

Fannie Mae: Good to Great to Garbage

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No, this is not going to be about my 401(k), even though this title is not too bad as a summary of its recent history.

This is inspired by Jim Collins's best-selling book, *Good to Great*. I have been and still am a big fan of pretty much everything Collins has written. *Built to Last*, co-authored with his then-colleague at Stanford Business School Jerry Porras, was my favorite business book in the decade of the 90s. I still think it has profound truths to teach about building solid organizations. "Lasting" or "enduring" is not always the highest virtue of a business; and it not a particular failure if some company is "built to flip" or "built to be acquired" or "built to serve a purpose for a particular market, time, or place."

Critics of Collins and Porras have said that "you can't manage looking in the rear view mirror" (I heard Phil Condit say that a couple years before his inglorious end as CEO of Boeing). Of course only a fool would spend all their time looking in a rear view mirror or attempting to reproduce exactly some previous era or strategy. Nobody ever seriously recommended that. Another famous wise saying is "those who cannot remember the past are condemned to repeat it" (George Santayana, 1905). Far from spending too much time looking back, many of our contemporaries don't spend any time looking at the lessons of either the recent or distant past. And that is a serious weakness in our culture of twitter and blather.

Still, the fact is that some of the star companies in *Built to Last* didn't last. And now some of the star companies of *Good to Great* are not so great. Circuit City is dead, not great. And Fannie Mae, far from great, is a truly pathetic and shameful failure that has inflicted pain on millions. No need to last forever, but it is disturbing when a presumably great company becomes toxic and inflicts suffering and devastation on the innocent. What happened?

Fannie Mae Grows Up: 1938-1999

Fannie Mae was born in 1938 in the depths of the Great Depression with a mission to purchase and securitize mortgages to ensure that funds are consistently available to the institutions that loan money to home buyers, especially low income families. In 1968 the government converted Fannie Mae into a private shareholder-owned corporation to get it off the balance sheet of the federal government.

Good to Great's rosy view of Fannie Mae is based on its performance from 1984 to 2000 when, Collins reports, "\$1 invested in Fannie Mae multiplied sixty-four times, beating the general market --- including the wildly inflated NASDAQ of the late 1990s --- by nearly six times" (*Good to Great*, pp. 172-73). Fannie was led by CEOs David Maxwell (1981-91) and James Johnson (1991-98) during this growth period. Maxwell, one of Collin's beloved "Level Five" leaders, took over Fannie in 1981 when it was losing \$1 million every day, and nine years later retired when it was making \$4 million per day and beating the stock market 3.8 to 1. Maxwell's retirement package had grown to \$20 million over his decade of service but when controversy erupted in congress over the size of that award, not wanting to jeopardize public support for the company and its mission, he declined the final remaining balance of \$5.5 million and asked that it all be contributed to the Fannie Mae foundation for low-income housing (*GTG*, p. 25). Amazing guy. And remember that profits and earnings were flying high at the time. This was no case of gouging the rank and file or the tax-paying electorate in a time of economic failure and scandal. Collins praises Maxwell's successor Johnson as an equally capable and effective leader.

The secret to Fannie Mae's rise from good to great, in Collins's view, is that the leadership got the company to believe that "(1) they could be a full capital markets player as good as any on Wall Street and (2) that it could develop a unique capability to assess risk in mortgage-related securities" (*GTG*, p. 101). Fannie was not obsessed about growth *per se* but rather "it built a powerful economic machine by reframing its business model on risk management, rather than mortgage selling. And it drove the

machine with great passion, the Fannie Mae people inspired by its vital role in democratizing home ownership” (GTG, p. 112). “They were terrifically motivated by the whole idea of helping people of all classes, backgrounds, and races realize the American dream of owning their home.” A Fannie executive is quoted, “Whenever I drive through difficult neighborhoods that are coming back because more families own their homes, I return to work reenergized” (GTG, p. 110). Fannie Mae’s achievement was that a “smarter system of risk analysis increases access to home mortgages for lower-income groups, linking to passion for democratizing home ownership” (GTG, p. 150).

Fannie Falls: 1999-2009

In 1999 the Clinton administration pressured Fannie Mae to expand mortgage loans to low and moderate income borrowers. The *New York Times* reported prophetically (30 Sept 1999) that “Fannie Mae is taking on significantly more risk, which may not pose any difficulties during flush economic times. But the government-subsidized corporation may run into trouble in an economic downturn, prompting a government rescue similar to that of the savings and loan industry in the 1980s.”

In September of 2003 the Bush administration recommended a full scale regulatory overhaul in the housing finance industry, recognizing that the oversight of Fannie Mae and Freddie Mac was broken. Both risk management and capital reserve requirements were inadequate. Rep. Barney Frank, the ranking Democrat on the Financial Services Committee opposed these regulatory initiatives: “These two entities,” Frank said, “Fannie Mae and Freddie Mac, are not facing any kind of financial crisis. The more people exaggerate these problems, the more pressure there is on these companies, the less we will see in terms of affordable housing” (*NYTimes*, Sept 30, 2003). The fact that Frank had been in a romantic relationship with Fannie Mae executive Herbert Moses through the 1990s may or may not have affected his judgment but it should have been disclosed. Despite the move to riskier loans, and despite \$164 billion in implicit federal subsidies, “Fannie Mae and Freddie Mac . . . have done little to increase home ownership or reduce the cost of home loans, according to a draft study by the Federal Reserve” (*NYTimes*, 23 Dec 2003). The bloom is off the rose.

Fannie lost its way especially under CEO Franklin Raines (1999-2004) who rashly promised Wall Street to double Fannie’s earnings. And already in June 2000 a House Banking Committee held hearings on Fannie’s business and accounting practices. By September 2004 a House report alleged widespread accounting errors. In December 2006 U.S. regulators filed 101 civil charges against Raines and two other executives, accusing them of manipulating earnings to maximize their bonuses, seeking to recoup more than \$115 million in bonus payments and \$100 million in penalties. In June 2008 Raines was also called on the carpet by the *Wall Street Journal* for receiving below-market loans from the pathetic Countrywide Financial during his tenure (Fannie was the biggest buyer of Countrywide’s mortgages).

From August 2007 to August 2008, shares of Fannie Mae dropped 90% as the mortgage crisis spun out of control. Fannie Mae now has \$145 billion in delinquent loans on its books. It lost \$23 billion in the first quarter of 2009. Fannie Mae and Freddie Mac have received about \$60 billion in bailout funds so far. On May 9, 2009, Fannie gravely announced that it needed \$19 billion more now to keep it afloat.

And last month Fannie and Freddie were discovered handing out \$210 million in executive retention bonuses, including at least \$1 million to each of four top executives. Not quite in the David Maxwell leadership tradition. More in the Franklin Raines tradition. Raines’s successors Daniel Mudd and Herb Alison didn’t (and don’t) get it.

Great to Garbage: How?

The housing crisis and financial recession obviously have multiple causes and enabling conditions. No one company or leader or industry can alone be held responsible. The individuals who signed on to loans they could not afford while trusting in myths of unending growth that could not be true certainly have to take responsibility. Their defaults on their debts brought down Fannie and other institutions. But we wouldn’t have had so many of these defaults if the mortgage brokers and loan agents had not so aggressively and deceptively sold them to clients incapable to paying them back in difficult times.

But why did Fannie Mae as a company go from great to garbage? In my view it has everything to do with a shift in mission and in culture, led by vain, self-serving, avaricious executives and facilitated by incompetent and irresponsible boards of directors. If they had any gonads, if they had a moral compass, if they had any sense of responsibility, if they had any sense, they would have stood up to Barney Frank, Wall Street, and unqualified loan applicants and refused to go from great toward garbage. Instead they grabbed for the big, easy money.

In *Built to Last*, Collins and Porras were very helpful in describing the critical function of mission/purpose and vision in driving organizations. They did a good job of showing how enduringly great companies do not make financial growth their mission. Financial success is essential but it cannot serve as a core purpose that inspires a great company, they argue.

I don't think Collins is right, however, to treat core ideology (purpose and values) as an unchangeable "given" simply to be discovered in a company. This underplays the potential of a company's purpose to deteriorate --- and to improve. And while Collins and Porras talk about the importance of alignment, I don't think they emphasize enough how purpose can and does leverage culture and ethics.

There are some observers who argue that Fannie Mae's culture already moved just a bit away from the "serve and enable the home buyer population" of CEO David Maxwell to a more numbers orientated worldview under CEO Jim Johnson in the 1990s, coming out of his investment banking background. In any case Franklin Raines is the most disappointing and disastrous of all, utterly abandoning the social ideals of the Clinton administration to exploit Fannie Mae in pursuit of his own personal wealth. Put this guy at the top, surround him with lackeys with the same corrupt values, enable and coddle him with an impotent, irresponsible board, and watch the whole thing collapse. It's Arthur Andersen all over again.

But this was not inevitable. The market did not make Fannie Mae or Franklin Raines do it. They chose to sell out on the mission and values of founder FDR and later CEO star David Maxwell. Lose the mission and core values, then lose the day-to-day ethical decisions, then lose the company. Unless, that is, you can bill your mistakes and crimes to the taxpayers.

Thanks to Wikipedia for some of the data and quotations in this essay.