Freedom v. Fairness:

How Unresolved Normative Tension Contributed to the Collapse of the U.S. Housing Market in 2008 -- and Policymaker Inability to Reform It a Decade On

Susan W. Gates

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Susan W. Gates

Virginia Tech

swgates@vt.edu

Abstract:

Rohr (1989) urged public administrators exercising discretion within the realms of public law and regulation to draw on regime values as a necessary bulwark against "low road" rules-based compliance. When norms conflict, as they inevitably do, Rohr cautioned against normative absolutism, elevating instead normative compromise as a legitimate administrative response. Using Rohr's framework, this chapter explores the normative dimensions of the 2008 financial crisis, particularly the interplay between freedom and equality. This tension is evident in the continuing controversy over the role of the government-sponsored enterprises, Fannie Mae and Freddie Mac. Nearly bankrupted by losses on high-risk mortgages, the firms were bailed out by taxpayers in 2008 and remain under government control more than a decade later. Reform efforts would be helped by policymaker recognition of the competing norms that underpin the American dream of homeownership and the possibilities of normative compromise.

Introduction

The second edition of John Rohr's seminal *Ethics for Bureaucrats* made a compelling case for the use of regime values, the values that define a people, to guide public administrators through the gray space of administrative discretion. Although law gives broad policy contour, and detailed regulations follow with the specs, there remains a time and place for ethical reasoning on the part of unelected bureaucrats. *What is the right thing to do*?

For the purpose of ethical training, Rohr distinguished the use of regime values from the "low road" of conflict-of-interest style rule adherence with its "emphasis on meticulous attention to trivial questions." Using USDA "check the box" ethics training as the bête noir, Rohr said rules-based ethics training "runs the risk of developing a dangerous attitude of pharisaism" where bureaucrats strain gnats while swallowing camels (Rohr, 1989, 63).

Rohr also took issue with basing ethical training on the "high road" of social equity, which would add egalitarian concerns to traditional administrative norms of "efficient, economical and coordinated management" (Rohr, 1989, 64). Perhaps dating himself here, Rohr argued that basing the ethical education of "professional bureaucrats" on the equalitarian aspects of Rawlsian-style political theory would be "questionable" (Rohr, 1989, 65).

A more promising and operational approach, he argues, is to use regime values that "can be discovered in the public law of the regime" (Rohr, 1989, 68). By considering the nuanced arguments of Supreme Court cases public administrators not only gain insights into "the values of the American people" (Rohr, 1989, 74) but also are exposed to a disciplined methodology for thinking through ethical quandaries. Because of the bureaucrat's oath to the Constitution, regime values could thus be viewed as normative flashlights they could use when implementing regulations, disbursing funds, meting out enforcement, etc.

Sounds straightforward, but what to do when treasured constitutional norms conflict? Acknowledging the imperfect science of balancing norms and the not-unheard-of occurrence of "dirty hands," Rohr relieves the conscience of the conscientious bureaucrat by saying that "not every moral principle is an absolute principle, that is, a principal that must be followed regardless of circumstances." Like De Tocqueville, Rohr hints that there are normative tradeoffs to be made, particularly between cherished American norms of freedom and equality and that governing does, indeed, involve horse-trading at times. At its best, it's called compromise, which Rohr calls "one of the most important values of any organization [because] it is the catalyst that makes possible the realization of other values" (Rohr, 1989, 10). A timely reminder.

Helping bureaucrats develop a deeper ethical awareness of the regime value of property (in its "redeemed" form) is instructive for regulatory agencies overseeing their shareholder-owned charges. Rather than seek to squelch "corporate greed," Rohr posits that government overseers might do better to "regard the acquisitive spirit" as a "great national resource and to point this mighty engine in directions that are socially useful" (Rohr, 1989, 244). Of course, regulators also need to take an aggressive stance toward the industries they regulate; this kind of muscle

does not come from mere rule-adherence. Rather, deeper ethical reflection about competing norms is necessary to operate well in the discretionary administrative space, particularly where money and power cast a long shadow.

Analysis of the normative tension that contributed to the collapse of the U.S. housing market in 2008 indicates that John Rohr was on to something. As will be explored below, large financial institutions, notably government-sponsored enterprises (GSE) Fannie Mae and Freddie Mac, responded competitively to free market incentives by lowering mortgage underwriting standards, thereby pushing house prices to unsustainable highs. At the same time, regulatory and societal expectations that the firms expand homeownership among traditionally underrepresented groups – requirements which heretofore had tempered GSE animal spirits – became an unwitting partner to the firms' out-sized purchases of higher-risk mortgages in the name of affordable housing. Unnoticed and unchecked, the lethal normative combination crippled the nation's housing markets.

In hindsight, federal regulators should have recognized and sought to assuage the dangerous interplay between the regime values of freedom and equality masquerading, in this instance, as private profiteering and efforts to equalize homeownership rates across groups. Instead, as Rohr predicted, regulators were traveling the low road of rule adherence: straining remedial accounting reports while the GSEs loaded their balance sheets with high-risk mortgage assets in the name of affordable housing. In the fall of 2008, Fannie Mae and Freddie Mac were essentially bankrupted and placed under government control, where they remain at this writing in 2019. Tragically, the homeowners who had been the focus of well-intended social policy were the most hurt by the 30-percent collapse in house prices – and have taken the longest to recover.

Drawing on Rohr's insights into regime values, this chapter seeks to elucidate the normative tension between freedom and equality in U.S. housing markets. It is not a mere philosophical exercise. The central institutions at the heart of the crisis have remained in a 2008 freeze frame for over a decade and, as of this writing, have yet to be structurally reformed. Difficulty triangulating the age-old tension between freedom and equality is at the heart of the policy gridlock then – and now.

The 2008 Financial Crisis

The financial crisis of 2007-2008 stands as a dismally remembered and hotly debated U.S. economic debacle with painful global repercussions. To recap the arc of the disaster: On the heels of a decade that saw a 30 percent rise in national house prices, beginning in 2007 there was a sudden and concomitant house-price collapse that set off a tsunami of mortgage defaults. The problems began in the so-called subprime mortgage market, which was characterized by high-risk mortgages made to high-risk borrowers, such as those who had weak credit scores or other financial anomalies. Many subprime loans were adjustable-rate mortgages (ARM) with very low introductory mortgage rates that increased dramatically after the first two years, otherwise known as exploding ARMs. When the Federal Reserve began increasing interest rates from their post 9/11 lows, the staircase of rate increases made the payments on subprime mortgages too expensive for many borrowers – and they defaulted. As these defaults spread through the broader housing market, house prices began to weaken, which caused more borrowers to go

"underwater" when homes values fell below the level of debt they owed to the bank or other creditor. With zero or negative equity in their homes, many borrowers simply abandoned their properties. Still other defaults were driven by predatory lenders talking unsuspecting borrowers into mortgages they could neither understand nor afford. Taken together, upwards of 10 million Americans lost their homes to foreclosure as a result of the housing bubble and subsequent crash.

The losses were as staggering as they were widespread. The financial pain extended from Main Street to Wall Street and eventually around the world. In 2013, GAO estimated that the housing market collapse had cost Americans $9.1 trillion in home equity and a year's worth of GDP (GAO, 2013, 21). As losses mounted, businesses shuttered, jobs were lost and unemployment skyrocketed. Local governments, which had relied on property taxes, were suddenly strapped, if not bankrupted. The federal government responded with billions in bailouts, unemployment insurance and stimulus packages, but most of the funds went to maintain systemically important institutions, not to individual homeowners. To maintain mortgage market liquidity, the Federal Reserve bought up billions in mortgage assets that remain on its balance sheet a decade on.

As widespread as the economic calamity was, lower-income and minority communities bore the heaviest brunt of foreclosures, and negative secondary effects. These neighborhoods have been the slowest to recover, if they ever will.

Whodunnit?

After a decade of analysis, reflection and debate, and a trove of academic papers on a broad array of variables, there continues to be a clear lack of consensus about the root cause of the crisis. The dominant explanations fall into two opposing camps: unwitting government housing policy caused the dangerous house-price bubble, or unregulated and rapacious Wall Street banks did it.

The official government account – the 2011 Report of the Financial Crisis Inquiry Commission – takes the latter view. The FCIC laid the lion's share of the blame at the feet of the "shadow" banking system driven by Wall Street firms which had turned traditional mortgage finance upside down. Instead of *borrower* demand for mortgages driving the market, Wall Street firms fed *investor* demand for high-risk mortgages. These loans, which at first flunked GSE quality standards, were needed to fill complex financially engineered asset-backed securities that investment firms (think Lehman Brothers, Goldman Sachs and others) pedaled around the world as safe and sound. And profitable due to their higher yields. Aside from castigating individual firms for shameless greed, co-opted credit rating firms and moribund regulators, the broader indictment here is that financial de-regulation started under the Reagan administration had opened the door for the abuses that occurred (FCIC, 2011, xviii).

Not everyone agreed with this diagnosis. In the back of the FCIC report are the dissenting voices from the 10-person commission. Chief among them is Peter Wallison, an economist with the conservative American Enterprise Institute. Wallison's disagreed strongly with the official narrative and turned the blame on the government itself, particularly Fannie Mae and Freddie Mac, gigantic firms with murky government ties that were undergirding the U.S. housing market. Fannie and Freddie were creatures of Congress, created in 1938 and 1970, respectively, with the job of ensuring wide availability of mortgage money by purchasing mortgages from lending

institutions, thereby replenishing funds for homeownership. The GSEs accomplished this by packaging loans into mortgage-backed securities (MBS) for sale to investors. With the GSEs guaranteeing the securities against borrower default, investors viewed the securities as safe and desirable investment instruments. This system of transactional relationships comprises the secondary mortgage market.

Wallison – and other conservatives – argue that the GSEs were goaded into expanding their purchases of higher-risk mortgages by government regulation and the politics of expanding homeownership. Specifically, the GSEs were required to purchase a growing share of mortgages that financed homes for families in lower-income and minority communities. Over two decades, the GSE affordable housing goals had risen from around 32 percent of business to above 50 percent. To meet those increasingly tough regulatory requirements, the firms competed furiously for "goal-rich" mortgages by any means possible: They adversely selected against – or raided – FHA, the government's mortgage insurance program; crafted dubious mortgage rental arrangements with banks; and "paid up" for the desired loans when market conditions did not produce the mortgages needed to fill the regulatory buckets. The low-road rationale was that even if their purchases were unethical and market-distorting, it was preferable than the political fall-out of "missing" a regulatory goal.

More broadly, Wallison and others argue that the existence of two systemically important, lightly regulated and minimally capitalized institutions was a recipe for disaster. Not only did GSE special privileges lead to complaints of "unfair playing field" that stifled competition, there were also graver concerns that the fast-growing balance sheets of the firms could someday cause systemic threats to the economy. Decades of reports by OMB, Treasury and others fretted that due to their unusual structure and privileges – which gave rise to the notion of the entities were "implicitly" backed by the U.S. government – the GSEs would eventually "privatize the profits and socialize the losses" of their activities. Which is essentially what happened.

The housing lobby and progressives have generally sided with the findings of the FCIC report and defended the GSE structure and their affordable housing goals against conservative claims that they were a root cause of the crisis. With increasing perspective on the events of 2008, researchers have ascertained that the high-risk mortgages swept into Wall Street securities defaulted at significantly higher rates than those securitized by the GSEs, indicating that the worst offending loans were not those that counted for GSE housing goals that targeted low- and moderate-income households.

The FCIC report noted that the GSEs had a "deeply flawed business model," and they did. They were publicly traded corporations that enjoyed implicit backing from the U.S. government. Even so, FCIC did not finger the companies as the primary cause of the crisis. While the two firms did participate in the expansion of subprime and other risky mortgages, they were followers, not leaders in this regard; company documents indicate the GSEs entered those markets largely to maintain market share against growing competition from Wall Street firms. As recounted by the Commission:

> "[The GSEs] relaxed their underwriting standards to purchase or guarantee riskier loans and related securities in order to meet stock market analysts' and investors' expectations

> for growth, to regain market share, and to ensure generous compensation for their executives and employees—justifying their activities on the broad and sustained public policy support for homeownership" (FCIC, 2011, xxiv).

The continuing debate about the role the GSEs played in the crisis goes to the heart of the normative tension between freedom and fairness. If they were merely shareholder-owned companies, then pursuing profits and perks should hardly have been surprising. Yet because they were chartered by Congress and given certain statutory purposes, they also had a public mission to make mortgage money widely available so that more people could become homeowners – and not just for a day. The GSEs were also expected to provide stability, which meant that the mortgages those homeowners received could stand the test of time. Unfortunately, way too many did not.

Were the seeds of the financial crisis sown into the founding documents of these two systemically important firms?

Creation Story

In the ashes of the Great Depression, the U.S. government created institutions to restore confidence to the nation's battered mortgage delivery system. Fannie Mae was one of them. Chartered by Congress in 1938, its job was to purchase mortgages originated by private lenders and insured by another government agency – the Federal Housing Administration (FHA), which had been established a few years earlier in 1934. In purchasing FHA-insured mortgages, Fannie Mae replenished lender funds for housing and increased investor confidence; the purchases were financed by bonds issued by FHA. Over the years, Fannie Mae's job grew to include purchasing mortgages guaranteed by the Veterans Administration.

In 1968, legislation converted Fannie Mae to a publicly held company; its growing debt obligations were conveniently moved off budget, but it retained its federal charter and the accompanying privileges. It was also given a green light to purchase mortgages originated by mortgage bankers; unlike the nation's savings and loan (S&L) institutions, mortgage bankers lacked a depository base for originating mortgages and so needed a different source of liquidity.

In 1970, Congress chartered another entity – Freddie Mac – to purchase mortgages originated by the S&Ls. Initially capitalized by the twelve Federal Home Loan Banks (FHLBs), Freddie Mac purchased mortgages alongside Fannie Mae, packaging them all into securities and selling them to investors. Rising interest rates in the late 1970s and early 1980s exerted pressure on the S&Ls, which were squeezed between the low interest rates they were receiving on the long-term fixed-rate mortgages they held on their balance sheets, and the high interest rates they had to offer savers to attract deposits. Caught in the same squeeze, Fannie Mae was essentially insolvent for several years until interest rates eased.

The response of the Reagan Administration was to deregulate the mortgage market to attract private capital and create competition. In 1982, the President's Commission on Housing called for as much, with the assumption that old-school players Fannie Mae and Freddie Mac would lose out to more innovative competitors. It didn't turn out that way, however. The special quasi-governmental status of the firms resulted in an uneven playing field where new entrants could

not compete with the firms that "paid less taxes, could borrow at cheaper rates and were lightly regulated in that they faced low capital requirements for holding similar risks compared to private-sector counterparts" (Acharya, Richardson, Nieuwerburgh, White, 2011, 22.) Instead of being side-lined under deregulation, the GSEs thrived. In 1989, Freddie Mac paid off the FHLBs and became a shareholder-owned corporation traded like Fannie Mae. Both firms retained their original congressional "charters," which resulted in strong growth and profits. The unique charters barred other firms from market entry; they also gave the impression that the GSEs were safer than they really were.

Operating as a protected duopoly with widespread political support, the combined GSE share of the mortgage market grew from 7.1 percent in 1981 to 28.4 percent in 1991 and nearly 45 percent by 2002 (*Ibid*., 20). Along with their charters, GSE activities and innovations, such as standard mortgage documentation and development of new securities, attracted new funds to housing and expanded the investor base for mortgages.

But complaints and worries abounded. Lenders balked at the dominance of the two firms, which were flexing their market muscle and pushing the boundaries of the secondary market. Progressives pounced on their out-sized profits and prodded the firms to expand homeownership to so-called "underserved" households and neighborhoods. Regulations expanded to require the firms to meet tougher affordable housing goals, meet "duty to serve" requirements and contribute funds to magnet funds commensurate with their profits.

Conservatives were increasingly concerned about the growth of the entities. By 2007 the firms were two of the largest and most profitable firms in the country, together supporting a $5.5 trillion mortgage market. Many railed against the increasing political power of the GSEs and the daunting system risk they posed should anything go wrong.

Despite their differences, both conservatives and progressives gave continued allegiance to the American dream of homeownership.

The Collapse

In early September 2008, amid rising mortgage foreclosures and losses on subprime bonds, Fannie Mae and Freddie Mac teetered on the edge of insolvency. Investor confidence had collapsed, and short sellers were dragging company stocks to single digits. To stave off a broader collapse, then-Treasury Secretary Paulson acted expeditiously and placed the pair in government conservatorship. The disgraced outgoing executives signed over control of the firms to their regulator, cum conservator, and acquiesced to a stringent bailout agreement that gave Treasury an 80 percent stake in the companies, thereby wiping out common shareholders.

Over the next few years, as mortgage losses ran through their balance sheets, the firms required close to $200 billion in bailout funds, which came with a hefty 10 percent dividend. In 2012, as the tide of red ink seemed to be ending – and hedge funds eagerly piled into the penny stocks – the government increased the dividend to almost 100 percent of profits. This bold move immediately drew legal action on the part of shareholders who expected the newly profitable firms to be soon released from conservatorship, with bountiful profits to be made. At this writing, the total bailout of $191 billion has been more than repaid; Fannie and Freddie have paid

$267 billion in dividends to the general fund of the Treasury where they are applied to deficit reduction.

Reform Attempts Fail

In the 11 years since the government take-over, Congress has attempted, on numerous occasions to pass GSE reform legislation that would end the conservatorship, but to no avail. Without agreement on the fundamental cause of the crisis, particularly the contributory role of Fannie and Freddie, and with so much money riding on the outcomes and so much at stake if zealous reformers get it wrong, congressional hearings invariably devolve into arguments and make little progress. In the meantime, the Federal Housing Finance Agency, the regulator and conservator of Fannie and Freddie, has made a number of administrative reforms that likely would be included in any broader legislative solution.

Notwithstanding the political inertia, the GSEs once again are the dominant players in the nation's mortgage markets. In 2019, the firms financed nearly one-half of all mortgages. Their dominance is a direct result of being fully backed by the government, which makes it impossible for private firms to compete. Housing and real estate trade groups, builders and bankers are comfortable with the status quo (primarily because of the homeownership subsidy government control affords), but taxpayers should not be. Unlike before the crisis when the firms had retained earnings and a capital cushion, today they have none. Fully 100 percent of GSE risk rides on taxpayer shoulders.

In 2019, the newly confirmed director of FHFA has signaled fresh determination to work with Congress to find a market-based solution that does not eviscerate the GSE's traditional public mission to expand homeownership. Can it be done? How will this bureaucratic agency thread the needle between freedom and equality?

Normative Tension

Very little of the past decade of research into the financial crisis has looked at its normative roots. There is no shortage of books decrying Wall Street excesses in the wake of deregulation (Lewis, 2010), the political power of firms and their weak regulators (McLean, Nocera, 2010) and (Morgenson, Rosner, 2011). A few have looked at the unintended consequences of government intrusion in the housing market (Wallison, 2016). Housing economists have plumbed mortgage default data for clues into underlying causes, while others have considered the weaknesses of predictive models and underestimation of risk.

A former Freddie Mac employee, Gates (2017) wrote an insider account of the GSE role in the crisis with an eye to the normative conflict between freedom and equality and the critical importance of "high-road" ethical reflection. Gates likens the housing's normative conflict to "fault-lines under major cities" which, because they are hidden, "make true recovery elusive and unsustainable." Invariably the "competing philosophies and ideologies" running beneath the debate on housing finance reform pit freedom against fairness, tracking political divides (Gates, 2017, 10).

Normative preference for freedom shows up in debates about government's role in the provision of private goods, like homeownership. The conservative rap on the GSEs was that by allowing them to retain their congressional charters, which gave the firms preferential treatment in the capital markets, the government was enabling private individuals to borrow funds as cheaply as top-rated corporations, which led to an "overinvestment" in housing. To many conservatives, the economic returns to homeownership were not worth it. Former Federal Reserve Chairman Greenspan was particularly emphatic that the nation would be better served if it eliminated subsidies to Fannie Mae and Freddie Mac and invested instead in factories, jobs and other more productive sectors of the economy. Freedom also shows up in the debate about mortgage products. Proponents for consumer choice regularly opposed policies that would restrict access to certain mortgage types that others deemed higher-risk or even dangerous.

On the other hand, preference for fairness and equality were seen in the growing reliance on the GSEs as an off-budget tool to expand housing opportunities, combat discrimination, bring liquidity to central cities, Native American communities, and rural housing, particularly in the form of manufactured housing. Homeownership is a significant emblem of having made it to the middle class, and, for most middle- income families, home equity represents a greater component of retirement savings that stock market investments. Homeownership rates for African Americans and Hispanics significantly trailed rates for Whites and Asians. Greater equality in homeownership rates therefore became a rallying point, and tight GSE underwriting was often viewed as a barrier to accession to the rolls.

Not surprisingly, these external normative tensions led the GSEs to play their political masters off one another. Maximizing either norm could spell disaster for the delicate political balance the firms had carefully cultivated over the years. In the early 1990s, Fannie Mae lobbied hard for the affordable housing goals to be added to the GSE charters; it was more a shrewd move than an altruistic one. By appeasing progressives, GSE housing goals had the perverse effect of strengthening the government ties with the two firms, further "hardening" the lucrative implicit government guarantee.

For its part, in 2002, Freddie Mac talked the Bush Administration in making a commitment to boost homeownership rates among minority homeowners. The policy plank focused on assuaging wealth inequality through increased access to low-cost mortgages, but it was also a Trojan horse. It was a political win to be positively associated with a president whose party sought to privatize the GSEs to reduce systemic risk. Aligning with President Bush to expand minority homeownership thus neutralized privatization (for a time), and GSE stock prices rose in response.

First-Hand Account

Having worked at Freddie Mac during the two decades prior to the government take-over, Gates experienced first-hand the ideological rifts that were embedded in the firm's valuable – but schizophrenic – congressional charter and which would turn business decisions into political standoffs.

> The GSEs and broader housing market comprise a highly complex and interrelated system crisscrossed by very serious political and ideological fault lines. The refusal to acknowledge, at a minimum, or better to seek to reconcile these fault lines spelled the doom of the entire system (Gates, 2017, 23).

What were these lines? Hewing to free-market economics, conservative Republicans regularly called out the firms for trading on their government ties, wrung hands over their thin capital cushions and called them "spongy conduits" for soaking up profits and passing along relatively little to homeowners. Democrats, on the other hand, railed against the firms' eye-popping profits and exceedingly low losses, which suggested to them that the firms were discriminatory by cream-skimming the market and not adequately serving more challenging borrowers. "How to please a powerful Representative who wanted the firm to invest in higher-risk apartment buildings? Or a Senator who wanted Freddie Mac to hold more capital?" To choose a path forward, the companies struggled to reconcile competing regime values, which were embedded in sharp political realities, with the temptation of alluring profits to be made in the subprime market.

> These rifts were keenly felt at Freddie Mac. Nearly every major business decision required managing competing politics and players, reconciling jarring differences in public policies and bridging deep ideological divides between supporter and naysayer, friend and foe. In the years leading up to the crisis, managing the company was a constant game of three-dimensional chess (Gates, 2017, 23).

Gates recalled tensions within the employee base between the "housers," those deeply committed to the company's housing mission, and the "Wall Street types," whose entire job was to buy and sell securities for the sole purpose of making money – on which their handsome commissions depended. Concerns about fairness, predatory lending and the dangers of portfolio growth were not easily raised on the trading room floor. Gates recalled bringing "peer mediators" to meetings to help manage the tension.

> The fact that our friendly discussions became heated debates is revealing. Almost parallel to the political debates exploding around us, some employees thought Freddie's primary job was about expanding homeownership, while others thought it was to make the secondary mortgage market more efficient. Yet others said our fundamental purpose was to "maximize shareholder value (subject to not losing the charter)."
>
> That rankled some of us, but here was their point: By maximizing profits, they claimed, we would be the most efficient by definition, and that would be the best way to support homeownership. It was classic business theory for a shareholder-owned company. But we had a problem: Freddie was a GSE. Maximizing profits might have been what the traders thought about every day, but it was not the mission politicians expected us to fulfill (Gates, 2017, 165).

Freddie Mac's 2003 accounting scandal, in which the firm understated earnings by $5 billion, resulted in "one of the largest restatements in corporate history." In addition to imposing a fine of $125 million, the regulator required the company to develop a plan to change its corporate

culture from being so focused on earnings, profits…and employee bonuses…and to be more focused on mission. It was a hard assignment. How could a shareholder-owned company not think or behave like one?

GSE leaders operated at the fateful intersection of freedom and equality. "Their inability to manage this great schism, to bridge this enormous ideological fault line, contributed to the undoing of both firms. Politicians also could have played their cards differently; certain political appeasements would have helped the companies steer clear of the more dangerous shoals. The GSEs needed Congress to provide bi-partisan support for the GSE housing mission, while upholding traditional strong underwriting standards. Instead of taking a balanced approach, the political parties moved to the edges like two boats widening. The GSEs tried unsuccessfully to straddle both norms. The divided Congress became the GSE divide, and management struggled to balance these two important (and sometimes competing) objectives" (Gates, 2017, 27.)

Threading the Needle

To deal with the tension, GSE managers became good at satisficing norms by "threading the needle." The decision to enter the subprime market in the years before the crisis was a way to gain back market share while meeting the company's understood mission to expand homeownership to underserved households. At the time, company leaders rationalized that by participating in the subprime mortgage market, Freddie Mac could bring its efficiencies and high standards to "the wild west" of the mortgage market, which was serving (or taking advantage of), borrowers in low-income communities. A classic case of "doing well while doing good." Except that it didn't turn out that way.

The tension over subprime pitted David Andrukonis, the company's chief credit officer, responsible for ensuring the firm invested in quality instruments, and new CEO, Dick Syron. In a damning internal memo that appeared later on congressional oversight websites, Andrukonis urged Syron to exit the high-risk market, saying, "What better way to highlight our sense of mission than to walk away from profitable business because it hurts the borrowers we are trying to serve" (Gates, 2017, 181).

Where were the regulators while all this gamesmanship was going on? They too seemed oblivious to the normative tension that the firms were able to exploit. Believing in the power of market discipline and that firms would act in their own self-interest, former Federal Reserve chair, Alan Greenspan, spurned calls to use Fed regulatory authority dating from 1994 to govern subprime mortgages and protect consumers.

GSE regulatory oversight was similarly bifurcated along normative lines. The housing goals were under the purview of HUD, while the safety and soundness of the firm was managed separately by independent regulator, the Office of Federal Housing Oversight (OFHEO). This unfortunate structure aggravated the normative tension. When the GSEs protested against unrealistically high (and risky) affordable housing goals, they could not appeal to the prudence of the safety and soundness regulator.

As the GSEs proved to be difficult and wily charges, OFHEO sought additional legislative authority while failing to use the authority it already had to oversee and limit the types of mortgages the companies were purchasing. Reproving the company after its 2003 accounting scandal became so central to OFHEO's oversight that it blinded the regulator from grosser sins. From the perspective of Freddie Mac employees, OFHEO was still checking compliance reports dating back to the 2003 scandal when the company gorged itself on high-risk mortgages without the ability – or capital – to manage the added risks.

In the summer of 2008, Congress enacted comprehensive reform legislation that finally unified the GSE regulator (thereby dismantling OFHEO and replacing it with the Federal Housing Finance Administration), enabling a unified approach to balancing mission and risk. Unfortunately, the reforms came too late. The GSEs were placed into conservatorship just two months after passage of that landmark legislation. For over a decade, both firms had funded lobbying efforts to block enactment of legislation that would unduly curb their business interests.

Challenges Going Forward

Important policy ramifications flow from the different explanations of what/who/why caused the financial crisis. Democrats, for their part, tend to draw a direct line from the deregulation that began under President Reagan to the Wall Street firms that pushed bad mortgages to unsuspecting borrowers and sold complex mortgage related instruments to unsuspecting global investors. Their policy prescription, it follows, is a clamp-down on banks in terms of greater oversight and accountability, enhanced investment disclosures and the institution of consumer protections, including greater legal recourse. In short, more regulation.

Many of these changes are well underway. In 2010, Congress passed the Dodd-Frank Wall Street and Consumer Protection Act (DFA), the most mammoth reconstruction of the U.S. financial services system since the Great Depression. The hundreds of regulations spawned by the watershed legislation took years to develop, promulgate and implement. Some have not yet gone into effect. At this juncture, the full impact on mortgage lending of these complex and interactive regulations is still unknown.

On the other side of the aisle, Republicans generally despise the DFA as over-reach, and have taken initial steps to rescind part of it. They tend to agree with Wallison that government intrusion into the housing market distorted market incentives, creating a government-sanctioned erosion of underwriting standards and subsequent house-price bubble and collapse.

Given these largely irreconcilable viewpoints, it is no wonder that congressional hearings designed to sift through difficult and complex restructuring choices invariably end up in a shouting match, where Republicans blame Democrats and Democrats blame Republicans for their role in the crisis. It has become a national sport to blame the GSEs.

For Gates, truth is somewhere in between these two views.

> Government indicia and intervention (at times well intended and at times not) did complicate, incent and reward some of the worst behavior on the part of the GSEs. But it is equally true that had fly-by-night brokers been regulated and Wall Street firms been prevented from jumping headlong into the riskiest mortgages, Freddie Mac, at least,

> would have been far less inclined to abandon tried and true mortgage underwriting standards in the name of market share. Hence, both sides of the aisle have something important to contribute to our understanding of how things got so badly out of control—and how to see our way forward (Gates, 2017, 22).

Normative Separation – or Compromise?

A first pass at the question of reform might suggest that freedom and equality need to be separately pursued – given that their interplay, according to this thesis, wreaked havoc on U.S. housing markets and homeowners. Under this view, the GSEs should be completely privatized; their government ties would be severed such that if they failed to manage their businesses profitably in the future, their shareholders – and not taxpayers – would be the ones to suffer. The corollary to this bi-furcated approach would be that government agencies – not shareholder-owned companies – should be the ones to implement pro-social housing policies that could entail social costs. By keeping freedom and equality at arms' length, the argument goes, mortgage markets would be safer and more transparent, with targeted benefits placed on-budget for all to see. However, the separation would come at a price: mortgage rates would be noticeably higher and there could be shortages of mortgage capital as investors adjust to a world without government backing.

Conservatives tend to support this clear-cut distinction. But is it realistic? Now that the government has shown its willingness to "save" housing, will it not do it again? Representing a large share of GDP, housing itself is "too big to fail," not just the entities that make the mortgages available. Under this view, policymakers should not be so naïve to think that investors won't be fooled by a governmental statement that the privatized firms will not be bailed out again. "Merely stating that the companies are private and will not be rescued again is not credible if there are only two of them, because the government will not allow the resulting disruption to the housing market if they fail," (Gates, Swagel, Schnare, 2017).

By the same token, progressives tend to look askance at the moral hazard raised by two firms operating with a government guarantee without the discipline of market competition. Amnesia also has set in. The recovery of the housing market and today's seemingly "safe" mortgage delivery system is turning policy attention away from free markets back to equality. Once again, presidential hopefuls are focused on policies to address the inequality of homeownership rates (Riley, 2019). Equality-focused reform seeks to create opportunity by providing subsidies and liberalizing underwriting standards. However, to become a homeowner only to lose one's equity or home when house prices collapse hits vulnerable borrowers the hardest, as we have sadly seen.

Maxing out on either freedom or equality is politically unstable, if not dangerous. Something less ideologically pure is needed to resolve the normative puzzle that has engulfed housing for over a decade. Rohr's wizened insight that "not every moral principle is an absolute principle" suggests that freedom and equality must find a way to co-exist, that some sort of pragmatic approach is urgently needed.

Conclusion: Normative Accommodation

By considering examples of normative tension running beneath the nation's mortgage market prior to 2008 it is possible to discern the dangers of ideological gridlock. Both freedom and fairness are deeply held American values. Rather than play one against the other, it ought to be possible to construct a housing finance system that incorporates both. There is a place, even within the hyper-charged politics of housing finance, for compromise. In fact, Rohr goes so far to say that when practiced earnestly, compromise becomes its own regime value. It also has a catalytic quality, breaking the logjam and making "possible the realization of other values." In this case, compromise would pave the way for a stronger housing finance system.

What might a compromise look like for GSE reform that honors both regime values of freedom and equality? Is there a "golden mean?"

Despite a decade of stand-off in Congress, there are hints that policymakers are finding a bipartisan way forward. First, there is growing realization, albeit reluctantly among progressives, that the quasi-government structure of the GSEs led to market misperceptions about the risks they posed. This has led to greater openness to allowing more market competition; the unique nature of the two firms created a privileged space where other firms could not enter or compete. Allowing more players to compete also spreads the risk that any one of them might fail, reducing taxpayer exposure.

Second, there appears to be grudging acceptance among conservatives that because of the size and importance of housing to the US economy, privatization is unrealistic; given the GSE bailout in 2008, investors will not believe that the U.S. government would let housing fail in the future. A second-best solution would be to provide a limited government guarantee on mortgage securities – not on the firms issuing them – to keep mortgage money flowing and to ensure the continued availability of the popular 30-year fixed rate mortgage. Fannie Mae, Freddie Mac and other securitizing firms would pay a fee for having a government guarantee on their bonds, which would be passed along to homeowners. Although higher costs could dampen enthusiasm for homeownership, the system would provide truer reflection of the costs and risks of a homeownership society.

These are simply broad contours of how a new housing finance system might evolve. The key point is that whatever reform scheme is ultimately adopted, it will not be normatively pure. Housing will always be messy and involve normative compromise. Hopefully we're wiser to the mischievous bed-fellows freedom and equality can become – especially when lots of money and political power is at stake. Going forward, mindful oversight and strong enforcement is needed to prevent the dangerous entanglement of these norms, despite the tempting political elixir they represent. If policymakers can keep their eye on the normative concessions that need to be made, progress is possible. A housing finance system that is both resilient and broadly accessible is solidly in the national interest. As such, it deserves strong bipartisan support.

Susan W. Gates

A former Presidential Management Intern, Susan Wharton Gates served for five years as a budget examiner at the Executive Office of the President, Office and Management and Budget. In 1990, she joined Freddie Mac as an economist. Over the course of a 19-year career, she worked in financial research, mortgage credit risk and government relations. In 2004 she became vice president of public policy.

Since leaving Freddie Mac in 2009, Susan founded Wharton Policy Group, LLC, which provides policy analysis with an eye to developing consensus solutions. She is the author of *Days of Slaughter: Inside the Fall of Freddie Mac and Why It Could Happen Again* (Johns Hopkins University Press, 2017), an insider account of how ideology and public policy contributed to the financial crisis.

Susan teaches normative theory, public administration and business ethics for Virginia Tech's Center for Public Administration and Policy and the Pamplin School of Business. She is also a capstone advisor for Georgetown University's Masters in real estate program.

Susan received a Bachelors of Arts at the University of Delaware, a Masters in public and international affairs from the University of Pittsburgh and a PhD in public administration from Virginia Tech. In 2007, she completed the Advanced Management Program at the University of Pennsylvania's Wharton School of Business.

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