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## Fannie's Perilous Pursuit of Subprime Loans

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As It Tried to Increase Its Business, Company Gave Risks Short Shrift, Documents Show

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In January 2007, as years of loose mortgage lending were about to send the nation's housing market into devastating decline, [Fannie Mae](#) chief executive [Daniel H. Mudd](#) wrote a confidential memo to his board.

Discussing the company's successes, Mudd said one of Fannie Mae's achievements in 2006 was expanding its involvement in the market for subprime and other nontraditional mortgages. He called it a step "toward optimizing our business."

A month later, Fannie Mae outlined plans to further expand its activities in the subprime market. The company recognized the already weak performance of subprime loans but predicted that they would get better in 2007, according to another Fannie Mae document.

Internal documents show that even late in the housing bubble, Fannie Mae was drawn to risky loans by a variety of temptations, including the desire to increase its market share and fulfill government quotas for the support of low-income borrowers.

Since then, Fannie Mae's exposure to loosely underwritten mortgages has produced billions of dollars of losses and sent its stock price plummeting, prompting the federal government to prepare for a potential taxpayer bailout of the company. This month, Fannie Mae reported that loans from 2006 and 2007 accounted for almost 60 percent of its second-quarter credit losses.

Fannie Mae documents from the period, obtained by [The Washington Post](#), paint a picture of a company with the dual incentives of fostering affordable housing and making money, and of one caught between the imperatives of increasing its market share while avoiding excessive risk. In a bid to juggle these demands, the company's executives took on risks they either misunderstood or unduly minimized.

## Engaging the Market

Fannie Mae aimed to benefit from subprime loans and expand the market for them -- and hoped to pass much of the risk on to others, documents show. Along with subprime loans, which were typically issued to borrowers with blemished credit, the company targeted so-called Alt-A loans, which were often made with no verification of the borrower's income.

"By entering new markets -- especially Alt-A and subprime -- and guaranteeing more of our customers' products at market prices, we met our goal of increasing market share from 22 to 25 percent," Mudd wrote in a 2006 year-end report to the Fannie Mae board dated Jan. 3, 2007.

In other internal documents, there was a common refrain: One of Fannie Mae's objectives for 2006 was to "increase our penetration into subprime."

In an interview, Fannie Mae Executive Vice President Thomas A. Lund said the company pursued the purchase of subprime loans in 2006 and 2007 at the request of lenders, who wanted Fannie Mae to take the loans off their books. He said Fannie Mae hoped to bring higher standards to the market, and he added that the loans helped the company in its struggle to meet goals the government had set for Fannie Mae's advancement of affordable housing.

Fannie Mae spokesman [Brian Faith](#) said that as early as 2005, the company's management was publicly expressing concern about loans with layer upon layer of risky characteristics.

At a conference in spring 2005, Lund warned about the danger to borrowers, asking, "Are we setting them up for failure?" according to news reports.

Despite such reservations, Fannie Mae moved ahead.

In 2006 and 2007, Fannie Mae "carefully broadened our entry into the subprime market," Faith said in a statement. At the time, it wasn't clear how severe the problems in the housing market would become, he said.

In a written statement provided for this story, Mudd said, "In 2006 and early 2007, the industry, many analysts and market observers were generally not predicting a downturn in the housing and credit markets to the magnitude of what has since emerged, and outlooks for particular market segments at that time varied significantly."

Compared with the broader market for Alt-A loans, Fannie Mae "was more conservative in its approach and the loans have continued to perform better," Mudd added.

Chartered by the government to keep mortgage money flowing, Fannie Mae buys loans from lenders, enabling them to make more loans. It also packages loans into securities for sale to other investors, guaranteeing it will make the payments if borrowers default. Its mortgage-related investments and guarantees total \$3 trillion.

During the peak years of the housing bubble, the company was distracted by an accounting scandal and its fallout. For much of 2006, the company was focused on a continuing effort to correct years of false financial reports, a massive project that cost more than \$1 billion and ultimately revealed that Fannie Mae had overstated past profits by \$6.3 billion.

Mudd promised his employees a celebration when the restatement was done, and he delivered. In December 2006, the company threw a holiday bash at a Washington hotel with entertainment by Earth, Wind & Fire, the '70s group known for such hits as "Boogie Wonderland" and "Fantasy."

"I hope you had a fantastic time at the holiday party. I sure did. And my feet still hurt. Thank you for making the party a blowout," Mudd wrote in a year-end message to employees.

In his year-end memo to the board, Mudd said he hoped the completion of the accounting corrections would prove to be a turning point -- "a time when we began to put a difficult past behind us and also to build for the future."

Mudd said he worried that while the company focused on its accounting problems, "the business itself would get away from us." He said the company avoided that pitfall but now faced another: intense competition from "usurpers and innovators."

Buying Alt-A and subprime mortgages was part of Fannie Mae's effort to meet the challenge. Fannie Mae sought to reap the rewards and protect itself from the downside of the investments through a feat of financial engineering it called its "Risk Transformation Facility," which was meant to transfer the riskiest elements to other investors.

"We engaged in the subprime market, for the first time closing deals to guarantee and securitize subprime loans, with help from the new facility that allows us to sell off the riskiest layers," Mudd wrote. By October, the company had signed \$3 billion of such deals.

Although the deals discussed in Mudd's memos were small in relation to the overall scale of Fannie Mae's business, they reflected the company's appetite for subprime and Alt-A mortgages. The company had a long and deep involvement in this market through a different form of investment.

Instead of buying the loans and securitizing them itself, Fannie Mae had invested in securities packaged by others from pools of these loans. Going back at least as far as 2002, Fannie Mae had taken on tens of billions of dollars of such securities, according to regulatory data.

Fannie Mae's investment in Alt-A and subprime securities issued by others would later prove costly. But in Mudd's January 2007 report, as he reviewed the company's business, they didn't even draw a mention.

A month later, Fannie Mae management outlined a plan to acquire \$11 billion more in "subprime/non-prime mortgages" in 2007 and expressed confidence in its ability to handle the risk.

The company had "approached its expansion of this business cognizant of the relatively weak credit performance of recent subprime originations, which were affected by issues relating to underwriting quality, home price de-appreciation . . . and risk layering," one February 2007 document said, referring to loans with multiple risky characteristics. "However, management expects improvement in the quality and credit performance of subprime mortgages originated this year."

## Emerging Crisis

By March 2007, when Mudd sent the board an update, major subprime lenders were failing, delinquency rates were climbing, and the emerging crisis was impossible to ignore.

The subprime sector "is in partial meltdown," Mudd wrote. He reported to directors that Fannie Mae's investment in subprime mortgage assets totaled about \$55 billion.

Mudd told the board that Fannie Mae had run its subprime portfolio through a stress test to determine the losses in a hypothetical scenario that involved a two-percentage-point rise in interest rates and two years of 5 percent declines in home prices. The resulting prediction: "zero credit losses net of earnings."

Mudd remained so sanguine about Fannie Mae's outlook that he asked the board to consider giving up its special status as a government-sponsored enterprise -- an advantage that helped the company borrow money at low rates by leading investors to believe the government stood behind its obligations.

Since then, the government's more explicit support has provided a crucial backstop for the struggling company.

As it turned out, Fannie Mae did not buy as many subprime loans as it intended in 2007 because few of them met its criteria and the market worsened, Lund said. The subprime loans the company did buy in 2006 and 2007 performed as expected, Faith said, declining to say whether they had produced profits or losses.

But the continuing purchases of securities backed by loosely underwritten loans have been a source of trouble.

Though the deterioration in home prices has not been as extreme as the hypothetical "stress test" scenario Mudd cited in his memo last year, Fannie Mae has incurred losses of \$3.4 billion on securities backed by subprime and Alt-A loans since the beginning of 2007, the company reported last week. Alt-A loans accounted for almost half of the red ink the company attributed to foreclosures and other bad loans during the quarter ended June 30.

Faith declined to discuss the stress test.

At the end of June, Fannie Mae owned or guaranteed \$388.3 billion of Alt-A and subprime mortgage investments. In comparison, it said its capital -- the financial cushion that enables it to absorb losses -- totaled \$47 billion, which exceeded the government's minimum requirement by \$9.4 billion.

In his statement to The Post, Mudd said Fannie Mae's Alt-A investments have been hurt "by the most severe decline in home prices since the Great Depression." Making matters worse, the investments are concentrated in states "where home prices have fallen further and faster than in the rest of the nation," he said.

This month, Fannie Mae said it would stop taking on new Alt-A loans by the end of this year.

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