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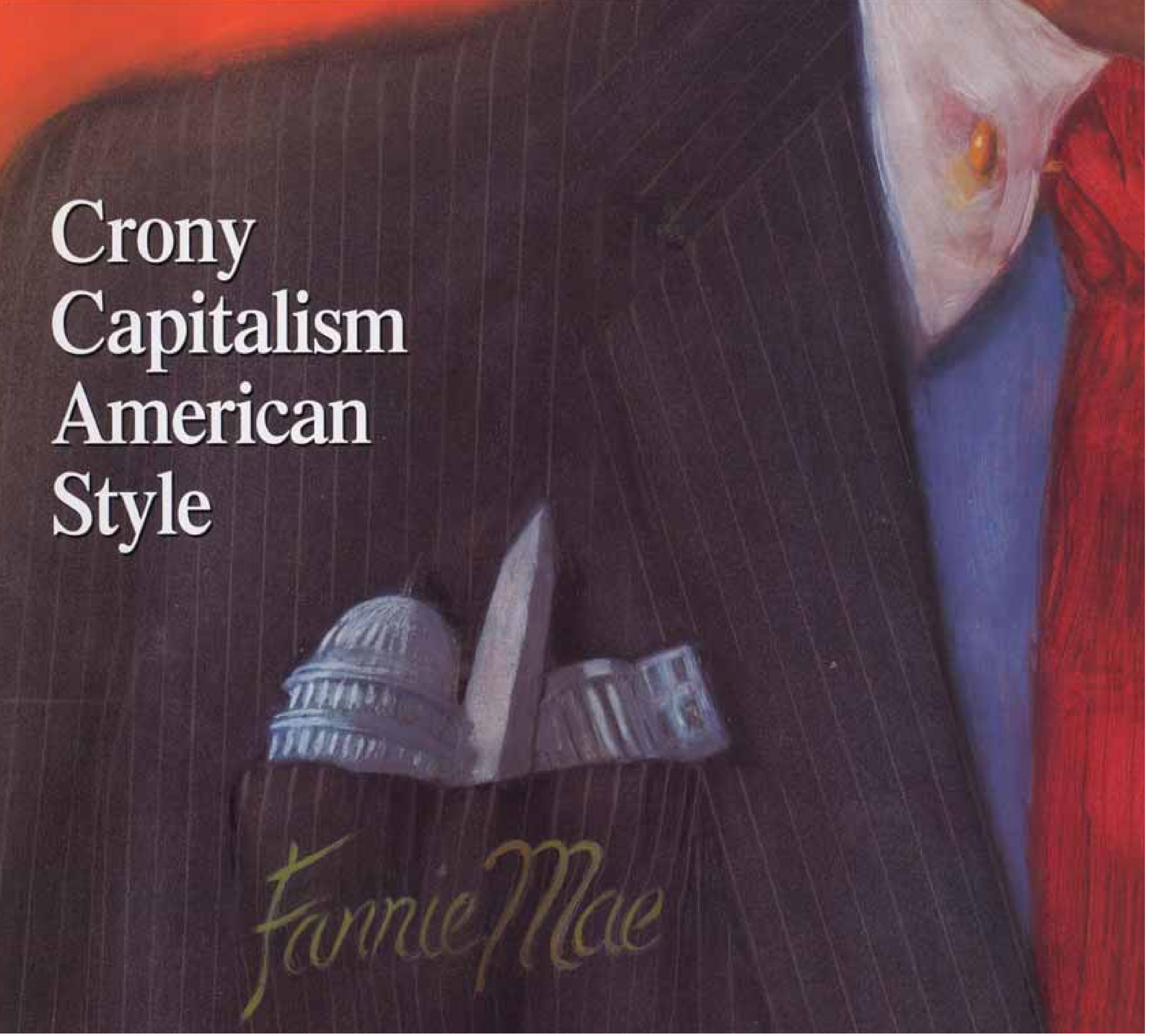
Crony Capitalism American Style



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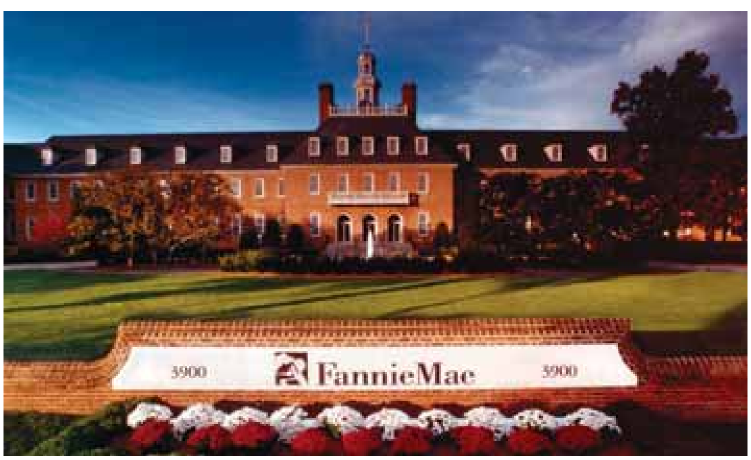
U.S. officials piously lecture the world. But what about Fannie Mae and the other cozy arrangements right under their noses?

Crony Capitalism: American Style

BY OWEN ULLMANN



In the wake of the financial crisis that spread through Asia in 1997 and 1998, Treasury Secretary Robert Rubin and his deputy, Lawrence Summers, pinned the region's problems in part on a pervasive business culture commonly known as "crony capitalism," the cozy relationship between government officials and corporate execs that encouraged bad investment decisions. In a January 1998 speech, Rubin, who resigned this summer, cited "close links between governments, banks and corporations [that] led to fundamentally unsound investments." And in March 1998, Summers, Rubin's successor as secretary, faulted a system that relied on "relationship-driven finance not capital markets." The criticism is right on point.

Yet in Washington, D.C., a form of crony capitalism exists right under Treasury's nose — and with its blessing. It is called a government-sponsored enterprise (GSE), a private corporation that receives special benefits under a charter granted by the federal government. The relationship is worth billions to the GSEs and their shareholders. The rewards have been great, as well, for the executives who run the companies, and government

Owen Ullmann, a former senior writer at Business Week, *covers economic policy and politics for* USA Today.

In a January 1998 speech, Rubin, who resigned this summer, cited "close links between governments, banks and corporations [that] led to fundamentally unsound investments" as reason for the Asian crisis. Yet in Washington, D.C., a form of crony capitalism exists right under Treasury's nose — and with its blessing.

officials in the Executive Branch and Congress who see to it that the taxpayer-borne subsidies keep flowing.

The largest GSE by far is Fannie Mae, formerly called the Federal National Mortgage Association. It is one of the most profitable enterprises on earth. Together with its younger and smaller sibling, Freddie Mac (the Federal Home Loan Mortgage Corporation), Fannie has a lock on the secondary market for conventional mortgages—loans of up to $240,000. Congress created Fannie in 1938 to buy mortgages from lenders in order to recirculate the supply of money for new home loans. But in 1968, Congress turned Fannie Mae into a private, shareholder-owned company with a charter tantamount to a money printing license. Two years later, Freddie came into existence with the same golden charter. The special benefits exempt Fannie from registering with the Securities and Exchange Commission, paying state or local income taxes, or meeting capital requirements imposed on banks and thrifts. Fannie also can draw on a $2.25 billion line of credit from the Treasury Department. But Fannie's biggest advantage comes from an implicit benefit: a belief by the financial markets that the federal government will guarantee payment on any debt or securities issued by a GSE. Though there is no actual federal guarantee, Fannie, nonetheless, can borrow at rates close to those for Treasury Securities. The advantage over private competitors has been estimated by various studies at 25 to 75 basis points.

In 1996, the Treasury Department and the Congressional Budget Office valued the total federal subsidy to Fannie and Freddie at more than $6 billion a year. Two thirds of that is delivered to homeowners in the form of lower mortgages — a savings of about 25 basis points on average. The remaining one-third is divided up by shareholders and the executives who run Fannie and Freddie. "As a means of funneling federal subsidies to home buyers, the GSEs are a spongy conduit — soaking up nearly $1 for every $2 delivered," the CBO report concluded.

As a result, Fannie's bottom line has been nothing short of sensational. Last year, the company earned $3.4 billion, up 14 percent from 1997, and it is continuing that pace this year: In the first quarter, earnings rose 14 percent to $925 million. That's no recent growth spurt. The company boasts that it is one of just seven companies in the Standard & Poor's 500 to have recorded double-digit growth in operating earnings since 1986. Its portfolio of mortgage-backed securities now tops $1 trillion, making it the largest financial company in the United States, and its market valuation is up 50 percent from two years ago to $70 billion. Thoughts of slowing down haven't occurred to Fannie. It is aiming to double earnings per share over the next five years.

Fannie is also one of the most efficient enterprises in the world. Since it doesn't deal directly with consumers,

Fannie Mae Plays Hardball

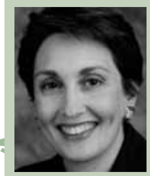
When reason fails, opponents claim, Fannie plays hardball. It will hire key government critics to buy their silence, and it will intimidate lawyers, consultants and financiers who go up against it by pressuring clients of the opponents to withdraw their business. "Fannie has this grandmotherly image," says a congressional source. "But they'll castrate you, decapitate you, tie you up and throw you in the Potomac. They're absolutely ruthless."

— O. Ullmann

Fannie's Connections

Director **Jack Quinn** was Vice President Al Gore's chief of staff

Director **Kenneth Duberstein** was President Reagan's chief of staff



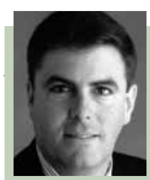
Vice Chair **Jamie Gorelick** was Deputy Attorney General under Clinton

Senior Vice President **Arne Christenson** was a top adviser to House Speaker Newt Gingrich (R-Ga.)

Ellen Seidman, director of the Office of Thrift Supervision, was a FM senior vice president

Commerce Secretary **William Daley** was a FM director

Wendy Sherman, counselor to Secretary of State Madeleine Albright, was President of the FM Foundation



Vice President **Duane Duncan** was staff director for Congressman Richard Baker (R-La.), chairman of the House Banking subcommittee that oversees Fannie and other GSEs

Robert Zoellick, senior adviser to Texas Governor George W. Bush and former top White House, State Department and Treasury official under Presidents Reagan and Bush, was FM's general counsel

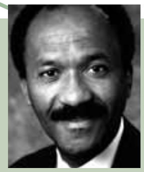
CONNECTION KEY:

- **Government Alumni who are Fannie officials**
- **Fannie Alumni who are government officials or political advisers**
- **Current or past Fannie lobbyists with government ties**

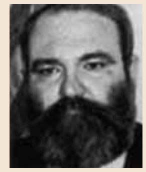
Former Congressman **Tom Downey** (D-N.Y.)

Nicholas Calio, President George Bush's chief legislative lobbyist

James Johnson, Chairman of the Executive Board and former CEO, was a close adviser to Vice President Walter Mondale and managed Mondale's 1984 Presidential campaign



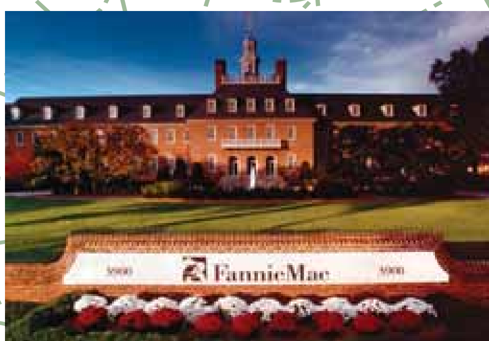
Franklin Raines, current CEO, was director of the Office of Management and Budget under President Bill Clinton

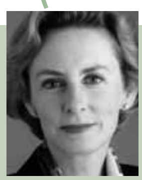


Congressional Budget Office Director **Dan Crippen** (past lobbyist)

Former Congressman **Vin Weber** (R-Minn.)

Former Senator **Steve Symms** (R-Idaho)



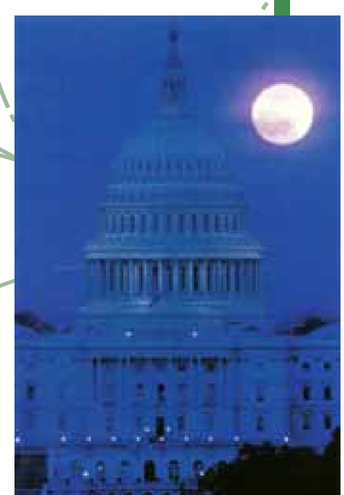


Executive Vice President **Ann Logan** was a policy adviser to Senator Edward Kennedy (D-Mass.) in the 1980s

Senior Vice President **Thomas Nides** was chief of staff to U.S. Trade Representative Mickey Kantor and chief of staff to Speaker Tom Foley (D-Wash.)

Senior Vice President **William Maloni** was a lobbyist for the Federal Reserve in the 1980s

Senior Vice President **John Buckley** was press secretary for Congressman Jack Kemp (R-N.Y.), and communications director for the presidential campaigns of Ronald Reagan in 1984 and Bob Dole in 1996



Courtesy of U.S. Capitol Historical Society.

Director **Eli Segal** was a senior White House adviser to President Clinton

Director **Ann McLaughlin** was Labor Secretary under President Reagan it saves billions on the cost of retail offices that have to be staffed by employees. That means it can turn a profit on a smaller margin. Banks, for example, average a 400 basis-point spread between their borrowing and lending rates, with 100 basis points going toward expenses. But Fannie operates on a 100 basis-point spread, with expenses accounting for only 7 basis points. So with a workforce of less than 4,000, Fannie's net income works out to about $900,000 per employee. There's not a company in the world that comes close to that level of productivity.

So if Fannie is so efficient, the return to shareholders so high and the mortgage costs to the average American homeowner lower than it would otherwise be, what's the problem? Fannie's critics say the financial behemoth is not playing by the usual free-market rules. Its federal charter guarantees that it will make enormous profits on risk-free investments at the expense of wholly private competitors. Fannie should go completely private or become a government agency again so taxpayers could reap all the benefits, argue the opponents. "Crony Capitalism is a good analogy," says American Enterprise Institute Fellow Peter Wallison, a former Treasury Department and White House counsel under President Ronald Reagan. "Investments are being affected by a close relationship between the enterprise and the government, and the money flows back to the government patrons in many forms — political donations, the hiring of government officials, distribution of grants in every congressional district. Everyone is getting paid out of that big trough."

Wallison sees a parallel to the savings and loan industry collapse of a decade ago. In that case, the guarantee of federal deposit insurance fueled speculative investments without the restraints of market risk, and the federal government ultimately got stuck with a staggering $500 billion tab. "It's the same with Fannie and Freddie," says Wallison. "They have very low capital margins (less than 2 percent of assets versus 8 percent for commercial banks), and they've been looking for higher-risk investments to improve their profitability. It's a prescription for financial disaster if interest rates go up. And Congress is ignoring it."

House Banking Committee Chairman James Leach, a Republican from Iowa, agrees that GSEs like Fannie aren't burdened by normal market risks. "The implied government guarantee reduces a key aspect of credit risk and the interest risk can be hedged," he notes. "The principal risk for a GSE is political risk: Will Congress change or charge for the powers granted?"

His answer is a resounding "NO!" — even though Leach personally favors a change in the GSEs' favored status. But most members of Congress will sit on their hands because Fannie is a terror when it comes to lobbying in defense of its benefits.

For one thing, Fannie has a tradition of filling its executive ranks and board of directors with former government officials who have the contacts and influence to preserve the status quo. Former Chairman James Johnson was a close adviser to former Vice President Walter Mondale.

Current Chairman Franklin Raines was budget director under President Bill Clinton. Vice Chair Jamie Gorelick was Clinton's Deputy Attorney General. Senior Vice President John Buckley is a former Republican staffer in Congress who served as a senior official on the Presidential campaigns of Ronald Reagan in 1988 and Bob Dole in 1996, and Senior Vice President Arne Christenson was a top adviser to former House Speaker Newt Gingrich. The directors include former Reagan Labor Secretary Ann McLaughlin, former Reagan chief of staff Kenneth Duberstein, former Clinton White House assistant Eli Segal, and Jack Quinn, Vice President Al Gore's former chief of staff. The pay is great: Johnson collected $9.5 million last year, while Raines will make about half that this year.

Another S&L Type Debacle?

AEI's **Peter Wallison**

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And just in case all those federal connections aren't sufficient, Fannie keeps nearly 20 top-drawer law firms on retainer to help lobby. Buckley, Fannie's chief spokesman, says most of the law firms are needed to handle the 10,000 foreclosures the company initiates each year. He claims Fannie's lobbying expenses total $4 million a year — typical for a company its size.

There's nothing typical about Fannie's lobbying clout, however, for those on the receiving end. Leach says Fannie alone has more influence with Congress than all the private banks in the United States put together. In 1996, Leach merely floated the idea of assessing Fannie a fee equal to the interest-rate discount it gets in the credit markets because of its federal charter. It took just twelve hours for Fannie to blow the idea out of the water. Around the same time, according to government and congressional sources, Fannie officials persuaded Summers to tone down a Treasury Department report that was expected to be critical of the government's sponsorship of Fannie and Freddie. The final report was more balanced and said firm conclusions on whether to end or modify the government charter were "premature."

When reason fails, opponents claim, Fannie plays hardball. It will hire key government critics to buy their silence, and it will intimidate lawyers, consultants and financiers who go up against it by pressuring clients of the opponents to withdraw their business. "Fannie has this grandmotherly image," says a congressional source. "But they'll castrate you, decapitate you, tie you up and throw you in the Potomac. They're absolutely ruthless."

Buckley doesn't deny that Fannie can be aggressive when its self-interest is at stake, even if it means trying to hurt opponents financially. "We're in a tough business," he says. "We're not shy about protecting our turf. But brutish? No." He says what's intimidating about Fannie to members of Congress is not its lobbying tactics, but its spectacular accomplishments. No one denies that Fannie helps shave costs for homebuyers. What's more, it's the largest investor in every congressional district in the country, and its non-profit foundation sprinkles millions more in grants and low-cost housing programs around the country each year. "Every member sees us in action every day," Buckley boasts.

The Treasury Department and the Congressional Budget Office valued the total federal subsidy to Fannie and Freddie at more than $6 billion a year.

Recently, the battle lines have shifted from attempts to rein in Fannie to fears that Fannie and Freddie are trying to fatten their bottom lines by moving into areas beyond their original charter, such as insuring and underwriting original mortgages.

The pay is great: Johnson collected $9.5 million last year, while Raines will make about half that this year.

Fannie officials insist that they plan to improve profits by expanding market share in their core business, and have no designs on the mortgage insurance and lending industries. But the critics don't believe them and are gearing up for a fight in Congress to block any expansion of GSEs.

And what about the merits of the argument that Fannie should try to be a success in the marketplace by competing on an equal footing instead of depending on a government handout. Buckley, a free-market Republican (and nephew of conservative icon William F. Buckley), ducks the issue.

Instead he defends the status quo on purely political terms: "The critics have never been able to prove that consumers won't suffer (by paying higher mortgage rates) if we give up our charter." He's right. But neither can Fannie prove that the current system would keep rates lower. The private secondary market for mortgages has ballooned over the past two decades, and it's quite possible that real competition would result in rates just as low or even lower than Fannie makes possible. But Congress does not have the courage to take the risk to find out.

Ironically, the international financial crisis that was spawned by crony capitalism may turn out to be the ultimate protector of Fannie and its government privileges. During the summer and fall of 1998, when Russia's default caused credit markets to seize up around the globe, Fannie and Freddie were able to raise $300 billion in the international capital markets without paying a single extra basis point as a risk premium. That shut down any talk on Capitol Hill about revoking Fannie's charter.

So Fannie Mae will continue to thrive. It's not fair to the competition, and it's certainly not how the game of American capitalism is normally played. But in Washington, you never argue with success — especially when it's the work of your cronies. ◆