DEPARTMENT OF THE TREASURY

The mission of the Department of the Treasury is to "maintain a strong economy and create economic and job opportunities by promoting the conditions that enable economic growth and stability at home and abroad, strengthen national security by combating threats and protecting the integrity of the financial system, and manage the U.S. Government's finances and resources effectively."[1] In addition to acting as the president's lead adviser on "economic and financial issues," the Secretary of the Treasury manages a vast array of federal bureaus that oversee federal finances, tax collection, currency and coinage, the public debt, bank supervision and enforcing tax law.[2]

In Fiscal Year 2011, the Treasury Department's total budget is $13.1 billion, a slight decrease from the year before.[3] Of this, the Internal Revenue Service (IRS) accounts for $12.1 billion, or nearly 93 percent, of the Department's total budget.[4] Nearly two-thirds of IRS funding, or approximately $8 billion, falls under the broad category of "enforcement," while the remaining amounts fall largely to "taxpayer services."[5]

Unfortunately, the Treasury Department and the IRS, in particular, have not adequately managed taxpayer dollars, resulting in significant waste. Few examples were as embarrassing as the results of a recent investigation of the Treasury Inspector General for Tax Administration (TIGTA), which oversees the work of the IRS. A February 2011 report revealed 11 contractors hired by the IRS—our nation's tax collector—were severely delinquent in paying down their own tax debts, owing a combined $4.3 million.[6] The contractors were ultimately paid $356 million by the IRS, in addition to $3.7 billion more from other federal agencies.[7]

Treasury also oversees administration of the Earned Income Tax Credit (EITC), a tax benefit available to low-income workers, which suffers from significant mismanagement and loses tens of billions a year to fraud and abuse. Administration officials dubbed EITC a "high-error program" after it was discovered for 2009 its improper payment rate was as high as 29 percent,

[1] Website of the Department of Treasury, "About," http://www.treasury.gov/about/role-of-treasury/Pages/default.aspx, accessed June 29, 2011.

[2] Website of the Department of Treasury, "About," http://www.treasury.gov/about/role-of-treasury/Pages/default.aspx, accessed June 29, 2011.

[3] Hatch, Garret, Congressional Research Service, *Financial Services and General Government Appropriations: FY2012 Budget Request Fact Sheet*, (R41655), June 16, 2011, http://www.crs.gov/pages/Reports.aspx?PRODCODE=R41655&Source=search.

[4] Hatch, Garret, Congressional Research Service, *Financial Services and General Government Appropriations: FY2012 Budget Request Fact Sheet*, (R41655), June 16, 2011, http://www.crs.gov/pages/Reports.aspx?PRODCODE=R41655&Source=search.

[5] Chart provided by the U.S. Department of Treasury, *Taxpayer Services vs. Enforcement Spending Since FY2004, Adjusted to 2010 Dollars*, May 2010, (accessed July 12, 2011), http://www.irs.gov/pub/irs-news/taschart.pdf.

[6] Department of Treasury, Office of Inspector General, *Existing Practices Allowed IRS Contractors to Receive Payments While Owing Delinquent Taxes*, Reference Number 2011-30-013, February 4, 2011, http://www.treasury.gov/tigta/auditreports/2011reports/201130013fr.html.

[7] Department of Treasury, Office of Inspector General, *Existing Practices Allowed IRS Contractors to Receive Payments While Owing Delinquent Taxes*, Reference Number 2011-30-013, February 4, 2011, http://www.treasury.gov/tigta/auditreports/2011reports/201130013fr.html.

resulting in $16.9 billion in fraudulent payments.[8] GAO auditors found much of the problem was preventable, attributing such high losses to, "high turnover of eligible claimants, confusion among eligible claimants, complexity of the law, structure of the program, unscrupulous return preparers, and fraud."[9]

A second tax program was also recently criticized for wasting considerable sums of money, by the IRS inspector general. The TIGTA investigation found that weaknesses with IRS internal controls "allowed potentially erroneous refunds of more than $513 million to be received by taxpayers who most likely did not qualify for the Homebuyer Credit."[10] Auditors felt that the problem was not isolated to this program and that there was a strong need "also for strengthening controls over all refundable credits."[11]

Considerable savings can be achieved from addressing these and other areas of mismanagement and waste within Treasury and eliminating unnecessary programs.

Eliminate Unnecessary, Duplicative, Inefficient, and Wasteful Programs

While many of Treasury's functions are legitimate and vital for our nation's financial security, there are programs at Treasury that are either non-essential or duplicative of other efforts elsewhere in the federal government and should be eliminated.

End Funding for the Community Development Financial Institutions Fund
Funded at $246.7 million in Fiscal Year 2010,[12] the Community Development Financial Institutions (CDFI) Fund was established to provide economic revitalization efforts in low-income communities. According to the Treasury, the purpose of the CDFI program is "to use federal resources to invest in CDFIs and to build their capacity to serve low-income people and communities that lack access to affordable financial products and services."[13] A CDFI is an institution that provides financing and assistance to "underserved" communities for a range of purposes.

These efforts are intended "to promote economic development, to develop businesses, to create jobs, and to develop commercial real estate; to develop affordable housing and to promote homeownership; and to provide community development financial services, such as basic

---

[8] Official United States Government Improper Payments Website, PaymentAccuracy.gov, "High-error Programs," accessed July 17, 2011, http://paymentaccuracy.gov/content/programs-not-reported.
[9] Government Accountability Office, "Improper Payments: Recent Efforts to Address Improper Payments and Remaining Challenges," GAO-11-575T, April 15, 2011, http://www.gao.gov/new.items/d11575t.pdf.
[10] Department of Treasury, Office of Inspector General, *Administration of the First-Time Homebuyer Credit Indicates a Need for Improved Controls Over Refundable Credits*, Report Number 2011-41-035, March 31, 2011, http://www.treasury.gov/tigta/auditreports/2011reports/201141035_oa_highlights.html.
[11] Department of Treasury, Office of Inspector General, *Administration of the First-Time Homebuyer Credit Indicates a Need for Improved Controls Over Refundable Credits*, Report Number 2011-41-035, March 31, 2011, http://www.treasury.gov/tigta/auditreports/2011reports/201141035_oa_highlights.html.
[12] [12] U.S. Department of the Treasury, 2012 Congressional Budget Justification, http://www.treasury.gov/about/budget-performance/Documents/CJ_FY2012_Complete_508.pdf.
[13] Department of Treasury, "Community Development Financial Institutions Fund Overview," http://www.cdfifund.gov/what_we_do/programs_id.asp?programid=7, accessed June 29, 2011.

banking services, financial literacy programs, and alternatives to predatory lending."[14] However, in reality, this program's success is unclear.

The most prominent CDFI institution, ShoreBank in Chicago, Illinois, has also been one of the program's most controversial spokesmen by highlighting how taxpayer money is often put at needless risk. Formerly known as South Shore Bank, it was the first community development bank, and was in continuous operation for 30 years until it failed in August 2010.[15] ShoreBank received millions in federal assistance from the CDFI fund, dating back as far as the fund's creation. Upon its failure, however, an investigation by the FDIC Inspector General found that it was the result of poor management decisions.[16] "ShoreBank management was not responsive to repeated examiner concerns pertaining to these areas, particularly from 2007 until the bank failed."[17]

Treasury's Inspector General found the CDFI's controls over investing and accounting had significant deficiencies,[18] which open the door for waste and abuse. Another CDFI-certified Chicago bank, Park National, showed even more clearly the program's investments are not always well-considered. On the same day the Secretary of the Treasury announced CDFI awarded Park National $50 million in federal tax credits, the FDIC closed the bank down permanently and sold it to another financial institution.[19] Why the Treasury Department was not able to determine the bank's unstable condition is not clear, but FDIC auditors blamed the failure on poor "day-to-day decision making" and a bad business plan.[20]

One of the most popular programs within the CDFI fund has been the New Markets Tax Credit (NMTC), which is intended to spur development in low-income neighborhoods. Only that is not always the case. The biggest beneficiaries of the program have been some of the nation's biggest financiers, including J.P. Morgan Chase, Goldman Sachs and U.S. Bancorp, which among others have collected at least $10 billion since 2003.[21] Some of the questionable projects benefiting from the program have included a Georgia aquarium and a Washington State car museum.[22] Drawing perhaps the most controversy was a $116 million renovation for the

---

[14] Department of Treasury, "Community Development Financial Institutions Fund Overview," http://www.cdfifund.gov/what_we_do/programs_id.asp?programid=7, accessed June 29, 2011.
[15] Taub, Richard, "Commentary: After Shorebank," Report of the Institute for Comprehensive Community Development, December 2, 2010, http://www.instituteccd.org/library/1732.
[16] Federal Deposit Insurance Corporation, Office of Inspector General, *Material Loss Review of ShoreBank, Chicago, Illinois*, Report No. MLR-11-012, February 2011, http://www.fdicoig.gov/reports11%5C11-012.pdf.
[17] Federal Deposit Insurance Corporation, Office of Inspector General, *Material Loss Review of ShoreBank, Chicago, Illinois*, Report No. MLR-11-012, February 2011, http://www.fdicoig.gov/reports11%5C11-012.pdf.
[18] Department of Treasury, Office of the Inspector General, "Semiannual Report to Congress,http://www.treasury.gov/about/organizational-structure/ig/Documents/Final%20March%202011%20SAR%20-%20April%2029.pdf, accessed June 29, 2011.
[19] Yerak, Becky, "FBOP owner faults U.S. Treasury for failure," *Chicago Tribune*, November 3, 2009, http://articles.chicagotribune.com/2009-11-03/news/0911020418_1_fbop-tarp-faults.
[20] Yerak, Becky, "FBOP owner faults U.S. Treasury for failure," *Chicago Tribune*, November 3, 2009, http://articles.chicagotribune.com/2009-11-03/news/0911020418_1_fbop-tarp-faults.
[21] Dietz, David, "Rich Take From Poor as U.S. Subsidy Law Funds Luxury Hotels," *Bloomberg*, February, 8, 2011, http://www.bloomberg.com/news/2011-02-08/rich-taking-from-poor-as-10-billion-u-s-subsidy-law-funds-luxury-hotels.html.
[22] Attkisson, Sharyl, "Fancy Hotel Renovated with Your Tax Dollars," *CBS News*, February 9, 2011, http://www.cbsnews.com/stories/2011/02/08/eveningnews/main7330767.shtml.

Blackstone Hotel in Chicago, one of the city's most upscale locations.[23] A 2010 GAO study found it is not entirely clear whether projects being funded with NMTC awards required federal funding.[24][25]

This program also duplicates the $4 billion a year Community Development Block Grant (CDBG) program, housed at the Department of Housing Urban Development (HUD), which also funds community development initiatives that aim towards improving economic development and affordable housing, and several other programs within our government. In fact, in a report this past March, GAO identified more than 80 similar programs targeting "economic development," which received a combined $6.5 billion in federal funding.[26] Each one of these programs appears to overlap with at least one other program in funding certain economic development activities. These programs are administered in a fragmented and duplicative manner that discourages the maximum efficiency and fails to ensure constituents can easily find and apply for assistance. In a previous 2005 study, at least 180 economic development programs were identified within more than a dozen different agencies costing taxpayers about $17.9 billion annually on community development, regional development, and other economic development programs.[27]

Federal dollars for the CDFI fund is also questionable given large amounts provided for CDFIs by private institutions. In 2010, Bank of America alone pledged $10 million to CDFIs, with large institutions such as Wells Fargo and others promising to follow suit.[28]
Estimated Ten-Year Savings: $2.77 Billion

Replace the $1 Bill With $1 Coin
The Treasury Department should phase out use of the $1 bill and replace it with the $1 coin. Paper-based currencies wear out faster than coins, and so cost taxpayers more in the long run. According to GAO, starting in the 1980's, "Over the last 47 years, Australia, Canada, France, Japan, the Netherlands, New Zealand, Norway, Russia, Spain, and the UK, among others, have replaced lower-denomination notes with coins."[29] GAO also estimates that over a 30-year period, the average annual savings would be approximately $184 million.[30]
Estimated Ten-Year Savings: $2.04 Billion

---

[23] Dietz, David, "Rich Take From Poor as U.S. Subsidy Law Funds Luxury Hotels," *Bloomberg*, February, 8, 2011, http://www.bloomberg.com/news/2011-02-08/rich-taking-from-poor-as-10-billion-u-s-subsidy-law-funds-luxury-hotels.html.
[24] Government Accountability Office, "New Markets Tax Credit: The Credit Helps Fund a Variety of Projects in Low-Income Communities, but Could Be Simplified," GAO-10-334, January 2010, http://www.gao.gov/new.items/d10334.pdf.
[25] A more detailed discussion of the New Markets Tax Credit can be found in the Reforming the Tax Code & Ending Special Interest Giveaways section of this report.
[26] Government Accountability Office, "Opportunities to Reduce Potential Duplication in Government Programs, Save Tax Dollars, and Enhance Revenue," GAO-11-318SP, March 2011, http://www.gao.gov/new.items/d11318sp.pdf.
[27] Drabenstott, Mark, "A Review of the Federal Role in Regional Economic Development," Center for the Study of Rural America & Federal Reserve Bank of Kansas City, May 2005, ftp://urban.csuohio.edu/utility/ledebur/622-722/Nov%206%20%20Federal%20Policy/Supplemental%20Resources/drabenstott%20federalreview.pdf.
[28] Hughes, Darrell A., "Bank of America Commits $10M in Small-Business Grants," *Wall Street Journal*, July 29, 2010, http://online.wsj.com/article/SB10001424052748703578104575397321802765204.html.
[29] Government Accountability Office, "U.S. Coins: Replacing the $1 Note with a $1 Coin Would Provide a Financial Benefit to the Government," GAO-11-281, March 2011, http://www.gao.gov/new.items/d11281.pdf.
[30] Government Accountability Office, "U.S. Coins: Replacing the $1 Note with a $1 Coin Would Provide a Financial Benefit to the Government," GAO-11-281, March 2011, http://www.gao.gov/new.items/d11281.pdf.

Eliminate the Office of Technical Assistance
Funded at $25 million in Fiscal Year 2010, [31] the Office of Technical Assistance (OTA) Department of Treasury program designed to assist and advise foreign countries in how to manage their finances. Its core mission is “to develop strong financial sectors and sound public financial management in countries where assistance is needed and there is a strong commitment to reform.”[32] Treasury’s program consists of five main areas including, Budget Policy and Accountability, Banking and Financial Services, Government Debt Issuance and Management, Financial Crimes, and Revenue Policy and Administration.

This office duplicates ongoing efforts at the United States Agency for International Development (USAID), which has programs that also focus on building financial infrastructure and knowledge for poor and developing countries, often in conjunction with the World Bank.[33] USAID, whose mission is to educate, build, and support developing countries, is a more appropriate agency to advise foreign nations in this area.

The Office of Technical Assistance has also been involved in training overseas police forces in counterterrorism and counternarcotics strategies, but it is one of many federal agencies doing this. An April 2011 review by GAO (see chart below) found that, “during fiscal year 2009, seven federal agencies and 24 components within them funded or implemented police-assistance activities to support their counternarcotics, counterterrorism, and anticrime missions,” and spent more than $3.5 billion.[34]

Table 1: U.S. Departments, Agencies, and other Organizational Units that Provided Police Assistance in Fiscal Year 2009

Agency	Unit
DOD	Deputy Assistant Secretary for Counternarcotics and Global Threats Five Combatant Commands: Africa, Central, European, Pacific, Southern Joint Interagency Task Force-West Defense Threat Reduction Agency
DOE	National Nuclear Security Administration
DHS	Customs and Border Protection Federal Law Enforcement Training Center Immigration and Customs Enforcement
DOJ	Criminal Division Bureau of Alcohol, Tobacco, Firearms, and Explosives DEA FBI U.S. Marshals Service
State	Bureau of Diplomatic Security Bureau of International Security and Nonproliferation Bureau of International Narcotics and Law Enforcement Affairs Office of the Coordinator for Counterterrorism
Treasury	Internal Revenue Service Office of Technical Assistance
USAID	Bureau of Democracy, Conflict, and Humanitarian Assistance Multiple regional bureaus

Source: GAO analysis of DOD, DOE, DOJ, State, Treasury, and USAID information.

[31] U.S. Department of the Treasury, 2012 Congressional Budget Justification, http://www.treasury.gov/about/budget-performance/Documents/CJ_FY2012_Complete_508.pdf.
[32] Department of Treasury, Office of Technical Assistance, “Mission Statement,” http://www.treasuryota.us/, accessed June 29, 2011.
[33] United States Agency for International Development, “Financial Markets,” http://www.usaid.gov/our_work/economic_growth_and_trade/eg/financial_markets.html, accessed June 29, 2011.
[34] Government Accountability Office, letter to The Honorable John F. Tierney, “Subject: *Multiple U.S. Agencies Provided Billions of Dollars to Train and Equip Foreign Police Forces*,” GAO-11-402R, April 27, 2011, http://www.gao.gov/new.items/d11402r.pdf.

Estimated Ten-Year Savings: $277 million

Eliminate Debt Restructuring Programs
Debt restructuring programs at the Department of Treasury were established to alleviate the debt burdens of poor and/or underdeveloped countries. The $60 million annual budget for these programs enables funding for three initiatives: the Heavily Indebted Poor Countries Initiative (HIPC) debt reduction, the HIPC Trust Fund, and the Tropical Forest Conservation Act (TFCA).[35] The HIPC initiatives provide debt relief to impoverished countries in return for domestic economic reforms to bolster growth and to reduce poverty, while the TFCA writes off debt owed to the U.S. in return for conservation of tropical forests.

A recent example of questionable use of TFCA funds abroad involved the country of Brazil, whose economy has exploded in the past couple of years. According to USAID, "the Governments of the U.S. and Brazil signed a Debt-for-Nature Agreement in August 2010 to reduce Brazil's debt payments to the United States by close to $21 million through 2015. In return, the Government of Brazil has committed these funds to support grants to protect the country's tropical forests."[36]

The primary and appropriate entity responsible for aiding indebted and impoverished nations is the World Bank. In 2010, the World Bank made over $72 billion in loans to developing countries.[37] The Department of Treasury should remove itself from debt forgiveness for other countries and instead focus on eliminating our debt to other nations.
Estimated Ten-Year Savings: $666.05 million

Improve Energy Efficiency at IRS Data Centers
The IRS should update its policies regarding energy use at its data centers, which could achieve significant savings. Data centers are rooms or warehouses containing large amounts of computer equipment, such as servers, that also consume huge quantities of energy, often 40 times as much as a conventional office.[38] A TIGTA audit revealed that IRS data centers, however, were following outdated practices and needlessly wasting significant amounts of energy. At just two of these 42 sites, auditors found that making simple changes could save as much as $3.2 million over four years, and further savings were possible if extended to all data centers.[39] Among the suggestions were ideas for simple upkeep, like replacing missing tiles in floors, making sure

[35] Website of the Department of Treasury, Treasury International Programs, Program Summary by Appropriations Account, accessed July 17, 2011, http://www.treasury.gov/about/budget-performance/budget-in-brief/Documents/International%20FY11%20508.pdf.
[36] United States Agency for International Development, "Tropical Forest Conservation Act Program Descriptions," http://www.usaid.gov/our_work/environment/forestry/tfca_descs.html#Brazil, accessed June 21, 2011.
[37] The World Bank, "Projects and Lending," http://web.worldbank.org/WBSITE/EXTERNAL/PROJECTS/0,,contentMDK:20264002~menuPK:572065~pagePK:41367~piPK:279616~theSitePK:40941,00.html, accessed June 29, 2011.
[38] Greenberg, Steve, and others. 2006. Best Practices for Data Centers: Lessons Learned from Benchmarking 22 Data Centers. Proceedings of the ACEEE Summer Study on Energy Efficiency in Buildings in Asilomar, CA. ACEEE, August. Vol 3, pp 76-87. http://eetd.lbl.gov/emills/PUBS/PDF/ACEEE-datacenters.pdf
[39] U.S. Department of the Treasury, Treasury Inspector General for Tax Administration, *Implementing Best Practices and Additional Controls Can Improve Data Center Energy Efficiency and the Environmental and Energy Program*, Reference Number 2010-20-044, May 7, 2010, http://www.treasury.gov/tigta/auditreports/2010reports/201020044fr.pdf.

furniture does not block airways and alternating hot and cold servers.[40]
Estimated Ten-Year Savings: $10 million

Reduce Administrative Expenses for the Department
For Fiscal Year 2012, the Obama administration recommended reducing the administrative budget of the Treasury Department by $199 million. This would include "eliminating printing and mailing of certain forms, publications and inserts," which would save $4 million per year.[41]
Estimated Ten-Year Savings: $2.18 billion

Increase the Number of Paperless Transactions
The Treasury Department, as keeper of the nation's money, interacts with millions of employees, citizens, taxpayers, contractors and others every day. By increasing the number of electronic, paperless transactions it has, the administrative cost of these interactions would decrease significantly. The Obama administration has endorsed a plan that would pay benefits electronically, require businesses to pay taxes electronically, issue more electronic savings bonds, sell more Treasury securities online, and automate many paper-based processes, such as Freedom of Information Act requests.[42] The White House estimates the five-year savings from this would result in savings of $524 million.[43]
Estimated Ten-Year Savings: $1.05 billion

Consolidate Various Information Technology Programs
For 2012, the Obama administration recommended consolidating five different information technology systems used by the Bureau of Public Debt and the Financial Management Service. The move would better integrate systems that both bureaus depend on, and possibly eliminate certain contractor costs. OMB estimates the five-year savings would be $96 million.[44]
Estimated Ten-Year Savings: $192 million

Increase Levy Payments for Federal Contractors with Delinquent Tax Debts
A recent investigation by GAO uncovered that 3,700 federal stimulus contractors with $757 million in tax debt were awarded over $24 billion in federal funds.[45] The government should do more to end problems like this by increasing the amount the government can collect from federal contractors from 15 percent to 100 percent until the debt is repaid. OMB estimates this would generate nearly $1.5 billion in savings over ten years.[46]
Estimated Ten-Year Savings: $1.47 billion

---

[40] Kauffman, Tim, "IG: IRS wasting money at data centers," *Federal Times*, June 7, 2010, http://www.federaltimes.com/article/20100607/AGENCY05/6070302/1001.
[41] Office of Management and Budget, Executive Office of the President, Budget of the U.S. Government, "Fiscal Year 2012 Terminations, Reductions, and Savings," http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/trs.pdf.
[42] Office of Management and Budget, Executive Office of the President, Budget of the U.S. Government, "Fiscal Year 2012 Terminations, Reductions, and Savings," http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/trs.pdf.
[43] Office of Management and Budget, Executive Office of the President, Budget of the U.S. Government, "Fiscal Year 2012 Terminations, Reductions, and Savings," http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/trs.pdf.
[44] Office of Management and Budget, Executive Office of the President, Budget of the U.S. Government, "Fiscal Year 2012 Terminations, Reductions, and Savings," http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/trs.pdf.
[45] Government Accountability Office, "Recovery Act: Thousands of Recovery Act Contract and Grant Recipients Owe Hundreds of Millions in Federal Taxes," GAO-11-485, April 2011, http://www.gao.gov/new.items/d11485.pdf.
[46] Office of Management and Budget, Executive Office of the President, Budget of the U.S. Government, "Fiscal Year 2012 Terminations, Reductions, and Savings," http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/trs.pdf

Eliminate Ten-Year Statute of Limitations on Debt Collection
Under current law, federal debts not collected within a ten year window of time are not collected at all. AS proposed by the Bush administration, the government should eliminate the restriction and allow, with proper safeguard, full collection of all unpaid debts. [47]

Estimated Ten-Year Savings: $88.81 million

PROGRAMS ELIMINATED:

- The Community Development Financial Institutions Fund
- The Office of Technical Assistance
- Tropical Forest Conservation Act
- The Heavily Indebted Poor Countries Initiative
- The Heavily Indebted Poor Countries Trust Fund

DEPARTMENT OF THE TREASURY TEN YEAR SAVINGS
Discretionary: $9.67 billion
Total: $9.7 billion

[47] Office of Management and Budget, Executive Office of the President, "Major Savings and Reforms in the President's 2009 Budget," February 2008, http://www.gpoaccess.gov/usbudget/fy09/pdf/savings.pdf.

PHOTO: KEN CEDENO/BLOOMBERG/LANDOV

GOVERNMENT SPONSORED ENTERPRISES: FANNIE MAE AND FREDDIE MAC

In the last three years, few entities have negatively impacted the economy as much as two particular government sponsored entities (GSE): the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Together, these GSEs helped inflate the housing market to record levels, setting up the financial crisis of 2008.

Fannie Mae and Freddie Mac were chartered by Congress to encourage homeownership in two primary ways: first, by providing a secondary market for home mortgages and second, by purchasing loans for their own portfolios. The former was accomplished by purchasing mortgage loans, which the GSEs bundled and sold as securities that investors believed were backed by the federal government. The existence of a secondary market encouraged lenders to originate more loans, from which they could profit by selling them to the GSEs and others. The latter was accomplished by simply purchasing large numbers of loans and holding them as investments.

Over time, Fannie Mae and Freddie Mac encouraged increasingly risky lending by purchasing larger and larger quantities of high risk loans. According to the Treasury Department: "[A]s their combined market share declined – from nearly 70 percent of new originations in 2003 to 40 percent in 2006 – Fannie Mae and Freddie Mac pursued riskier business to raise their market share and increase profits. Not only did they expand their guarantees to new and riskier products, but they also increased their holdings of some of these riskier mortgages on their own balance sheets."[48]

In fact, the Treasury Department characterized the two GSEs this way, "Fannie Mae and Freddie Mac were allowed to behave like government-backed hedge funds, managing large investment portfolios for the profit of their shareholders with the risk ultimately falling largely on taxpayers."[49]

Between 2005 and 2007, Fannie Mae alone purchased billions of dollars in loans with questionable characteristics. Data from Fannie Mae shows that for all Option Adjustable-Rate Mortgage (ARM) loans, one of the riskiest types of mortgages, it had on its books through the

[48] Joint report of the U.S. Department of the Treasury and the Department of Housing and Urban Development, *Reforming America's Housing Finance Market: A Report to Congress*, February 2011, http://www.treasury.gov/initiatives/Documents/Reforming%20America's%20Housing%20Finance%20Market.pdf.
[49] Joint report of the U.S. Department of the Treasury and the Department of Housing and Urban Development, *Reforming America's Housing Finance Market: A Report to Congress*, February 2011, http://www.treasury.gov/initiatives/Documents/Reforming%20America's%20Housing%20Finance%20Market.pdf.

middle of 2008, 62 percent were purchased between 2005 and 2007.[50] Likewise, 84 percent of its interest-only loans were purchased in that time, as were 57 percent of those with FICO (credit-worthiness) scores less than 620; 62 percent of its loans with loan-to-value ratios greater than 90; and 73 percent of its Alt-A loans.[51] While these same risky loans would constitute only a small percentage of Fannie Mae's purchases at the time, they came to account for some its most significant losses. By the middle of 2009, Fannie Mae reported an unpaid principal balance of $878.2 billion for its loans with subprime characteristics, out of a total portfolio of $2.7 trillion, representing a full third.[52]

As mentioned above, Fannie Mae and Freddie Mac were able to bundle these mortgages into securities and sell them to investors because many believed the securities carried the implicit support of the federal government. According to the Congressional Budget Office (CBO), the risk carried by these securities was then spread throughout the financial system:

> "Because of their [Fannie Mae and Freddie Mac] size and interconnectedness with other financial institutions, they posed substantial systemic risk—the risk that their failure could impose very high costs on the financial system and the economy. The GSEs' market power also allowed them to use their profits partly to benefit their other stakeholders rather than exclusively to benefit mortgage borrowers. The implicit guarantee created an incentive for the GSEs to take excessive risks: Stakeholders would benefit when gambles paid off, but taxpayers would absorb the losses when they did not.
>
> . . . One way that Fannie Mae and Freddie Mac increased risk was by expanding the volume of mortgages and [mortgage-backed securities] MBSs held in their portfolios, which exposed them to the risk of losses from changes in interest or prepayment rates. Over the past decade, the two GSEs also increased their exposure to default losses by investing in lower-quality mortgages, such as subprime and Alt-A loans."[53]

These risks finally materialized in September 2008, when both Fannie Mae and Freddie Mac were taken in to conservatorship by the federal government. By the fall of 2008, Fannie Mae and Freddie Mac were projected to incur up to $3.8 trillion in losses,[54] deemed insolvent and placed into conservatorship where they have remained, and put on life support in the form of frequent injections of billions in cash from federal taxpayers.

---

[50] Fannie Mae, 2008 Q2 10-Q Investor Summary, August 8, 2008, http://www.fanniemae.com/media/pdf/newsreleases/2008_Q2_10Q_Investor_Summary.pdf.

[51] Fannie Mae, 2008 Q2 10-Q Investor Summary, August 8, 2008, http://www.fanniemae.com/media/pdf/newsreleases/2008_Q2_10Q_Investor_Summary.pdf.

[52] Fannie Mae, 2009 Second Quarter Credit Supplement,, August 6, 2009, http://www.fanniemae.com/ir/pdf/sec/2009/q2credit_summary.pdf.

[53] Congressional Budget Office, "Fannie Mae, Freddie Mac, and the Federal Role in the Secondary Mortgage Market," December 2010, http://www.cbo.gov/ftpdocs/120xx/doc12032/12-23-FannieFreddie.pdf.

[54] Testimony of Deborah Lucas, Congressional Budget Office, before the House Budget Committee, "The Budgetary Cost of Fannie Mae and Freddie Mac and Options for the Future Federal Role in the Secondary Mortgage Market," June 2, 2011, http://www.cbo.gov/ftpdocs/122xx/doc12213/06-02-GSEs_Testimony.pdf.

Since that time, the Treasury Department has spent nearly $150 billion dollars to support the two GSEs, a total which projections show could rise to as high as $363 billion.[55] According to CBO in August 2009, while the two organizations were previously considered private corporations, their new status was that of a government agency. Consequently, CBO projected that Fannie Mae and Freddie Mac would cost taxpayers $291 billion over the long term for all of its mortgage-related activities through 2009.[56]

On June 2, 2011, CBO revised this estimate upward and stated that GSEs are estimated to produce "a fair value cost to the government of about $317 billion in obligations incurred through March 2011," $26 billion more than the previous measurement. The increase in that total compared with CBO's 2009 estimate reflects "continued deterioration in the condition of the housing market that is increasing default rates on distressed mortgages and depressing the amounts that can be recovered following defaults."[57]

Moving forward, CBO still estimates continued bailouts for the next decade absent reform. "In its most recent baseline projections from March 2011, CBO estimated that the subsidy costs of the GSEs' new business would total about $42 billion over the [next decade], an average of about $4 billion a year."[58]

Recommendations

Unfortunately, Congress has yet to enact GSE reforms despite ample opportunities to do so. While a quick transition to a fully private secondary market for mortgages potentially would create more harm than good, Congress must begin the process of slowly reforming GSEs to help curtail the massive losses to American taxpayers.

Over time, the government should phase out its involvement in both Fannie Mae and Freddie Mac, devolving all activities related to a secondary mortgage market to the private sector. The immediate actions include:

Increase Down-Payments for GSE-Backed Mortgages to at Least 10 Percent
This proposal would improve the mortgage products that the GSEs securitize, diminishing the default risk and consequent need of bailouts by taxpayers. Currently, there is no down payment requirement for GSE products. In its model for GSE reform, the Department of Treasury

---

[55] Federal Housing Finance Agency, News Release, "FHFA Releases Projections Showing Range of Potential Draws for Fannie Mae and Freddie Mac," October 21, 2010, http://fhfa.gov/webfiles/19409/Projections_102110.pdf.
[56] Congressional Budget Office, Background Paper, "CBO's Budgetary Treatment of Fannie Mae and Freddie Mac," January 2010, http://www.cbo.gov/ftpdocs/108xx/doc10878/01-13-FannieFreddie.pdf.
[57] Testimony of Deborah Lucas, Congressional Budget Office, before the House Budget Committee, "The Budgetary Cost of Fannie Mae and Freddie Mac and Options for the Future Federal Role in the Secondary Mortgage Market," June 2, 2011, http://www.cbo.gov/ftpdocs/122xx/doc12213/06-02-GSEs_Testimony.pdf.
[58] Testimony of Deborah Lucas, Congressional Budget Office, before the House Budget Committee, "The Budgetary Cost of Fannie Mae and Freddie Mac and Options for the Future Federal Role in the Secondary Mortgage Market," June 2, 2011, http://www.cbo.gov/ftpdocs/122xx/doc12213/06-02-GSEs_Testimony.pdf

outlined a requirement for 10 percent down-payment to qualify to be included in a GSE loan portfolio to prevent "risky, low-quality mortgage products and predatory lending."[59]

By requiring a down-payment, it decreases the likelihood of borrowers walking away from their homes as it increases the personal losses they face in foreclosure. This lowered default risk in turn strengthens the loan portfolio of the GSEs since they, not the bank of origination, are ultimately responsible for the mortgage.

Gradually Lower the Conforming Loan Limits
This proposal will lower the level of risk GSEs are allowed to incur by reducing the size of the mortgages they can purchase. Under current law, the GSEs are able to guarantee mortgages in amounts up to $729,750 in areas with high costs until the end of the current fiscal year when that limit will fall to $625,500. The limit outside of high-cost areas currently is $417,000 (meaning homes worth $500,000).

This plan, which Treasury endorsed, "would set a maximum loan limit of $417,000 nationally beginning in 2013 and freeze that limit going forward. The option would retain the scheduled reduction—to $625,500 starting October 1, 2011—in the loan limit for high-cost areas for FY12 only; thus, no savings would be realized in 2012."[60]

CBO estimates that lowering loan limits would reduce federal subsidies for the GSEs by $3.5 billion over the next decade.[61] Further reductions would achieve additional savings. According to CBO, the primary advantage of this plan is "that it could provide a transition from conservatorship and restore a role for the private sector in the secondary mortgage market while reducing taxpayers' exposure to the risk of defaults." Additionally, CBO argues, "current loan limits, which are high compared with the median price of about $170,000 for an existing single-family residence in 2010, leave little scope for a private secondary market, which had been significant before the financial crisis."[62]
Estimated Ten-Year Savings: $3.5 billion

Gradually Reduce GSE Investment Portfolio
This proposal would lower the volume of guaranteed loans on Fannie and Freddie's books, further reducing taxpayer exposure to its losses. As mentioned previously, the Department of Treasury found that "Fannie Mae and Freddie Mac were allowed to behave like government-backed hedge funds, managing large investment portfolios for the profit of their shareholders with the risk ultimately falling largely on taxpayers."[63] The Treasury plan requires "a reduction

---

[59] Joint report of the U.S. Department of the Treasury and the Department of Housing and Urban Development, *Reforming America's Housing Finance Market: A Report to Congress*, February 2011, http://www.treasury.gov/initiatives/Documents/Reforming%20America's%20Housing%20Finance%20Market.pdf.
[60] Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011, http://www.cbo.gov/ftpdocs/120xx/doc12085/03-10-ReducingTheDeficit.pdf.
[61] Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011, http://www.cbo.gov/ftpdocs/120xx/doc12085/03-10-ReducingTheDeficit.pdf.
[62] Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011, http://www.cbo.gov/ftpdocs/120xx/doc12085/03-10-ReducingTheDeficit.pdf.
[63] Joint report of the U.S. Department of the Treasury and the Department of Housing and Urban Development, *Reforming America's Housing Finance Market: A Report to Congress*, February 2011, http://www.treasury.gov/initiatives/Documents/Reforming%20America's%20Housing%20Finance%20Market.pdf.

in this risk-taking by winding down their investment portfolios at an annual pace of no less than 10 percent."[64] By selling off a relatively small portion of its assets over an extended time frame, it both reduces the GSEs and, by extension, the taxpayer's liabilities.

This reform will not unduly impact the housing markets with a large dump of government backed assets all at once, while increasing the supply of available mortgage-backed securities to encourage private sector investment back into the housing market. This government divestment will be coordinated with the appropriate regulators, such as the Federal Reserve and the Department of Treasury.

Gradually Increase the Guarantee Fees GSEs Charge
This proposal would shift the costs of guaranteeing mortgage losses from taxpayers to the issuers of loans purchased by the GSEs, consequently lowering future taxpayer exposure to losses on failed GSE loan securitizations. According to CBO, Fannie Mae and Freddie Mac could move to "raise the average guarantee fee they assess on loans in the MBSs they issue by 5 basis points (100 basis points are equivalent to 1 percentage point) and to raise the effective guarantee fee on loans acquired for their portfolios by the same amount. Those increases, constituting roughly a 20 percent rise in fees, would reduce federal costs for the GSEs by about $27 billion over the next decade."[65]

The Department of Treasury summed up the policy impact this way: "this will mean that the price of the guarantee offered by Fannie Mae and Freddie Mac explicitly reflects its risk, and will help the private market compete on a level playing field, reducing Fannie Mae and Freddie Mac's market share over time."[66] According to CBO, "the main advantage of raising guarantee fees would be to reduce the projected costs of conservatorship. Another advantage of this option is that it would help address the current underpricing of risk, which could shift the allocation of capital too far toward housing and away from more productive activities."[67]
Estimated Ten-Year Savings: $26.5 billion

Reduce Executive Pay to that of Federal Pay Schedules and End Funding of Legal Fees for Former Executives
This proposal would cap excessive executive compensation at the GSEs while also ending taxpayer funded legal services provided to former executives. The top six executives at Fannie Mae and Freddie Mac made a combined $35.4 million in 2009 and 2010.[68]

---

[64] Joint report of the U.S. Department of the Treasury and the Department of Housing and Urban Development, *Reforming America's Housing Finance Market: A Report to Congress*, February 2011, http://www.treasury.gov/initiatives/Documents/Reforming%20America's%20Housing%20Finance%20Market.pdf.
[65] Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011, http://www.cbo.gov/ftpdocs/120xx/doc12085/03-10-ReducingTheDeficit.pdf.
[66] Joint report of the U.S. Department of the Treasury and the Department of Housing and Urban Development, *Reforming America's Housing Finance Market: A Report to Congress*, February 2011, http://www.treasury.gov/initiatives/Documents/Reforming%20America's%20Housing%20Finance%20Market.pdf.
[67] Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011, http://www.cbo.gov/ftpdocs/120xx/doc12085/03-10-ReducingTheDeficit.pdf.
[68] Prior, Jon, "What Fannie, Freddie execs made while in conservatorship," *HousingWire*, April 1, 2011, http://www.housingwire.com/2011/04/01/what-fannie-freddie-execs-made-while-in-conservatorship.

Since the GSEs are currently in government conservatorship, which according to CBO renders them government entities, they should be compensated the same as others in federal service. For as long as the GSEs are in government conservatorship or receivership, they will be compensated on the Federal "General Schedule" (GS) pay scale. Additionally, no taxpayer money would be used to pay legal fees defending the former executives of the GSEs. Since the GSEs went into conservatorship, taxpayers have funded $81.2 million in legal fees for former Fannie and Freddie executives, including $7.9 million for Franklin Raines, former Fannie Mae Chief Executive, and $11.8 million for Leanne Spencer, former Fannie Mae Controller.[69]

Estimated Ten-Year Savings: $50 Million

GOVERNMENT SPONSORED ENTERPRISES TEN YEAR SAVINGS
Mandatory: $30.05 billion
Total: $30.05 billion

[69] Morgensen, Gretchen, "Mortgage Giants Leave Legal Bills to the Taxpayers," *New York Times*, January 24, 2011, http://www.nytimes.com/2011/01/24/business/24fees.html?_r=1.