1 million Realtors and brokers—"local community connectors who have tremendous word-of-mouth capabilities," said a former NAR employee. Many brokers and Realtors are middle-class "soccer moms" who work part-time. They epitomize grassroots support, standing ready to write letters and make phone calls to their lawmakers on short notice. The NAR's PAC was the largest donor to federal candidates in the 2004 election cycle, contributing $3.8 million, with 52 percent going to Republicans and 48 percent going to Democrats, according to the Center for Responsive Politics. In 2004, the NAR spent $14 million on lobbying, putting it among the top spending organizations in Washington, according to PoliticalMoneyLine.

NAR President Al Mansell, CEO of Coldwell Banker Residential Brokerage in Midvale, Utah, said, "We'll call out the dogs" if the association sees the developing legislation as a threat to the real estate market.

"If the homebuilders and the Realtors and the Fannie and Freddie constituency are unified in opposition, it's an uphill climb" for any bill that would impose new regulation on the GSEs, said Ralph Hellmann, who used to work on economic issues for House Speaker Dennis Hastert, R-Ill. "I'm not sure that anyone can beat that team." Hellmann is now a senior vice president at the Information Technology Industry Council.

Earlier this year, the NAR showed how it can be helpful to Fannie and Freddie. The association distributed a white paper to senators and representatives in March arguing how such a measure would hurt the housing market. The paper was similar to one distributed by Freddie Mac, and several lobbyists speculated that Freddie was the original author. A spokesman for the Realtors said the group distributed its own paper and "categorically" denied that it was authored by Freddie Mac.

One irony is that Democrats, typically strong advocates of financial regulation, have been pushing against Republican proposals for making significant changes to Fannie's and Freddie's federal oversight. "It's like *Alice Through the Looking-Glass* in the GSE world," said one House Democrat. "Things are upside down."


LIZ LYNCH

MIKE HOUSE: He felt "a real sense of satisfaction" when the SEC announced that Fannie Mae had violated accounting rules.

Rep. Barney Frank, D-Mass., the ranking member of the House Financial Services Committee, said he has no trouble with the GSEs' using their government benefits to get a leg up on their competitors. The reason, Frank believes, is that the GSEs are the backbones of support for affordable housing in America.

"Fannie and Freddie have done a good job with members in poor districts because they produce for their districts—and the critical element is housing," Frank said. He predicted that Fannie's and Freddie's competitors "will be disappointed" by the final bill that comes out of Congress this year. "They won't get the restrictions on [Fannie and Freddie's] abilities to compete with them," he said.

Still, the relationships between the GSEs and their longtime allies are showing some strain. Howard is concerned that Fannie and Freddie are so motivated to put the debate about their futures behind them that the companies will "cut a deal" with lawmakers that would end up shrinking their roles in the housing market just to "support their business model and balance sheet." That kind of deal, Howard said, could damage the overall home-financing system because a smaller Fannie and Freddie would be limited in their ability to help stabilize the market during a recession.

Howard and his colleagues could even end up abandoning Fannie and Freddie if the homebuilders think the legislation would hurt their industry. "I don't think it's good for housing to have this [questioning of Fannie and Freddie] hanging out there," Howard said. "But no legislation is better than bad legislation."

Fannie's Duncan said the associations have the ability to "push back a bit," because they aren't feeling the same pressures as Fannie. "We've told them why we need the legislation," Duncan said, "but we haven't told them what to do." Duncan, a former aide to longtime GSE critic Rep. Richard Baker, R-La., doesn't share the homebuilders' and Realtors' concerns that Congress will pass a bill that hurts the GSEs' bottom lines. "Congress supports the role we play in the housing finance industry and the economy," he said.

Administration Beaten Back

Lobbying intensified in the days leading up to May 25, when House Financial Services Committee Chairman Michael Oxley, R-Ohio, opened the formal drafting of the GSE regulatory reform bill he co-sponsored with Baker, who is chairman of the panel's Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises. Much of the lobbying energy was focused on the Bush administration's push to incorporate language into the Oxley-Baker bill that would limit asset levels in Fannie's and Freddie's portfolios.

The Treasury proposal, which was offered as an amendment during the May 25 markup by Rep. Scott Garrett, R-N.J., would allow Fannie and Freddie to keep on their books only those assets that a regulator determines "are necessary ... to maintain a liquid secondary mortgage market." This portfolio limit is what housing-industry advocates feared that Congress might try to push, and what House Democrats say is a nonstarter. Moreover, said Gabriel of Prudential Securities, "the view from the financial markets is that the proposal would lobotomize the GSEs."

The homebuilders, the Realtors, the National Low Income Housing Coalition, and the Independent Community Bankers of America all responded negatively to the administration's proposal. "The regulator should have the authority to adjust portfolio size limits in case of safety and soundness concerns, but we strenuously oppose Congress's mandating portfolio limits," said ICBA President and CEO Camden Fine. The ICBA's 5,000 member banks have been lobbying against portfolio limits.

But, in a sign of how much has changed at Fannie, the company has had no comment. Freddie Mac spokeswoman McHale said her company opposes the measure. Meanwhile, Treasury Secretary Snow was personally lobbying House members to support the president, according to Hill staffers who spoke to *National Journal*. However, Fannie's and Freddie's supporters prevailed when Garrett withdrew his asset-limitation amendment after a contentious debate. Nonetheless, the White House is expected to push the measure with Senate Banking Committee members who are scheduled to begin formally drafting their bill this summer.

Under the House legislation, which passed the committee by a vote of 65-5, the government would create a new regulator, the Federal Housing Finance Agency, to oversee Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, a consortium of 12 banks that provides liquidity to commercial banks, savings institutions, credit unions, and insurance companies. *(See sidebar, p. 1614.)* The new agency would take the place of both OFHEO and the Home Loan banks' regulator, the Federal Housing Finance Board. The regulator would have broader authority to oversee the safety and soundness of Fannie's and Freddie's activities, as well as their progress toward meeting affordable-housing goals.

The legislation would not only establish a receivership mechanism, it would also set minimum capital standards. The regulator could withhold compensation for the GSEs' executives if it deemed that pay levels were inappropriate, and it would have the authority to preview Fannie's and Freddie's proposed new products and veto any that it judges are not in the public interest.

In previous legislative debates on tightening the GSEs' regulatory scheme, the White House and Congress fought over the structuring of the agency to oversee Fannie and Freddie. This year, most sides agree that the regulator should be independent, with a director nominated by the president and confirmed by the Senate. Because the GSEs' missions affect both the financial services and housing industries, the House bill would set up an advisory board composed of the Treasury secretary, the Housing and Urban Development secretary, and two presidential appointees.

In a bow to concerns about limiting the GSEs' portfolios, the bill would give the regulator the authority to limit the two companies' portfolios, but not by an explicit amount. Rather, the agency would be required to report to Congress on the risks tied to Fannie's and Freddie's holdings, and how the holdings relate to the GSEs' missions to provide affordable housing. The agency would conduct a study to determine whether the portfolios should be limited or reduced over time. Baker said the bill gives the new regulator "flexibility" to determine whether portfolios should be reduced to ensure safety and soundness, or to keep the companies focused on their secondary-market mission of repackaging mortgages as securities.

On the affordable-housing issue, a key to getting the Democrats' support, Fannie and Freddie will be required to set aside 5 percent of their annual profits in a fund for low-income housing projects. Conservative Republicans tried to strip the language from the bill, but were defeated in a vote of 53-17.

LIZ LYNCH

Bipartisan Action:
House Financial Services Chairman Michael Oxley and ranking Democrat Barney Frank (left) both support the GSE reform bill.

The House measure is likely to move to the floor this summer. Conservative Republicans are expected to press their opposition to the affordable-housing language when the bill comes to the House floor.

For now, the action moves to the Senate, where an even tougher regulatory reform bill may be developing behind the scenes. Senate Banking, Housing, and Urban Affairs Committee Chairman Richard Shelby, R-Ala., is considering using legislation introduced by Sununu, Sen. Elizabeth Dole, R-N.C., and Sen. Chuck Hagel, R-Neb., as a starting point. Shelby's bill is expected to have many of the same features as the Oxley-Baker bill, including a new independent regulator with power to raise capital requirements, and authority to disapprove new products and to put a failing GSE into receivership.

It may differ from the House bill, however, in requiring the new agency to issue regulations to define the boundary between the secondary-mortgage market—which comprises the purchase and resale of existing mortgages—and the primary market, which is mortgage origination. In other words, it would set the "bright line" that Fannie and Freddie and their allies oppose. Shelby has also publicly stated that he plans to specify that the regulatory agency should limit the companies' portfolios, but it is not clear whether he will adopt the White House measure that failed to pass muster at the House committee this week. "It was a heck of a statement," that the committee did not act on the Bush administration's provision, said Gabriel, who predicted that if Shelby were to press ahead with the administration's language, momentum on the bill would drop.

A Senate Banking Committee spokesman said that nothing has been ruled out, but added that Shelby "doesn't think Congress is the appropriate forum" for setting standards for GSE portfolios, and that such decisions should be left to a regulator.

This delicate dance among the Democrats, the House and Senate Republicans, and the White House leads some observers to question whether lawmakers can come up with a bill that will satisfy both chambers. "When it comes to things on the Hill, it's never over until it's over," said Lawrence White, a professor of economics at New York University's Stern School of Business. "I can imagine all kinds of scenarios … where the legislation could just lock up, and we get to a stalemate." ■

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