Pressured to Take More Risk, Fannie Hit a Tipping Point

By CHARLES DUHIGG

"Almost no one expected what was coming. It's not fair to blame us for not predicting the unthinkable."— Daniel H. Mudd, former chief executive, Fannie Mae

When the mortgage giant Fannie Mae recruited Daniel H. Mudd, he told a friend he wanted to work for an altruistic business. Already a decorated marine and a successful executive, he wanted to be a role model to his four children — just as his father, the television journalist Roger Mudd, had been to him.

Fannie, a government-sponsored company, had long helped Americans get cheaper home loans by serving as a powerful middleman, buying mortgages from lenders and banks and then holding or reselling them to Wall Street investors. This allowed banks to make even more loans — expanding the pool of homeowners and permitting Fannie to ring up handsome profits along the way.

But by the time Mr. Mudd became Fannie's chief executive in 2004, his company was under siege. Competitors were snatching lucrative parts of its business. Congress was demanding that Mr. Mudd help steer more loans to low-income borrowers. Lenders were threatening to sell directly to Wall Street unless Fannie bought a bigger chunk of their riskiest loans.

So Mr. Mudd made a fateful choice. Disregarding warnings from his managers that lenders were making too many loans that would never be repaid, he steered Fannie into more treacherous corners of the mortgage market, according to executives.

For a time, that decision proved profitable. In the end, it nearly destroyed the company and threatened to drag down the housing market and the economy.

Dozens of interviews, most from people who requested anonymity to avoid legal repercussions, offer an inside account of the critical juncture when Fannie Mae's new chief executive, under pressure from Wall Street firms, Congress and company shareholders, took additional risks that pushed his company, and, in turn, a large part of the nation's financial health, to the brink.

Between 2005 and 2008, Fannie purchased or guaranteed at least $270 billion in loans to risky borrowers — more than three times as much as in all its earlier years combined, according to company filings and industry data.

"We didn't really know what we were buying," said Marc Gott, a former director in Fannie's loan servicing department. "This system was designed for plain vanilla loans, and we were trying to push chocolate sundaes through the gears."

Last month, the White House was forced to orchestrate a $200 billion rescue of Fannie and its corporate cousin, Freddie Mac. On Sept. 26, the companies disclosed that federal prosecutors and the Securities and Exchange Commission were investigating potential accounting and governance problems.

Mr. Mudd said in an interview that he responded as best he could given the company's challenges, and worked to balance risks prudently.

"Fannie Mae faced the danger that the market would pass us by," he said. "We were afraid that lenders would be selling products we weren't buying and Congress would feel like we weren't fulfilling our mission. The market was changing, and it's our job to buy loans, so we had to change as well."

Dealing With Risk

When Mr. Mudd arrived at Fannie eight years ago, it was beginning a dramatic expansion that, at its peak, had it buying 40 percent of all domestic mortgages.

Just two decades earlier, Fannie had been on the brink of bankruptcy. But chief executives like Franklin D. Raines and the chief financial officer J. Timothy Howard built it into a financial juggernaut by aiming at new markets.

Fannie never actually made loans. It was essentially a mortgage insurance company, buying mortgages, keeping some but reselling most to investors and, for a fee, promising to pay off a loan if the borrower defaulted. The only real danger was that the company might guarantee questionable mortgages and lose out when large numbers of borrowers walked away from their obligations.

So Fannie constructed a vast network of computer programs and mathematical formulas that analyzed its millions of daily transactions and ranked borrowers according to their risk.

Those computer programs seemingly turned Fannie into a divining rod, capable of separating pools of similar-seeming borrowers into safe and risky bets. The riskier the loan, the more Fannie charged to handle it. In theory, those high fees would offset any losses.

With that self-assurance, the company announced in 2000 that it would buy $2 trillion in loans from low-income, minority and risky borrowers by 2010.

All this helped supercharge Fannie's stock price and rewarded top executives with tens of millions of dollars. Mr. Raines received about $90 million between 1998 and 2004, while Mr. Howard was paid about $30.8 million, according to regulators. Mr. Mudd collected more than $10 million in his first four years at Fannie.

Whenever competitors asked Congress to rein in the company, lawmakers were besieged with letters and phone calls from angry constituents, some orchestrated by Fannie itself. One automated phone call warned voters: "Your congressman is trying to make mortgages more expensive. Ask him why he opposes the American dream of home ownership."

The ripple effect of Fannie's plunge into riskier lending was profound. Fannie's stamp of approval made shunned borrowers and complex loans more acceptable to other lenders, particularly small and less sophisticated banks.

Between 2001 and 2004, the overall subprime mortgage market — loans to the riskiest borrowers — grew from $160 billion to $540 billion, according to Inside Mortgage Finance, a trade publication. Communities were inundated with billboards and fliers from subprime companies offering to help almost anyone buy a home.

Within a few years of Mr. Mudd's arrival, Fannie was the most powerful mortgage company on earth.

Then it began to crumble.

Regulators, spurred by the revelation of a wide-ranging accounting fraud at Freddie, began scrutinizing Fannie's books. In 2004 they accused Fannie of fraudulently concealing expenses to make its profits look bigger.

Mr. Howard and Mr. Raines resigned. Mr. Mudd was quickly promoted to the top spot.

But the company he inherited was becoming a shadow of its former self.

'You Need Us'

Shortly after he became chief executive, Mr. Mudd traveled to the California offices of Angelo R. Mozilo, the head of Countrywide Financial, then the nation's largest mortgage lender. Fannie had a longstanding and lucrative relationship with Countrywide, which sold more loans to Fannie than anyone else.

But at that meeting, Mr. Mozilo, a butcher's son who had almost single-handedly built Countrywide into a financial powerhouse, threatened to upend their partnership unless Fannie started buying Countrywide's riskier loans.

Mr. Mozilo, who did not return telephone calls seeking comment, told Mr. Mudd that Countrywide had other options. For example, Wall Street had recently jumped into the market for risky mortgages. Firms like Bear Stearns, Lehman Brothersand Goldman Sachs had started bundling home loans and selling them to investors — bypassing Fannie and dealing with Countrywide directly.

"You're becoming irrelevant," Mr. Mozilo told Mr. Mudd, according to two people with knowledge of the meeting who requested anonymity because the talks were confidential. In the previous year, Fannie had already lost 56 percent of its loan-reselling business to Wall Street and other competitors.

“You need us more than we need you,” Mr. Mozilo said, “and if you don’t take these loans, you’ll find you can lose much more.”

Then Mr. Mozilo offered everyone a breath mint.

Investors were also pressuring Mr. Mudd to take greater risks.

On one occasion, a hedge fund manager telephoned a senior Fannie executive to complain that the company was not taking enough gambles in chasing profits.

“Are you stupid or blind?” the investor roared, according to someone who heard the call, but requested anonymity. “Your job is to make me money!”

Capitol Hill bore down on Mr. Mudd as well. The same year he took the top position, regulators sharply increased Fannie’s affordable-housing goals. Democratic lawmakers demanded that the company buy more loans that had been made to low-income and minority homebuyers.

“When homes are doubling in price in every six years and incomes are increasing by a mere one percent per year, Fannie’s mission is of paramount importance,” Senator Jack Reed, a Rhode Island Democrat, lectured Mr. Mudd at a Congressional hearing in 2006. “In fact, Fannie and Freddie can do more, a lot more.”

But Fannie’s computer systems could not fully analyze many of the risky loans that customers, investors and lawmakers wanted Mr. Mudd to buy. Many of them — like balloon-rate mortgages or mortgages that did not require paperwork — were so new that dangerous bets could not be identified, according to company executives.

Even so, Fannie began buying huge numbers of riskier loans.

In one meeting, according to two people present, Mr. Mudd told employees to “get aggressive on risk-taking, or get out of the company.”

In the interview, Mr. Mudd said he did not recall that conversation and that he always stressed taking only prudent risks.

Employees, however, say they got a different message.

“Everybody understood that we were now buying loans that we would have previously rejected, and that the models were telling us that we were charging way too little,” said a former senior Fannie executive. “But our mandate was to stay relevant and to serve low-income borrowers. So that’s what we did.”

Between 2005 and 2007, the company’s acquisitions of mortgages with down payments of less than 10 percent almost tripled. As the market for risky loans soared to $1 trillion, Fannie expanded in white-hot real estate areas like California and Florida.

For two years, Mr. Mudd operated without a permanent chief risk officer to guard against unhealthy hazards. When Enrico Dallavecchia was hired for that position in 2006, he told Mr. Mudd that the company should be charging more to handle risky loans.

In the following months to come, Mr. Dallavecchia warned that some markets were becoming overheated and argued that a housing bubble had formed, according to a person with knowledge of the conversations. But many of the warnings were rebuffed.

Mr. Mudd told Mr. Dallavecchia that the market, shareholders and Congress all thought the companies should be taking more risks, not fewer, according to a person who observed the conversation. “Who am I supposed to fight with first?” Mr. Mudd asked.

In the interview, Mr. Mudd said he never made those comments. Mr. Dallavecchia was among those whom Mr. Mudd forced out of the company during a reorganization in August.

Mr. Mudd added that it was almost impossible during most of his tenure to see trouble on the horizon, because Fannie interacts with lenders rather than borrowers, which creates a delay in recognizing market conditions.

He said Fannie sought to balance market demands prudently against internal standards, that executives always sought to avoid unwise risks, and that Fannie bought far fewer troublesome loans than many other financial institutions. Mr. Mudd said he heeded many warnings from his executives and that Fannie refused to buy many risky loans, regardless of outside pressures .

“You’re dealing with massive amounts of information that flow in over months,” he said. “You almost never have an ‘Oh, my God’ moment. Even now, most of the loans we bought are doing fine.”

But, of course, that moment of truth did arrive. In the middle of last year it became clear that millions of borrowers would stop paying their mortgages. For Fannie, this raised the terrifying prospect of paying billions of dollars to honor its guarantees.

Sustained by Government

Had Fannie been a private entity, its comeuppance might have happened a year ago. But the White House, Wall Street and Capitol Hill were more concerned about the trillions of dollars in other loans that were poisoning financial institutions and banks.

Lawmakers, particularly Democrats, leaned on Fannie and Freddie to buy and hold those troubled debts, hoping that removing them from the system would help the economy recover. The companies, eager to regain market share and buy what they thought were undervalued loans, rushed to comply.

The White House also pitched in. James B. Lockhart, the chief regulator of Fannie and Freddie, adjusted the companies' lending standards so they could purchase as much as $40 billion in new subprime loans. Some in Congress praised the move.

"I'm not worried about Fannie and Freddie's health, I'm worried that they won't do enough to help out the economy," the chairman of the House Financial Services Committee, Barney Frank, Democrat of Massachusetts, said at the time. "That's why I've supported them all these years — so that they can help at a time like this."

But earlier this year, Treasury Secretary Henry M. Paulson Jr. grew concerned about Fannie's and Freddie's stability. He sent a deputy, Robert K. Steel, a former colleague from his time at Goldman Sachs, to speak with Mr. Mudd and his counterpart at Freddie.

Mr. Steel's orders, according to several people, were to get commitments from the companies to raise more money as a cushion against all the new loans. But when he met with the firms, Mr. Steel made few demands and seemed unfamiliar with Fannie's and Freddie's operations, according to someone who attended the discussions.

Rather than getting firm commitments, Mr. Steel struck handshake deals without deadlines.

That misstep would become obvious over the coming months. Although Fannie raised $7.4 billion, Freddie never raised any additional money.

Mr. Steel, who left the Treasury Department over the summer to head Wachoviabank, disputed that he had failed in his handling of the companies, and said he was proud of his work .

As the housing crisis worsened, Fannie and Freddie announced larger losses, and shares continued falling.

In July, Mr. Paulson asked Congress for authority to take over Fannie and Freddie, though he said he hoped never to use it. "If you've got a bazooka and people know you've got it, you may not have to take it out," he told Congress.

Mr. Mudd called Treasury weekly. He offered to resign, to replace his board, to sell stock, and to raise debt. "We'll sign in blood anything you want," he told a Treasury official, according to someone with knowledge of the conversations.

But, according to that person, Mr. Mudd told Treasury that those options would work only if government officials publicly clarified whether they intended to take over Fannie. Otherwise, potential investors would refuse to buy the stock for fear of being wiped out.

“There were other options on the table short of a takeover,” Mr. Mudd said. But as long as Treasury refused to disclose its goals, it was impossible for the company to act, according to people close to Fannie.

Then, last month, Mr. Mudd was instructed to report to Mr. Lockhart’s office. Mr. Paulson told Mr. Mudd that he could either agree to a takeover or have one forced upon him.

“This is the right thing to do for the economy,” Mr. Paulson said, according to two people with knowledge of the talks. “We can’t take any more risks.”

Freddie was given the same message. Less than 48 hours later, Mr. Lockhart and Mr. Paulson ended Fannie and Freddie’s independence, with up to $200 billion in taxpayer money to replenish the companies’ coffers.

The move failed to stanch a spreading panic in the financial world. In fact, some analysts say, the takeover accelerated the hysteria by signaling that no company, no matter how large, was strong enough to withstand the losses stemming from troubled loans.

Within weeks, Lehman Brothers was forced to declare bankruptcy, Merrill Lynchwas pushed into the arms of Bank of America, and the government stepped in to bail out the insurance giant the American International Group.

Today, Mr. Paulson is scrambling to carry out a $700 billion plan to bail out the financial sector, while Mr. Lockhart effectively runs Fannie and Freddie.

Mr. Raines and Mr. Howard, who kept most of their millions, are living well. Mr. Raines has improved his golf game. Mr. Howard divides his time between large homes outside Washington and Cancun, Mexico, where his staff is learning how to cook American meals.

But Mr. Mudd, who lost millions of dollars as the company’s stock declined and had his severance revoked after the company was seized, often travels to New York for job interviews. He recalled that one of his sons recently asked him why he had been fired.

“Sometimes things don’t work out, no matter how hard you try,” he replied.