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THE FEDERAL GOVERNMENT'S IMPLIED GUARANTEE OF FANNIE MAE AND FREDDIE MAC'S OBLIGATIONS: UNCLE SAM WILL PICK UP THE TAB

*David Reiss**

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I. INTRODUCTION

The slow motion meltdown of the residential mortgage market over the last year has revealed the risks associated with the subprime sector of that market.[1] Many believe that the largest sector of the mortgage market, the conforming mortgage market,[2] remains safe because it is supported by two government-chartered companies, the Federal National Mortgage Association (commonly known as "Fannie Mae") and the Federal Home Loan Mortgage Corporation (commonly known as "Freddie Mac").[3] This belief rests on the assumption that the federal government would assist these two companies if they were unable to make good on their debt obligations. This assumption is well-founded. This Article will argue, however, that this support has been purchased at a potentially enormous price by the American taxpayer and that it should be formally abandoned.

Fannie Mae (Fannie) and Freddie Mac (Freddie), two of the largest companies in the United States measured by assets,[4] are for-profit, privately owned mortgage finance companies whose shares trade on the New York Stock Exchange.[5] Congress created Freddie and Fannie to develop a liquid national market for residential

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[1] *See* James R. Hagerty & Ruth Simon, *Lenders Broaden Clampdown on Risky Mortgages*, WALL ST. J., Aug. 3, 2007, at A3 ("Jittery home-mortgage lenders are cutting off credit or raising interest rates for a growing portion of Americans, extending well beyond the market for subprime loans for people with the weakest credit records."); Greg Ip & Jon E. Hilsenrath, *How Credit Got So Easy and Why It's Tightening*, WALL ST. J., Aug. 7, 2007, at A1 ("Home buyers with poor credit are having trouble borrowing."). Subprime loans are those made to borrowers with "lower incomes, less wealth, and riskier credit profiles than traditional, 'prime' borrowers." David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985, 994 (2006).

[2] *See infra* notes 54–58 and accompanying text.

[3] *See* Gregory Zuckerman et al., *Dow Tumbles 2.8% As Fallout Intensifies; Moves by Central Banks*, WALL ST. J., Aug. 10, 2007, at A1 ("Rattled by a constant stream of bad news, investors in recent days have been shunning nearly all mortgages except for those that can be sold to Fannie Mae and Freddie Mac, the government-sponsored investors that guarantee payments on loans that 'conform' to their standards.").

[4] *See* The Forbes 2000, http://www.forbes.com/lists/2006/18/06f2000_The-Forbes-2000_Assets.html (last visited July 28, 2008) (showing Fannie Mae ranked at thirty-seven and Freddie Mac ranked at two hundred).

[5] *See* FAQ > A Private Company, http://www.fanniemae.com/faq/faq8.jhtml?p=FAQ (describing Fannie Mae as private company) (last visited July 28, 2008); Press Release, Freddie Mac, Freddie Mac Announces Voluntary Delisting From NYSE Arca (Dec. 14, 2006), *available at* http://www.freddiemac.com/news/archives/investors/2006/20061214_nyse_arca. html ("Freddie Mac common stock will continue to be listed on the New York Stock Exchange.").

mortgages in order to encourage homeownership.[6] Fannie and Freddie primarily engage in two activities. First, they help mortgage originators package their mortgages into residential mortgage-backed securities (RMBS) by providing credit guarantees for those securities. This helps maintain a stable and liquid market for RMBS. Second, the two companies raise capital by issuing debt securities throughout the world's financial markets and use those funds to purchase mortgages and related securities. Fannie and Freddie have historically profited in this line of business because of the spread between their low cost of capital and the amount that they must pay for the mortgage investments they keep for their own portfolio.[7] These two activities, and particularly the second one, have driven the rapid growth and high profitability of the two companies in recent years.[8]

In creating Fannie and Freddie, it appears at first glance that the federal government disavowed any guarantee of the two companies' obligations. Indeed, by statute, securities issued by Fannie and Freddie must contain an explicit disclaimer that they are "not guaranteed by the United States and do not constitute a debt or obligation of the United States."[9] This disavowal of a guarantee has been affirmed by Treasury officials and a leading legal scholar.[10]

Despite this seemingly clear language, Wall Street believes that the federal government would bail Fannie and Freddie out if they were to become insolvent. Because the financial markets perceive them to be low-risk borrowers, Fannie and Freddie can borrow money more cheaply than other private companies, which is the

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[6] *See infra* Part IV.A.*1.a*.

[7] *See* FAQ > Fannie Mae's Business, http://www.fanniemae.com/faq/faq2.jhtml?p=FAQ (last visited July 28, 2008) (describing Fannie Mae's business); Freddie Mac: Our Business, http://www.freddiemac.com/corporate/company_profile/our_business/ (last visited July 28, 2008) (describing Freddie Mac's business).

[8] *See infra* Part II. On average, "the combined size of the Fannie Mae and Freddie Mac has more than doubled every five years between 1968 and 2002." RONALD C. MOE & KEVIN R. KOSAR, CONG. RESEARCH SERV., THE QUASI GOVERNMENT: HYBRID ORGANIZATIONS WITH BOTH GOVERNMENT AND PRIVATE SECTOR LEGAL CHARACTERISTICS 11 (Cong. Research Serv., CRS Report for Congress Order Code RL30533, May 18, 2005).

[9] 12 U.S.C. § 1455(h) (2006) (as to Freddie Mac obligations and mortgage-backed securities); *id.* § 1719(b) (as to certain Fannie Mae obligations); *id.* § 1719 (d), (e) (as to Fannie Mae mortgage-backed securities and Fannie Mae subordinated or convertible obligations). "Obligations" include debts. *See* sources cited *supra*.

[10] For discussion about the views of former Treasury Secretary John Snow and Professor Robert Scott Carnell, see *infra* Part III.

source of their competitive advantage.[11] The reasonableness of Wall Street's belief is not merely of theoretical interest. If Fannie and Freddie were to become insolvent, the losses could easily dwarf the billions of dollars of losses that have already accrued to investors in the subprime mortgage market. This is because Fannie and Freddie have $4.90 trillion in mortgage-related obligations,[12] which is of the same magnitude as the $5.05 trillion of federal government debt held by the public[13] and the $5.70 trillion that is outstanding in the entire U.S. corporate bond market.[14] And, as important, it is the American taxpayer, and not sophisticated investors, who will absorb the losses that will be incurred if Fannie or Freddie become insolvent and are bailed out by the federal government. On the other hand, if the federal government did not bail out Fannie or Freddie, it could lead to an international financial crisis that could be greater than those posed by the 1994 Mexican peso collapse, the 1997 East Asian "flu" and the 1998 Russian bond default, the last of which triggered the collapse of the large U.S. hedge fund Long-Term Capital Management.[15]

Undertaking the most comprehensive statutory analysis to date, this Article evaluates the contradictory, but deeply held, understandings of the federal government's guarantee of Fannie and

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[11] *See infra* Part III.

[12] *See* FANNIE MAE, MONTHLY SUMMARY 1 (Nov. 2007), *available at* http://fanniemae.com/ir/pdf/monthly/2007/113007.pdf (providing Fannie data as of Nov. 30, 2007); FREDDIE MAC, MONTHLY VOLUME SUMMARY: NOVEMBER 2007, at 1 (2007), *available at* http://www.freddiemac.com/investors/volsum/pdf/1107mvs.pdf (providing Freddie data as of Nov. 30, 2007). These Fannie and Freddie figures include both RMBS guaranteed by the two companies and the mortgages and mortgage-related securities that they hold in their own portfolio. Fannie and Freddie's share of all outstanding mortgage debt stands at around forty percent. *See* Office of Federal Housing Enterprise Oversight, Enterprise Share of Residential Mortgage Debt Outstanding: 1990–2007, http://www.ofheo.gov/media/marketdata/ESRMDOutstanding19902007.xls (last visited July 28, 2008) (showing outstanding mortgage debt through 2007 with figures updated through Mar. 6, 2008).

[13] *See* FEDERAL RESERVE BOARD, *Federal Debt Subject to Statutory Limitation*, *in* STATISTICAL SUPPLEMENT TO THE FEDERAL RESERVE BULLETIN, DECEMBER 2007, at 25, 25 (2007), *available at* http://www.federalreserve.gov/pubs/supplement/2007/12/table1_40.htm (providing public debt data as of Sept. 30, 2007).

[14] *See Securities Issuance Rises to $5.06 Trillion Year-to-Date; Credit Market Conditions Reduce Third-Quarter Volume*, *in* RES. Q. (Sec. Indus. & Fin. Mkts. Ass'n, New York, N.Y.), Nov. 29, 2007, at 1, 1, *available at* http://www.sifma.org/research/research-quarterly.shtml (providing corporate debt data as of Sept. 30, 2007).

[15] *See generally* INTERNATIONAL FINANCIAL CONTAGION (Stijn Claessens & Kristin J. Forbes eds., 2001) (describing spread of turmoil through international financial markets causing collapse of large U.S. hedge fund); *see also infra* notes 143–46 and accompanying text.

Freddie's obligations. The Article contends that investors in Fannie and Freddie securities would likely not have any legally enforceable claim of a guarantee against the federal government should Fannie and Freddie default. Despite the absence of such a legally enforceable claim, this Article demonstrates that, as a practical matter, Fannie and Freddie are so deeply enmeshed in the regulatory regimes of other American financial institutions that the federal government has effectively signaled that it would support Fannie and Freddie if they were unable to make payments on their obligations. The federal government would provide this support in order to avoid a financial contagion that could quickly spread throughout the global financial markets. The federal government's guarantee of Fannie and Freddie's obligations is, thus, *implied* in the American financial system's regulatory environment.

This implied guarantee, in turn, presents enormous potential costs to American taxpayers. In exchange for shouldering these potential costs, American homeowners are eligible for a modest reduction in their monthly mortgage payments, which is just a small portion of the value of the implied guarantee that the federal government has given to Fannie and Freddie.[16] Ultimately, this presents a poor trade-off for American homeowners and taxpayers who would be called upon to support any bailout.

The once seemingly remote possibility of a bailout has become more likely as a result of the ongoing meltdown in the mortgage markets. In addition, serious accounting scandals involving the misstatement of earnings have swept over the two companies, exposing the operational risk to which these companies are exposed.[17] Compounding these risks are the hedging strategies used by the two companies: if the interest payments that they owe to their lenders become mismatched with the interest payments they receive from homeowners whose mortgages they own, the companies could become insolvent.[18] It was an analogous mismatch between interest rates on long term mortgages and short term interest rates on savings deposits that caused the Savings & Loans collapse of the 1980s.[19] If Fannie and Freddie were to find that they were

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[16] *See infra* notes 132–33, 266 and accompanying text.

[17] *See infra* Part II.B.

[18] *See infra* Part II.

[19] *See* Timothy Curry & Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, 13 FDIC BANKING REV. 26, 27 (2000) (discussing reasons for collapse), *available*

paying more to borrow from investors than they were receiving in income from their mortgage portfolio they too could become insolvent. And if that were to happen, the costs of a bailout could easily dwarf the tens of billions of dollars that the government spent resolving the Savings & Loans crisis of the 1980s because Fannie and Freddie have trillions of dollars of obligations outstanding.[20]

The Article proceeds as follows. Part II first offers a brief history of Fannie and Freddie and their role in the creation and development of the secondary mortgage market.[21] Part II then introduces the loose regulatory environment in which Fannie and Freddie operate and provides a history of the recent accounting scandals that have accentuated the risks that the implied guarantee poses to the federal government. It closes with a review of the recent battles in Congress to impose a stricter regulatory framework on Fannie and Freddie, two entities known for their extraordinary lobbying might. As of this writing, Fannie and Freddie's critics have not been able to enact any legislation that would restrict their operations, which continues to expose the federal government to the contingent liability of the implied guarantee.

Part III reviews the various understandings of the implied guarantee put forward by market players, the federal government, Fannie and Freddie themselves, and scholars who study Government Sponsored Enterprises (GSEs).[22] The understanding of the implied guarantee varies dramatically among these parties and changes over time in reaction to changes in the law and in the market. This has created significant confusion regarding the meaning of the term "implied guarantee," which this Article hopes to resolve. Having a clear understanding of the implied guarantee, in the realm of finance, is the equivalent of having a clear understanding of the New Orleans levee system before Hurricane Katrina; without it, we

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at http://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf.

[20] *See id.* at 33 (providing figures for cost of Savings & Loans crisis); *supra* note 12 and accompanying text (regarding Fannie and Freddie obligations).

[21] The market for mortgage-backed securities is known as the "secondary mortgage market" or "secondary market" for short.

[22] The term "GSE" refers to "a federally chartered, privately owned, privately managed financial institution that has only specialized lending and guarantee powers and that bond market investors perceive as implicitly backed by the federal government." Richard Scott Carnell, *Handling the Failure of a Government-Sponsored Enterprise*, 80 WASH. L. REV. 565, 570 (2005); *see also* 2 U.S.C. § 622 (2006) (giving similar definition for purposes of Congressional Budget Act).

cannot properly assess risks and make appropriate contingency plans to respond to likely catastrophic scenarios.

Part III catalogues and explains the Byzantine web of regulatory privileges granted to Fannie and Freddie by their enabling statutes and other federal statutes and regulations. This Part offers the most comprehensive analysis of these privileges that has been done to date. Part IV then argues that these numerous regulatory privileges form the basis for the federal government's implied guarantee of Fannie and Freddie's obligations because they entangle the financial health of the two companies with that of so many other financial institutions. Taken as a whole, Part IV provides a definitive analysis of the legal status of the implied guarantee.

Part V proposes that Congress terminate the implied guarantee of Fannie and Freddie's obligations in order to protect American taxpayers from the hundreds of billions of dollars of potential liability that the implied guarantee represents. In particular, it proposes that Fannie and Freddie be privatized, along the model of the successful privatization of Sallie Mae (originally, the "Student Loan Marketing Association"), a former GSE that is now a fully-private corporation. Finally, Part V compares Fannie and Freddie to the Second Bank of the United States and concludes that a focused federal government can rein in a privileged financial institution so long as it is prepared for a fight from the beneficiaries of those privileges.

II. FANNIE AND FREDDIE CREATE THE MODERN SECONDARY MORTGAGE MARKET

Mortgages have always been bought and sold by investors, but until relatively recently, the secondary mortgage market has been an informal arrangement.[23] The introduction of residential mortgage-backed securities (RMBS) in the 1970s changed that; once mortgages are converted into RMBS, they can be easily traded on the secondary market with comparatively few transaction costs.[24] In the simplest terms, this is how it works:

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[23] Robert Van Order, *The U.S. Mortgage Market: A Model of Dueling Charters*, 11 J. HOUSING RES. 233, 236 (2000).

[24] *See id.* ("The rise in the secondary market in the 1970s and (especially) 1980s came about largely because of standardization of pools of mortgages . . . .").

> 1. Borrowers get mortgages from lenders in the primary market;[25]
> 2. primary market lenders then sell these mortgages to secondary mortgage market firms and use the proceeds to originate more mortgages in the primary market;[26] and
> 3. the secondary mortgage market firms then sell securities backed by the mortgages that they purchased to investors and use the proceeds of the sale to purchase more mortgages from primary market lenders.[27]

The most important factor in the development of the secondary mortgage market has been the creation of two GSEs by the federal government: Fannie Mae and Freddie Mac.[28] These two companies were unlike nearly all other financial institutions in the 1970s in that their businesses were not geographically restricted and they could develop a truly national market for mortgages.[29]

Fannie Mae was created in the 1930s to provide a government-owned secondary market for loans insured by the Federal Housing

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[25] *See Proposals for Reforming the Regulation of the Government-Sponsored Enterprises: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs,* 109th Cong. 4 (2005) (statement of Michael F. Petrie, Chairman, Mortgage Bankers Association) ("In the primary market, retail consumers consult lenders and brokers to learn about the types of loans available, decide which type meets their needs, and apply for loans. The lender counsels the consumer, takes and processes the loan application and obtains supporting information, such as a property appraisal and credit history. If approved, the lender agrees to make a loan to the consumer, funds it, and closes the loan. This process, from the consumer's first interest in a loan through and including funding and closing the consumer's loan, is called loan origination. Loan origination and its related activities are the work of the primary market.").

[26] *See* Our Role Within the Secondary Market-Freddie Mac, http://www.freddiemac.com/corporate/company_profile/our_role_secmkt/index.html (last visited July 20, 2008) (showing how Freddie Mac enters secondary market).

[27] *See id.* ("Freddie Mac uses the funds from sales of these securities sales to purchase more loans from primary lenders.").

[28] *See* Van Order, *supra* note 23, at 236 (discussing history of secondary mortgage market).

[29] THOMAS H. STANTON, DEVISING AN EFFECTIVE LEGAL FRAMEWORK FOR SUPERVISING THE PUBLIC BENEFITS AND PUBLIC COSTS OF GOVERNMENT SPONSORED ENTERPRISES 2–3 (1999), *available at* http://wbln0018.worldbank.org/html/FinancialSectorWeb.nsf/(attachment web)/september8,2000finalpaper/$FILE/september+8,+2000+final+paper.pdf (noting that Fannie and Freddie's national charters allowed them to overcome market imperfections in 1970s and 1980s that resulted from legal restrictions on banks and thrifts that since have been lifted). With the modernization of the financial system, the *raison d'être* of Fannie and Freddie disappeared, but they remained. *See* CARL FELSENFELD, BANKING REGULATION IN THE UNITED STATES 152–62 (1998) (reviewing loosening of restrictions on interstate banking in latter part of twentieth century).

Administration.[30] In 1954, Fannie Mae was reorganized to allow private capital to replace federal funds.[31] It operated by issuing its debt and purchasing mortgages that it held in its portfolio.[32] The Housing and Urban Development Act of 1968 partitioned Fannie Mae into a privately-financed secondary market institution, today's Fannie Mae, and a government agency called the Government National Mortgage Association, today's Ginnie Mae.[33]

Freddie Mac was created by the Emergency Home Finance Act of 1970 (EHFA) to form a secondary market for Savings and Loan (S&L) mortgages.[34] Freddie Mac was initially owned by the Federal Home Loan Bank System and its member thrifts; now it is a publicly-traded company like Fannie Mae.[35] When it was first created, Freddie Mac purchased mortgages from S&Ls, and Fannie Mae purchased mortgages from mortgage bankers; their purchasing practices have since converged.[36]

Fannie and Freddie, along with Ginnie Mae,[37] have made the U.S. secondary residential mortgage market "the envy of every other

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[30] Van Order, *supra* note 23, at 236. Fannie Mae was created pursuant to the National Housing Act of 1934, Pub. L. No. 73-479, 48 Stat. 246, which authorized the establishment of National Mortgage Associations. THOMAS H. STANTON, A STATE OF RISK: WILL GOVERNMENT-SPONSORED ENTERPRISES BE THE NEXT FINANCIAL CRISIS? 202 (1991). "In 1938, the Reconstruction Finance Corporation established [Fannie Mae] as a subsidiary." *Id.* Fannie Mae's charter is codified at 12 U.S.C. §§ 1716–1723d (2006). *Id.*

[31] Michael J. Lea, *Innovation and the Cost of Mortgage Credit: A Historical Perspective*, 7 HOUSING POL'Y DEBATE 147, 164 (1996).

[32] Van Order, *supra* note 23, at 236.

[33] *See id.* ("[GNMA] was created in 1968 to handle Fannie Mae's policy-related tasks and to provide a secondary market for government-insured loans. It is on the federal budget as part of the U.S. Department of Housing and Urban Development (HUD).

GNMA was responsible for promoting the major innovation in secondary markets, the MBS. . . . GNMA deals only in federally insured mortgages, primarily those insured by the FHA and the U.S. Department of Veterans Affairs, which account for 10 to 15 percent of the market.").

[34] About Fannie Mae > Our Charter, http://www.fanniemae.com/aboutfm/charter.jhtml ?p=About+Fannie+Mae (last visited July 20, 2008).

[35] *See* Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (codified in scattered sections of 12 U.S.C.) (converting Freddie Mac's ownership structure). The term "thrifts" is a catchall that includes savings and loans, savings banks, and mutual savings banks. *See* 12 U.S.C. § 1841(i) (2006) (defining "thrift institution" for purposes of Bank Holding Company Act of 1956).

[36] Van Order, *supra* note 23, at 236. While Fannie and Freddie started out with different missions, they grew to have the same one. *See id.* at 236 ("Fannie Mae and Freddie Mac are now . . . quite similar . . . ."). The fact that there are two such entities may be seen as a historical accident or as a way to ensure some competition in the conforming mortgage market.

[37] *See id.* at 236 (describing Ginnie Mae's role in secondary markets); *see also* PETER J. WALLISON & BERT ELY, NATIONALIZING MORTGAGE RISK: THE GROWTH OF FANNIE MAE AND

country."[38] While Fannie Mae had created a secondary market for government guaranteed and insured residential mortgage loans prior to 1970, the broad secondary market began in earnest with the passage of the EHFA, which created Freddie Mac and allowed both GSEs to purchase and securitize conventional mortgages as well as government-insured or guaranteed mortgages.[39] In the late 1970s, RMBS securitization took off as traditional lenders could not keep up with the demand for home mortgages.[40] Securitization is of such importance that it is no exaggeration to say that it is "the most important and abiding" financial innovation in recent history.[41]

Investment in RMBS exploded again after institutional investors entered the market; indeed, the RMBS market has increased by more than five hundred percent from 1984 through the early 2000s.[42] Starting sporadically in the late 1970s, non-federal-related issuers, such as commercial banks and mortgage companies, began to issue RMBS.[43] These "private label" RMBS are issued without a government or GSE guarantee that Ginnie, Fannie, or Freddie would give, and they are typically backed by subprime and/or jumbo loans.[44]

FREDDIE MAC 7 (2000) (noting that because Ginnie Mae can obtain funds for Federal Housing Authority (FHA) and Veterans Affairs (VA) loan purchases at lower rates than any of its competitors (including Fannie and Freddie), those competitors cannot compete for those products). Ginnie Mae is not the subject of this Article because it is wholly-owned by the federal government, *see supra* note 33, and does not present the same set of issues that Fannie and Freddie do.

[38] Richard Roll, *Benefits to Homeowners from Mortgage Portfolios Retained by Fannie Mae and Freddie Mac*, 23 J. FIN. SERVICES RES. 29, 29 (2003).

[39] *See* Peter M. Carrozzo, *Marketing the American Mortgage: The Emergency Home Finance Act of 1970, Standardization and the Secondary Market Revolution*, 39 REAL PROP. PROB. & TR. J. 765, 793–97 (2005) (describing enactment of EHFA).

[40] *See* Leon T. Kendall, *Securitization: A New Era in American Finance*, *in* A PRIMER ON SECURITIZATION 1, 6 (Leon T. Kendall & Michael J. Fishman eds., 1996) (describing funding shortfall caused by strong desire for home ownership); *see also* Lewis S. Ranieri, *The Origins of Securitization, Sources of Its Growth, and Its Future Potential*, *in* A PRIMER ON SECURITIZATION, *supra*, at 31, 34 (providing firsthand account of early history of securitization).

[41] Kendall, *supra* note 40, at 1.

[42] KENNETH G. LORE & CAMERON L. COWAN, MORTGAGE-BACKED SECURITIES §§ 1.3, 2.23 (2005).

[43] *See* Joseph Philip Forte, *A Capital Markets Mortgage: A Ratable Model for Main Street and Wall Street*, 31 REAL PROP. PROB & TR. J. 489, 491 (1996) ("[S]ome isolated Private Label MBS issuance occurred in the late 1970s . . . ."); *see also* Eric Bruskin et al., *The Nonagency Mortgage Market: Background and Overview*, *in* THE HANDBOOK OF NONAGENCY MORTGAGE-BACKED SECURITIES 5, 8–9 (Frank J. Fabozzi et al. eds., 2d ed. 2000) (providing history of nonagency securitization from late 1970s through mid-1980s).

[44] *See* LORE & COWAN, *supra* note 42, § 2.23. The term "jumbo mortgages," analogous to jumbo loans, is defined *infra* at note 60.

Fannie and Freddie participate in the secondary market in two ways: (1) By issuing and guaranteeing RMBS for a fee and (2) by issuing debt and purchasing, for their own portfolios, mortgages and RMBS with the proceeds.[45] The two firms face a variety of risk in their lines of business. In both lines, Fannie and Freddie absorb the risk that the borrower will default,[46] although such risk historically has not been a great one.[47] As to the mortgages that Fannie and Freddie keep for their own accounts, prepayment risk (the risk that a borrower will prepay a mortgage prior to the end of its term when interest rates have dropped) poses a greater threat to profitability.[48] Prepayment risk is linked to interest rate risk (the risk that the payments that the two companies owe on the short-term debt that funds their mortgage purchases become mismatched with the payments they receive from the mortgages with long-term interest rates that Fannie and Freddie keep for their own account) which poses the greatest threat to Fannie and Freddie's financial health.[49] Finally, Fannie and Freddie are exposed to operational risk, "the risk of loss due to inadequate or failed internal procedures and systems."[50] The accounting scandals that have overtaken the two companies in recent years have highlighted the seriousness of this operational risk.[51]

Fannie and Freddie, as the dominant purchasers of residential mortgages, have effectively standardized prime residential

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[45] *See* About Fannie Mae: The Industry, http://www.fanniemae.com/aboutfm/industry/index.jhtml (last visited July 20, 2008) (explaining involvement in U.S. housing industry); Freddie Mac: Our Business, *supra* note 7 (describing activity in secondary mortgage market).

[46] Dwight M. Jaffee, *Reining in Fannie Mae and Freddie Mac*, REGULATION, Fall 2006, at 22, 22. The recent meltdown of the mortgage market may, however, bode more credit risk in the future. *See* James R. Hagerty, *Fannie, Freddie Are Said to Suffer in Subprime Mess*, WALL ST. J., July 28, 2007, at A3 (finding that Fannie and Freddie have avoided large losses from defaults on subprime loans but "are likely at least to be singed" in future).

[47] Anthony Pennington-Cross, *Patterns of Default and Prepayment for Prime and Nonprime Mortgages* 16 (OFHEO Working Paper 02-1, 2002) (finding monthly default rate of 0.029% for prime loans which make up bulk of Fannie and Freddie's obligations).

[48] *See* ERIC WEISS, LIMITING FANNIE MAE'S AND FREDDIE MAC'S PORTFOLIO SIZE 4 (Cong. Research Serv., CRS Report for Congress Order Code RS22307, Oct. 21, 2005) ("Prepayment risk is potentially more serious [than credit risk].").

[49] *See id.* at 4–5 ("Interest rate risk can be very serious. Many savings and loan associations became insolvent in the early 1980s because of it.").

[50] *Id.* at 5.

[51] *See id.* ("Fannie Mae's current accounting problems, and those of Freddie Mac in 2003, raise questions about internal controls."); *see also infra* Part II.B (describing recent accounting scandals).

mortgages by promulgating buying guidelines.[52] Such standardization has led to increases in the liquidity and attractiveness of mortgages as investments to a broad array of investors.[53]

The GSEs' charters restrict the mortgages they may buy.[54] In general, they may only buy mortgages with loan-to-value ratios of eighty percent or less unless the mortgage carries mortgage insurance or other credit support[55] and may not buy mortgages with principal amounts greater than an amount set each year.[56] Loans that comply with the restrictions placed on Fannie and Freddie are known as "conforming" loans.[57] Those that do not comply with either of these restrictions are known as "nonconforming" loans, which may not be purchased by Fannie or Freddie.[58]

Fannie Mae and Freddie Mac now own or securitize roughly forty percent of the outstanding stock of single-family residential mortgages.[59] The remainder of the secondary market (other than the

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[52] *See* STANTON, *supra* note 30, at 86 ("Together, Fannie Mae and Freddie Mac standardized the terms of mortgage loan documents and helped to standardize the procedures used by mortgage sellers and servicers, thereby facilitating the emergence of a highly efficient national secondary market for home mortgages."). Fannie Mae and Freddie Mac also have increased the safety of RMBS investments by offering credit guaranties, "which involve[ ] guaranteeing the credit performance of single-family and multifamily loans for a fee." Mortgage-Backed Securities: Understanding Fannie Mae As a Securities Issuer, http://www.fanniemae.com/mbs/understanding/index.jhtml (last visited July 23, 2008).

[53] *See* Raymond A. Jensen, *Mortgage Standardization: History of Interaction of Economics, Consumerism and Governmental Pressure*, 7 REAL PROP. PROB. & TR. J. 397, 400 (1972) (noting that Fannie Mae created task force to identify "substantive mortgage clauses which would be essential to make the [uniform form of] mortgage saleable to investors").

[54] S. Wayne Passmore et al., *GSEs, Mortgage Rates, and the Long-Run Effects of Mortgage Securitization*, 25 J. REAL EST. FIN. & ECON. 215, 217 (2002).

[55] *See* 12 U.S.C. § 1454(a)(2) (2006) (providing restrictions for Freddie Mac); *id.* § 1717(b)(2) (providing restrictions for Fannie Mae).

[56] *See* Press Release, Office of Fed. Hous. Enter. Oversight, 2007 Conforming Loan Limit To Remain at $417,000, at 1 (Nov. 28, 2006), *available at* http://www.ofheo.gov/media/pdf/PRConfLoan07.pdf ("The conforming loan limit determines the maximum size of a mortgage that an Enterprise can buy or guarantee."). The 2007 conforming loan limit for a single-family home is $417,000. *Id.*

[57] *See* Glossary of Finance and Economic Terms, A-F - Freddie Mac, http://www.freddiemac.com/smm/a_f.htm (last visited July 22, 2008) (defining "conforming mortgage").

[58] *See* Bruskin et al., *supra* note 43, at 6–7 (identifying major categories of nonconforming loans as jumbos and B/C quality, which includes subprime low-doc and no-doc loans); Passmore et al., *supra* note 54, at 218 ("Most private-sector securitizations are backed by jumbo mortgages or mortgages held by 'sub-prime' borrowers, the bulk of which have blemished credit histories but adequate assets or income to support a mortgage.").

[59] *See* Office of Federal Housing Enterprise Oversight, *supra* note 12 (showing residential mortgage debt outstanding).

portion originated by Ginnie Mae) comes from "private label" firms—a large component of which is composed of jumbo and subprime mortgage securitizations.[60] Private-label firms are not in a position to compete head on with GSEs as their cost of capital is greater.[61] Because of this advantage, Fannie Mae and Freddie Mac can price their securities more attractively than private label issuers, and therefore have nearly the entire prime, conforming market to themselves—a market in which they can effectively act as duopolists.[62]

A. FANNIE AND FREDDIE HAVE FUNCTIONED WITH LIMITED REGULATORY OVERSIGHT

Fannie and Freddie are regulated in some regards by the U.S. Department of the Treasury, in some regards by the U.S. Department of Housing and Urban Development (HUD), and in some regards by the Office of Federal Housing Enterprise Oversight (OFHEO), which is an independent agency located within HUD.[63] In part because of this divided regulatory regime, it is generally agreed that Fannie and Freddie are insufficiently monitored as compared to other federally regulated financial institutions such as members of the Federal Reserve System and the Federal Deposit Insurance Corporation.[64]

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[60] *See* Van Order, *supra* note 23, at 237 (describing breakdown of secondary mortgage market and use of "private label" secondary market). According to the Federal Reserve, FHA and VA loans constitute about eleven percent of the total residential mortgage market; commentators believe that jumbos make up another fifteen. WALLISON & ELY, *supra* note 37, at 7. "That leaves 74 percent of the total residential market in which Fannie and Freddie can invest. Of that portion most are conventional/conforming loans; the balance are subprime, home equity, and multifamily housing loans." *Id.* at 7–8. Those loans that comply with Fannie Mae and Freddie Mac requirements, except for the restriction on loan amount, typically are referred to as "jumbo mortgages." Passmore et al., *supra* note 54, at 218.

[61] WALLISON & ELY, *supra* note 37, at 1 ("The lower interest rates that Fannie and Freddie can command because of their government backing permit them to out-compete any private-sector rival and to dominate any market they are permitted to enter.").

[62] *See* STANDARD & POOR'S, PRICING AND PREPAYMENT CHARACTERISTICS OF NONCONFORMING MORTGAGE POOLS 1 (2000). The nonconforming rate usually is twenty-five to fifty basis points higher than the conforming rate. *Id.*

[63] *See generally* HUD's Regulation of Fannie Mae and Freddie Mac, http://www.hud.gov/offices/hsg/gse/gse.pdf (last visited Feb. 10, 2008) (describing how Fannie Mae and Freddie Mac are regulated).

[64] *See, e.g.*, LORETTA NOTT & BARBARA MILES, GSE REGULATORY REFORM: FREQUENTLY ASKED QUESTIONS 2 (Cong. Research Serv., CRS Report for Congress Order Code RS21724, Apr. 27, 2006) ("There is a general consensus that the current regulatory regime is ill-equipped

Pursuant to their charters, Fannie and Freddie must receive the approval of the Treasury before issuing debt.[65] While the Treasury does require that Fannie and Freddie abide by this provision, the Treasury has not been known to deny any of Fannie and Freddie's requests.[66]

While current law appears to grant HUD broad regulatory oversight of Fannie and Freddie, its supervision is mostly limited to reviewing new programs that Fannie and Freddie want to initiate and ensuring that Fannie and Freddie comply with the affordable housing goals that have been set for them by statute.[67] Fannie and Freddie have not always acted consistent with this regulatory regime; Fannie and Freddie regulator, Assistant Secretary for Housing John Weicher, testified recently that he "sometimes learns about new GSE programs by reading about them in the newspaper," even though he has the responsibility to approve new programs.[68]

In 1992, Congress created OFHEO as an independent agency that was to be located within HUD, with responsibility for the "safety and soundness" regulation of Fannie and Freddie.[69] OFHEO has the

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to deal effectively with the housing GSEs.").

[65] *See* 12 U.S.C. § 1455(j)(1) (2006) (regarding Freddie) ("Any notes, debentures, or substantially identical types of unsecured obligations of the Corporation evidencing money borrowed, whether general or subordinated, shall be issued upon the approval of the Secretary of the Treasury and shall have such maturities and bear such rate or rates of interest as may be determined by the Corporation with the approval of the Secretary of the Treasury."); *id.* § 1719(b) (regarding Fannie) ("[T]he corporation is authorized to issue, upon the approval of the Secretary of the Treasury, and have outstanding at any one time obligations having such maturities and bearing such rate or rates of interest as may be determined by the corporation with the approval of the Secretary of the Treasury . . . .").

[66] *See* Randal K. Quarles, Under Sec'y for Domestic Fin., U.S. Dep't of the Treasury, Address Before the Women in Housing and Finance (June 13, 2006) (transcript available at http://www.treas.gov/press/releases/js4316.htm) (noting that Freddie and Fannie have obtained approval from Treasury for all debt issues).

[67] *See* 12 U.S.C. § 4541 ("Except for the authority of the Director of the Office of Federal Housing Enterprise Oversight . . . , the Secretary of Housing and Urban Development shall have general regulatory power over each enterprise . . . ."); *id.* § 4542 (granting authority for approval of new programs)*; id.* §§ 4561–4567 (providing affordable housing goals). Prior to the enactment of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, *id.* §§ 4501–4641, HUD had greater regulatory oversight of Fannie and Freddie; *see* HUD's Regulation of Fannie Mae and Freddie Mac, *supra* note 63 (noting that Fannie and Freddie have been regulated by HUD since 1968 and 1989 respectively). Freddie also had been regulated by the Federal Home Loan Bank Board in the past. W. Scott Frame & Lawrence J. White, *Fussing and Fuming over Fannie and Freddie: How Much Smoke, How Much Fire?*, 19 J. ECON. PERSP. 159, 174 n.10 (2005) (describing timeline of responsibility over Freddie).

[68] MORTGAGE BANKERS ASS'N, WHY THE BRIGHT LINE HELPS MORTGAGE MARKETS 6 (2005).

[69] Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Pub. L. No. 102-550, 106 Stat. 3941 (codified as amended at 12 U.S.C. §§ 4501–4641).

authority to regulate Fannie and Freddie in the following important ways: establish capital standards; conduct financial examinations; determine capital levels; and appoint conservators, if necessary.[70] Scott Frame and Lawrence White interpret the federal government's creation of OFHEO as an admission of its "concern about the likely political reality of the implied guarantee; paradoxically, this regulation may also strengthen the financial markets' belief in an implied guarantee."[71] Yet, according to leading critics of Fannie and Freddie, OFHEO "lacks many of the powers routinely provided the regulators of depository institutions."[72] Professor Carnell presents further detail about OFHEO's shortcomings:

> Congress created OFHEO with significant structural weaknesses. Specifically, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 . . . created a small, hyper-specialized agency—with uncertain funding and overly narrow powers—to regulate two huge, relatively homogeneous firms with great political clout. The Act housed that agency in a department with no institutional commitment to safety and soundness, little credibility to spare, and little ability to protect OFHEO against pressure from Fannie and Freddie.[73]

OFHEO's structural weaknesses may have, in part, led to the accounting scandals that engulfed Fannie and Freddie in the last few years.

B. FANNIE AND FREDDIE'S RECENT ACCOUNTING SCANDALS EXPOSE THE RISKS POSED BY THEIR OPERATIONS

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[70] 12 U.S.C. § 4513. OFHEO does not have, however, "the authority to alter these standards, which prevents the enforcement of greater capital requirements when there is an increase in perceived risk due to unsafe or unsound practices." NOTT & MILES, *supra* note 64, at 5.

[71] W. Scott Frame & Lawrence J. White, *Competition for Fannie Mae and Freddie Mac?*, 27 REGULATION 56, 58 (2004).

[72] PETER J. WALLISON, THOMAS H. STANTON & BERT ELY, PRIVATIZING FANNIE MAE, FREDDIE MAC, AND THE FEDERAL HOME LOAN BANKS: WHY AND HOW 7 (2004).

[73] *Improving the Regulation of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. 2 (2004) [hereinafter *Improving*] (statement of Richard S. Carnell, Professor, Fordham University School of Law), *available at* http://banking.senate.gov/_files/carnell.pdf.

Fannie and Freddie are well known for the political clout they wield on Capitol Hill.[74] But the waves of scandals that surfaced and continue to surface have weakened them somewhat. As a result, Congress has seriously considered bills that would increase the regulation of these two companies and limit their reach.[75] None of these bills, however, sought to end the implied guarantee or the Fannie/Freddie duopoly in the prime, conforming market. Thus, they are, at best, half-measures in terms of protecting the federal government from the massive contingent liabilities represented by the implied guarantee.

The two companies' recent troubles can be traced to June 9, 2003, when Freddie Mac announced that it had fired its President and Chief Operating Officer David Glenn.[76] These troubles revealed, to an extent not seen before, the level of operational and interest rate risk to which Fannie and Freddie's massive mortgage portfolios were exposed.[77] Freddie Mac fired Glenn because he had not cooperated fully with an internal review of the company's accounting practices that was being conducted by OFHEO.[78] Freddie's Chairman and Chief Executive Officer, Leland Brendsel, and its Chief Financial Officer, Vaughn Clarke, resigned soon thereafter.[79] A short time later, Freddie Mac announced that it would have to restate its earnings for 2000–2002.[80]

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[74] *See infra* notes 106, 112 and accompanying text.

[75] *See* N. ERIC WEISS, FANNIE MAE AND FREDDIE MAC: PROPOSALS TO REGULATE THEIR MORTGAGE PORTFOLIO SIZE IN THE 110TH CONGRESS 1–2 (Cong. Research Serv., CRS Report for Congress Order Code RL34236, Nov. 5, 2007), *available at* http://opencrs.cdt.org/document/RL34236 ("Congressional . . . action to increase GSE portfolios is being considered . . . .").

[76] *See* Press Release, Freddie Mac, Termination Provisions Relating to David Glenn 1 (June 11, 2003), *available at* http://www.freddiemac.com/news/glenn_comp.pdf ("Mr. Glenn was terminated for cause on June 6, 2003 . . . .").

[77] For a discussion of operational and interest rate risk, see *supra* notes 48–51 and accompanying text. Since 2003, Fannie and Freddie have increased their reliance on callable debt, which helps, to some extent, reduce their exposure to interest rate risk. *See* Allison Bisbey Colter, *Fannie, Freddie Are Expected to Shorten up Callable Debt*, WALL ST. J., June 7, 2005, at C4 (explaining relationship between callable debt and interest rate swings for Fannie and Freddie).

[78] Alex Berenson, *Mortgage Concern in Broad Shake-Up*, N.Y. TIMES, June 10, 2003, at A1.

[79] Jonathan D. Glater, *Freddie Mac Board Forced to Remove Chief Executive*, N.Y. TIMES, Aug. 23, 2003, at C1.

[80] *Fannie Mae Chronology*, L.A. TIMES, May 23, 2006, http://www.latimes.com/ business/investing/wire/sns-ap-fannie-mae-chronology,1,2072391.story?coll=sns-ap-investing-headlines.

Following this shake-up, investors began to question corporate governance at Fannie Mae.[81] In response, Fannie Mae's Chief Executive Officer, Franklin Raines, said that he believed his company had unfairly suffered "collateral damage" to its public image and business as a result of the improprieties at Freddie Mac, and further stated that "[u]nlike Freddie Mac, we didn't do any of these things."[82]

Except they did. In October 2003, Fannie Mae revealed an accounting error of over $1 billion for the third quarter.[83] Though it was not clear that the error had been intentional, it caused further doubt about the company's accounting practices. Reports of Fannie Mae's troubles continued to come out in dribs and drabs, keeping it in the news far more than Freddie. On September 22, 2004, Fannie Mae confirmed that the Securities and Exchange Commission commenced an investigation into its bookkeeping.[84] Fannie Mae acknowledged that the investigation was initiated due to OFHEO's review of the company's finances, which had uncovered serious accounting problems and earnings manipulation.[85] In response, Fannie Mae's board hired attorney, and former U.S. Senator, Warren Rudman, as an independent counsel.[86]

Just days later, on September 27, 2004, Fannie Mae agreed to boost its capital reserves by an estimated $4 to $5 billion and to take other actions such as tightening internal controls.[87] This was done in response to mounting concern about its stability, as well as pressure from OFHEO.[88] Rounding out the turbulent month of September was an announcement by the Justice Department that it had begun a criminal investigation of accounting at Fannie Mae.[89] With Fannie

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[81] *See* David S. Hilzenrath, *Fannie Mae Defends Its Reputation: CEO Decries Confusion with Freddie Mac Woes*, WASH. POST, July 31, 2003, at E1 (discussing "investors' uncertainty in the aftermath of the Freddie Mac accounting scandal").

[82] *Id.*

[83] *See* Jonathan Glater, *Fannie Mae Corrects Mistakes in Results*, N.Y. TIMES, Oct. 30, 2003, at C1 ("Fannie Mae announced yesterday that it had corrected errors in its most recent financial results, which in some cases varied from the correct amounts by more than $1 billion.").

[84] Jennifer Lee, *S.E.C. Opens Investigation of Fannie Mae,* N.Y. TIMES, Sept. 23, 2004, at C1.

[85] *Id.*

[86] *Id.*

[87] James R. Hagerty & John D. McKinnon, *Fannie Mae Board Agrees to Changes It Long Resisted*, WALL ST. J., Sept. 28, 2004, at A1.

[88] *Id.*

[89] John R. Wilke, John D. McKinnon & James R. Hagerty, *Fannie Criminal Probe Is*

Mae on the defensive, CEO Franklin Raines and CFO Timothy Howard testified at a congressional hearing on October 6, 2004, in defense of the company's business practices, explaining that the allegations against Fannie Mae were simply a reflection of different interpretations of complex rules.[90] One month later, Fannie Mae failed to file its third-quarter financial results with the SEC.[91] Fannie Mae's failure was the result of its independent auditor, KPMG, refusing to sign off on the report.[92] In response, the company was forced to acknowledge that some of its accounting practices did not comply with standard accounting principles, and further noted that if the SEC decided it had improperly accounted for derivatives (the financial instruments used to hedge against interest rate swings) it would show a net loss of $9 billion.[93]

On December 15, 2004, the SEC affirmed OFHEO's findings and ordered Fannie Mae to restate its earnings back to 2001 because it had violated accounting rules for derivatives and prepaid loans.[94] OFHEO director Armando Falcon Jr. testified to Congress that the company had engaged in a "pervasive and willful misapplication of generally accepted accounting principles."[95] Less than one week later, both CEO Raines and CFO Howard were forced out by Fannie's board.[96]

February 2005 brought news of further accounting problems as investigations into the company's internal controls continued. At the same time, rule changes and restructuring began. Fannie Mae agreed, in accord with OFHEO findings, to new accounting policies, in addition to dividing Chairman and CEO into two separate jobs.[97] In March, Fannie Mae disclosed that it might have to record an

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Launched, WALL ST. J., Sept. 30, 2004, at A2.

[90] *See* Stephen Labaton, *Chief Says Fannie Mae Did Nothing Wrong*, N.Y. TIMES, Oct. 7, 2004, at C1 (noting dispute over "company's presentation that the accounting issues reflected judgments over ambiguous standards").

[91] *Fannie Mae Misses Quarterly Report Filing*, N.Y. TIMES, Nov. 16, 2004, at C15.

[92] *Id.*

[93] *Id.* It should be noted that the underlying prime mortgage market was quite healthy in the late 1990s and early 2000s. *See* MORTGAGE BANKERS ASS'N, NATIONAL DELINQUENCY SURVEY, FOURTH QUARTER 2006, at 3 (2007) (showing foreclosure and delinquency rates).

[94] Stephen Labaton, *Fannie Mae Told to Revise Profit*, N.Y. TIMES, Dec. 16, 2004, at A1.

[95] Floyd Norris, *Bottom Line at Fannie Mae: Looking Safe vs. Being Safe*, N.Y. TIMES, Dec. 17, 2004, at C4.

[96] Stephen Labaton, *Chief Is Ousted at Fannie Mae Under Pressure*, N.Y. TIMES, Dec. 22, 2004, at A1.

[97] *Fannie Mae Agrees to Changes to Prevent Faulty Accounting*, N.Y. TIMES, Mar. 9, 2005, at C10.

additional loss of $2.4 billion.[98] When the Rudman Report was finally released on February 23, 2006, it both detailed the deficiencies in the company's financial controls and identified former CFO Timothy Howard and former Controller Leanne Spencer as those with primary responsibility for the deficiencies.[99] OFHEO's report, released in May 2006, found that Fannie Mae had undertaken risky business practices, including interest rate risk that led to billions of dollars of losses, had engaged in accounting manipulation aimed at lining executives' pockets, had a pliant board of directors, and had portrayed a false image of company excellence.[100] Following the report, Fannie Mae reached a settlement with OFHEO and the SEC to pay $400 million in fines, and limit the growth of its mortgage holdings.[101]

Freddie and Fannie's scandals were actually quite distinct. Freddie restated its earnings because it was over-reserved.[102] Fannie restated its earnings because of unaccounted-for losses.[103] Nonetheless, while these accounting scandals did not reveal that Fannie and Freddie were ever near insolvency, they did demonstrate that the two GSEs were exposed to operational risk. And operational risk, in another market, could have led to insolvency and financial contagion. Congress was thus encouraged to reconsider the regulatory environment for the two companies.

C. CONGRESS RESPONDS TO THE RISKS, BUT JUST BARELY

Long-time critics of Fannie and Freddie seized upon these events as an opportunity to impose additional restrictions on the mortgage finance giants.[104] Despite the attention that has been paid to this

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[98] *Fannie Mae to Delay Filing Annual Report*, N.Y. TIMES, Mar. 18, 2005, at C16.

[99] *See* PAUL, WEISS, RIFKIND, WHARTON & GARRISON, LLP, A REPORT TO THE SPECIAL REVIEW COMMITTEE OF THE BOARD OF DIRECTORS OF FANNIE MAE 5 (2006), *available at* http://download.fanniemae.com/execsum.pdf ("[W]e conclude that Howard, the former CEO, and Leanne Spencer, the former Controller, were primarily responsible for adopting or implementing accounting practices that departed from GAAP . . . .").

[100] *See* Press Release, Office of Fed. Hous. Enter. Oversight, OFHEO Report: Fannie Mae Facade 4 (May 23, 2006), *available at* http://www.ofheo.gov/media/pdf/fnmserelease.pdf (summarizing report's findings).

[101] *Fannie Mae Chronology*, *supra* note 80.

[102] *See* Patrick Barta & John D. McKinnon, *Freddie Mac Gets $125 Million Fine to Settle Case*, WALL ST. J., Dec. 11, 2003 at A3 (discussing causes of accounting abuses at Freddie Mac).

[103] *See supra* notes 93, 98 and accompanying text.

[104] *See infra* notes 251–61 and accompanying text.

chorus of voices and the growing coalition arguing for GSE regulatory reform, at present Congress has yet to pass legislation to effect such changes, although it has considered a number of bills that do so.[105] There are two possible explanations for Congress's failure to act on this. First, there are the formidable lobbying forces of Fannie Mae and Freddie Mac.[106] Second, there is substantial debate as to both the appropriate breadth and details of GSE regulatory reform, which this Article addresses.[107]

In 2005, Congress considered an oversight bill that appeared to have some bipartisan support.[108] The bill would have slightly

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[105] *See, e.g.*, Clyde Mitchell, *Government-Sponsored Enterprises – Are We There Yet?*, N.Y.L.J., Apr. 18, 2007, at 3 (reviewing recently proposed GSE legislation). Congress has considered a proposal to temporarily raise the limit on the size of mortgages that Fannie and Freddie can purchase from certain high-cost areas like San Francisco and New York City. *See* Sara Murray & Jonathan Karp, *Will New Rules on Mortgages Help Borrowers?*, WALL ST. J., Feb. 7, 2008, at D1 (discussing proposal and potentially benefited geographic areas). Congressional insiders believe that this proposal, which is part of a broader economic stimulus package, is likely to become law. *See id.* ("[C]ongressional insiders say [the Senate] is all but certain to accept the House provisions on Fannie and Freddie."); *see also* Sarah Lueck, *House Stimulus Bill Likely to Stand – Few Changes Are Expected to Survive Senate Debate*, WALL ST. J., Feb. 1, 2008, at A2 (discussing possibility of economic stimulus bill passing).

[106] *See* Charles W. Calomiris, *An Economist's Case for GSE Reform, in* SERVING TWO MASTERS, YET OUT OF CONTROL 85, 98 (Peter J. Wallison ed., 2001) ("Observers of the current GSEs often note that they spend an enormous amount of resources, time, and effort lobbying the federal government to influence economic policy. Fannie Mae and Freddie Mac's senior executives often seem to be hired more for their political connections than for their knowledge of the mortgage market."); JOHN J. KRIZ, MOODY'S INVESTORS SERV., GOVERNMENT-SPONSORED ENTERPRISES (GSEs) 3 (2003), *available at* http://www.moodys.com/moodys/cust/research/MDCdocs/20/2002400000428248.pdf ("The potential for governmental support can be enhanced by the presence of powerful political constituencies that are interested in the GSE's survival -- whether or not the GSE's policy role is deemed to be 'vital' to the overall national interest."); Jonathan G.S. Koppell, *Hybrid Organizations and the Alignment of Interests: The Case of Fannie Mae and Freddie Mac,* 61 PUB. ADMIN. REV. 468, 468–78 (2001) (providing history of intensive Fannie and Freddie lobbying of Congress prior to passage of Federal Housing Enterprise Financial Safety and Soundness Act of 1992). Fannie and Freddie's lobbying might have waxed and waned to some extent in response to various scandals and crises. *See, e.g.*, Eric Dash, *Fannie Mae's Offer to Help Ease Credit Squeeze Is Rejected, As Critics Complain of Opportunism*, N.Y. TIMES, Aug. 11, 2007, at C1 (noting "political maneuvering" of Fannie and Freddie and their critics in response to credit crisis).

[107] *See infra* Part V.

[108] *See* CANFIELD & ASSOCS., INC., THE GSE REPORT 5 (2007), *available at* http://www.gsereport.com/2007/Jan%208-Jan%2022.pdf (discussing proposed GSE reform). Increasing regulatory oversight is a perennial favorite, given that it is relatively easy to legislate. *See, e.g.*, W. Scott Frame & Lawrence J. White, *Regulating Housing GSEs: Thoughts on Institutional Structure and Authorities*, FED. RES. BANK OF ATLANTA ECON. R., Second Quarter 2004, at 87, 89 ("During the summer of 2003, several members of Congress introduced bills aimed at strengthening the current supervisory and regulatory framework for Fannie Mae and Freddie Mac."); *see also supra* note 105 and accompanying text.

increased the funding and supervisory power of Fannie and Freddie's safety and soundness regulator, OFHEO.[109] But the bill would have left OFHEO far weaker than necessary to supervise these two financial behemoths. And of greatest importance, the bill did not address the fundamental problem with Fannie and Freddie—the federal government's implied guarantee of their enormous financial obligations. In any event, the mounting credit squeeze that began in the summer of 2007 put GSE reform on hold.[110]

The accounting scandals revealed the extent to which GSEs could be exposed to operational and interest rate risk.[111] They also gave Fannie and Freddie's critics in Congress and elsewhere the cover to push for various reforms. But the extent to which the Fannie and Freddie duopoly has been able to fend off such reforms is a testament to their extraordinary influence in Washington.[112] Indeed, a *New York Times* news article once described Fannie Mae as politically untouchable, with "its army of high-powered lobbyists, its board and executive ranks stacked with Washington power brokers of all political stripes, a portfolio of $1 trillion and an apple pie core mission of helping people afford to buy housing . . . ."[113]

The debates concerning the appropriate safety and soundness regulation of Fannie and Freddie occur without much reference to the more fundamental question: Should Fannie and Freddie be treated so differently from other federally regulated financial institutions? This is in part because of the ambiguity that surrounds their special status, in particular, the ambiguity surrounding the implied guarantee of their obligations by the federal government. Until the scope of the implied guarantee is sufficiently defined,

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[109] H.R. 1461, 109th Cong. (2005). The bill also would have mandated that Fannie and Freddie place up to $500 million of their profits into an affordable housing fund. *Id.* This, no doubt, explains why the bill was so popular in the House. At the same time that it would impose these modest burdens on Fannie and Freddie, the bill actually would increase the conforming loan limit in certain high cost markets like New York and California—thereby allowing Fannie and Freddie to increase their market share. *Id.* This, no doubt, explains why the bill was acceptable to Fannie and Freddie.

[110] *See* Stacy Kaper, *Economy May Force Housing Legislation to Back Burner*, AM. BANKER, Jan. 17, 2008, at 3 ("As lawmakers rush to respond to the risk of a recession, they are pushing aside issues like mortgage bankruptcy reforms . . . .").

[111] *See supra* note 77 and accompanying text.

[112] *See* Damian Paletta, *House Backs Fannie, Freddie Bill, but Obstacles Loom in Senate*, WALL ST. J., May 23, 2007, at A12 (describing how Fannie and Freddie's Congressional allies have worked to limit scope of safety and soundness regulation).

[113] Jennifer Lee & Eric Dash, *Long Insulated, Fannie Mae Feels Political Heat,* N.Y. TIMES, OCT. 6, 2004, at C1.

Congress will not be able to properly assess how its safety and soundness should be regulated.

III. DOES THE FEDERAL GOVERNMENT'S IMPLIED GUARANTEE OF FANNIE'S AND FREDDIE'S OBLIGATIONS EXIST?

As noted above, the mandatory language required on Fannie's and Freddie's securities, as specified in their charters, indicates that their "obligations, together with the interest thereon, are not guaranteed by the United States and do not constitute a debt or obligation of the United States or of any agency or instrumentality thereof other than the corporation."[114] Notwithstanding the disclaimer language of Fannie's and Freddie's charters and securities, a consensus exists that there is a widespread perception of an implied guarantee of Fannie's and Freddie's obligations by the federal government, meaning that the federal government will assist them if they face financial difficulty. As a result, investors are willing to pay a premium for Fannie's and Freddie's securities over that which they would pay for the debt securities of other private companies.[115]

The depth, breadth and solidity of that perceived implied guarantee, however, is widely debated by market players, government officials, Fannie and Freddie themselves, and scholars. This Article argues that, while the federal government's support may not be a legally enforceable obligation of the federal government, it is more solid than the mere perception of support; it is an actual "implied guarantee" that has been written into the statutes and regulations governing Fannie, Freddie, and other financial institutions.

Market players, the entities that buy and sell Fannie and Freddie securities, speak with one voice regarding the relationship between the federal government and Fannie and Freddie; the federal government does, indeed, extend an implied guarantee to Fannie's and Freddie's obligations. Market players put their money where

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[114] *See* sources cited *supra* note 9.

[115] Wayne Passmore, *The GSE Implicit Subsidy and the Value of Government Ambiguity*, 33 REAL EST. ECON. 465, 483 (2005) ("One manifestation of the implicit subsidy is that investors view GSE assets as generally safer than most other financial assets, but GSE returns on equity are higher—contrary to the common view that financial markets generally reward taking increased risk with higher financial returns.").

their mouths are; they routinely purchase Fannie and Freddie obligations at prices just a bit higher than the prices they pay for Treasury securities.[116] That is, market players perceive the risk of default of Fannie and Freddie obligations, notwithstanding the potential insolvency of either of those companies, as nearly as unlikely as the risk of a default by the U.S. Government itself.[117] The market comes to its conclusion by identifying a pattern amidst the strands of "a complex web of relationships and market signals that, *in toto*, result in what may be deemed to be a de facto guarantee of the GSE's obligations."[118] These strands include explicit supports

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[116] *See* Dwight M. Jaffee, *Controlling the Interest Rate Risk of Fannie Mae and Freddie Mac*, NETWORKS FIN. INST. 2006-PB-04, at 18 n.9 (2006), *available at* http://ssrn.com/abstract =923568 (arguing that Fannie's and Freddie's ability to borrow at very "small spreads over Treasuries[ ] suggest[s] that investors normally ignore the possibility that the firms' strategy might have an adverse impact on their returns"). Spreads for private-label mortgages with the same characteristics as conforming mortgages would be between twenty-two and sixty basis points higher. *See infra* note 265 and accompanying text. At the height of the 2007 credit squeeze, the jumbo-conforming spread spiked even higher. *See* Murray & Karp, *supra* note 105 (referencing one percentage point spread).

[117] *See* Charles Kulp, Federal Deposit Insurance Corporation, *Assessing the Banking Industry's Exposure to an Implicit Government Guarantee of GSEs*, Mar. 1, 2004, http://www. fdic.gov/bank/analytical/fyi/2004/030104fyi.html ("[L]ow yield spreads between GSE direct obligations and Treasury securities indicate that market participants perceive what is commonly referred to as an implicit guarantee.").

[118] KRIZ, *supra* note 106, at 2. And, indeed, market players may distinguish the level of support that an implied guarantee may provide various GSE securities based on the characteristics of such securities. *See id.* at 3 ("Moody's may conclude that the implied support for some GSE obligations is greater than that for other obligations. Such is the case with Fannie Mae and Freddie Mac in the USA, whose senior debt is rated Aaa, but whose subordinated debt and preferred stock are rated lower."). The two other major rating agencies, Standard & Poor's and Fitch, offer similar analyses. *See* STANDARD & POOR'S, CRITERIA UPDATE: JOINT SUPPORT CRITERIA REFINED 5 (2006), *available at* http://www2.stan dardandpoors.com/spf/pdf/media/rfc_020306.pdf (discussing rating approach for GSEs); Fitch Ratings Definitions, http://www.fitchratings.com/corporate/fitchResources.cfm?detail=1 (last visited July 28, 2008) (describing rating methodologies); *see also* Edward L. Toy, *A Credit Intensive Approach to Analyzing Whole Loan CMOs*, *in* THE HANDBOOK OF NONAGENCY MORTGAGE-BACKED SECURITIES, *supra* note 43, at 219, 219 ("Fannie Mae and Freddie Mac supported securities are also treated by many as having the equivalent of U.S. government backing."); Lawrence J. White, *On Truly Privatizing Fannie Mae and Freddie Mac: Why It's Important and How to Do It*, HOUSING FIN. INT'L, Dec. 2005, at 13, 14 n.5 ("One important reflection -- and reinforcement -- of that halo is the way that financial information (eg, current prices and yields) about the two companies' debt obligations are listed in financial publications. The Wall Street Journal, for example, lists this information in a special box that is labeled 'Government Agency & Special Issues' and that is often located next to its listings of Treasury debt obligations (and unusually on a different page from its listings of corporate debt obligations)."); Robert A. Eisenbeis, W. Scott Frame & Larry D. Wall, *An Analysis of the Systemic Risks Posed by Fannie Mae and Freddie Mac and an Evaluation of the Policy Options for Reducing Those Risks* 5–6 (Fed. Res. Bank of Atlanta, Working Paper No. 2006-2, 2006) ("Taken together, the features of Fannie Mae's and Freddie Mac's federal charters have served

as well as implicit ones.[119] This view, while strongly held, is not clear enough to determine whether market players believe that the implied guarantee is a legal obligation of the federal government or whether they merely believe that the federal government, for all practical purposes, has agreed to assist the companies notwithstanding its statutory disclaimer of any guarantee.

While acknowledging that the markets act as if Fannie and Freddie benefit from an implied guarantee, the federal government has been very careful not to accept that conclusion as its own.[120] Instead, representatives of the Treasury and various federal agencies recently have been denying the existence of any such guarantee in no uncertain terms. For instance, then-Assistant Secretary of the Treasury for Financial Institutions Emil Henry stated that "the Treasury Department and other government officials have made it abundantly clear that the federal government does NOT guarantee the housing GSE debt,"[121] and then-Treasury Secretary John Snow has disavowed government backing for GSEs, referring to the "market misperception of an implied guarantee."[122]

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to create a perception in financial markets that the federal government 'implicitly guarantees' the companies' financial obligations. This belief, in turn, allows Fannie Mae and Freddie Mac to issue debt at interest rates that are far more favorable (better than AAA) than their stand-alone financial rating (around AA-) would justify." (citation omitted)).

[119] *See* KRIZ, *supra* note 106, at 2–3 (discussing explicit and implicit support).

[120] *See, e.g.*, *Proposals for Improving the Regulation of the Housing Government Sponsored Enterprises: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. 375 (2005) [hereinafter *Proposals*] (statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System) (noting that "[m]any counterparties in GSE transactions, when assessing their risk, clearly rely instead on the GSEs' perceived special relationship to the Government"); U.S. DEP'T OF THE TREASURY, REPORT OF THE SECRETARY OF THE TREASURY ON GOVERNMENT SPONSORED ENTERPRISES, at A-14 (1990) (noting that GSEs benefit "from *perceived* links to the Federal Government that support the capital market's *perception* that its debt and MBS have an implied Federal guarantee" (emphasis added)).

[121] Emil W. Henry Jr., Assistant Sec'y for Fin. Insts., U.S. Dep't of the Treasury, Address Before the Real Estate Roundtable (June 15, 2006) (transcript available at http://www.treas.gov/press/releases/js4322.htm); *see also* Kulp, *supra* note 117 (stating that benefits Fannie and Freddie receive "do not extend to a guarantee of GSE issues"). *But see* Frame & White, *supra* note 67, at 180–81 ("One useful step would be for government officials to state clearly, whenever the subject comes up, that the federal government does not guarantee the debt of Fannie Mae or Freddie Mac and will not bail them (or their creditors) out. No presidential administration has explicitly made such a statement. More typical are carefully crafted comments that reiterate that the federal government is not required to bail out Fannie Mae or Freddie Mac, but fall short of flatly stating that the government will not do so . . . .").

[122] *Proposals*, *supra* note 120, at 74 (statement of John W. Snow, Secretary, U.S. Department of the Treasury).

Fannie and Freddie appear to argue both ways, depending on their audience. Professor Carnell summarizes their position as follows:

> In managing their relationship to the federal government, the GSEs play an extraordinarily successful double game. They emphatically deny that they have any formal, legally enforceable government backing, leaving the impression that they have no government backing at all. At the same time, they work to reinforce the market perception of implicit government backing. In effect, the GSEs tell Congress and the news media, "Don't worry, the government is *not* on the hook" -- and then turn around and tell Wall Street, "Don't worry, the government really *is* on the hook."[123]

We have seen that market players speak with one voice, the federal government speaks with an opposing one, and Fannie and Freddie speak from both sides of their mouths on the topic of the implied guarantee. The scholarly community has split into two

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[123] *Improving*, *supra* note 73, at iii (statement of Richard S. Carnell, Professor, Fordham University School of Law). Carnell has catalogued a number of extraordinary statements that Fannie and Freddie have made, given their frequent disavowal of the implied guarantee:

> [T]he GSEs work to reinforce the perception of implicit government backing. Consider three examples involving Fannie. In the first example, Fannie sought legislative history stating that Fannie and Freddie "are *implicitly backed by the full faith and credit of the U.S. Government*." In the second example, Fannie attacked Treasury Under Secretary Gensler as "irresponsible" and "unprofessional" when he testified before a House subcommittee on March 22, 2000, that "the government does not guarantee [GSEs'] securities."
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> In the third example, Fannie argued in a 1998 letter to the Office of the Comptroller of the Currency that "all GSE issued securities merit" more favorable treatment under the federal banking agencies' risk-based capital standards than all "AAA-rated [non-GSE] asset-backed securities." Thus the mere fact that a GSE issues a security makes that security more creditworthy than any non-GSE security. An IOU issued by a financially troubled GSE (such as the Farm Credit System before its 1987 bailout) would, under Fannie's reasoning, still be more creditworthy than a top-tier asset-backed security guaranteed by the nation's healthiest fully private corporation. Fannie based this argument squarely on what it calls "the implied government backing of Fannie Mae . . . ."

Id. at 10 (footnotes omitted) (alterations in original).

camps, one aligned with the market and the other with the federal government.

The leading proponents of the market view of the implied guarantee include policy scholars Bert Ely, Thomas Stanton, and Peter Wallison.[124] Professor Carnell (himself a former Assistant Treasury Secretary for Financial Institutions) is perhaps the leading proponent of the government view.[125] The market-oriented group relies upon the market's wisdom in pricing Fannie and Freddie debt obligations and argues that the charter benefits and other regulatory privileges form the basis of the market pricing.[126] The government-aligned group primarily relies upon the explicit denial of federal support in Fannie and Freddie's charters, but allows that market players have mistakenly relied upon the web of privileges that the federal government has granted to Fannie and Freddie.[127]

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[124] *See, e.g.*, STANTON, *supra* note 30, at 204 ("The implicit federal guarantee arises from laws that give enterprise obligations and mortgage-backed securities (MBSs) many of the investment attributes of federal government securities. This is known as giving federal agency status to enterprise securities. Many elements of the implicit federal guarantee—such as the line of credit from the enterprise to the Treasury, the exemption of enterprise obligations and MBSs from SEC registration requirements, the eligibility of enterprise obligations and MBSs as lawful investments for federal fiduciary trust and public funds—are found in the enterprise charter acts."); WALLISON, STANTON & ELY, *supra* note 72, at 2 (describing financial risk to taxpayers created by government's implicit backing of GSEs); Passmore, *supra* note 115, at 465–66 ("The markets' impression that the government implicitly backs Fannie Mae and Freddie Mac is based on the GSEs' history, on the size of their portfolios, on the fact that the government mandates housing goals for these firms and on the many indicia of explicit government support. . . . The result is an ambiguous relationship between the GSEs and the federal government in which investors infer government support while government officials deny it.").

[125] *See, e.g.*, *Improving*, *supra* note 73, at 12 (statement of Richard S. Carnell, Professor, Fordham University School of Law) ("Market participants had long believed such [implied] backing to exist under the GSEs' charters. Congress did not act to correct that perception."); Carnell, *supra* note 22, at 584 (noting that federal government has no legally enforceable liability for GSEs securities).

[126] *See, e.g.*, STANTON, *supra* note 30, at 157 (arguing that investors rely more on implicit governmental backing than on creditworthiness or quality of loans, which creates temptation to take "excessive risk[s]"). These policy scholars tend to assume the existence of the implied guarantee without evaluating its basis in the law and regulatory environment of the two companies. WALLISON, STANTON & ELY, *supra* note 72, at 2 ("It is no longer a source of serious debate that the federal government bears some direct risk associated with its chartering and sponsorship of Fannie Mae and Freddie Mac.").

[127] *See* Frame & White, *supra* note 67, at 159–62 ("Fannie Mae's and Freddie Mac's special federal charters and the attendant package of special benefits directly lower their operating costs and have created a 'halo' of implied federal government support for the two companies."); *see also supra* note 125 and accompanying text.

Because this Article categorically disagrees with Professor Carnell's interpretation of the implied guarantee and because his is the leading view amongst the few legal scholars who have closely studied this issue, it is worth quoting him at length:

> "Implicit government guarantee" suggests that the government has already guaranteed GSEs' obligations, albeit without formally expressing that guarantee. . . . "Implicit guarantee" refers not to what the government *has done* but to investors' belief about what the government *would do* if a GSE failed—a belief manifest in investors' willingness to lend to GSEs on exceptionally favorable terms. Using "government guarantee" to describe investors' behavior has the potential to bias debates about GSE policy by insinuating that the government has a moral obligation to honor the supposed guarantee.[128]

Professor Carnell "refers to investors' 'perception of implicit backing' and GSEs' 'perceived implicit backing' " instead of the term " 'implicit government guarantee.' "[129] This is an important distinction because it reveals that Carnell does not believe that the market view is reality based. This Article argues that it is.

The stakes of this debate are obviously very high. Eliminating the implied guarantee or even the appearance of the implied guarantee "could affect the liquidity of some [FDIC] insured institutions by reducing securities values and pressure capital adequacy" through higher risk-based capital charges for Fannie and Freddie securities.[130] Indeed, even changes to individual strands of the statutory and regulatory web that makes up the implied guarantee may trigger big changes in the regulatory environment of many financial institutions.[131]

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[128] Carnell, *supra* note 22, at 584 n.113.

[129] *Id.*

[130] Kulp, *supra* note 117. That is, if the implied guarantee were no longer present, FDIC insured institutions might not be able to treat Fannie and Freddie securities as ultra-safe investments for the purposes of their capital requirements. They then would need to increase their capital requirements either by replacing such securities with safer ones or by increasing the overall amount of capital that they hold. This would reduce their ability to leverage their capital, thereby by reducing overall liquidity.

[131] The Congressional Budget Office has noted that:

Wayne Passmore, a researcher at the Federal Reserve, has estimated that the present value of the federal government's subsidy of Fannie and Freddie is nearly $150 billion.[132] One of the largest elements of this subsidy is the implied guarantee, the size of which is "only weakly controlled by policy makers because the GSEs control their own debt issuance and hence the size of the implicit subsidy."[133]

Although Fannie and Freddie claim that they pass the subsidy along to homeowners in the form of lower interest rates, numerous studies have demonstrated that Fannie and Freddie keep a large portion of the subsidy for the benefit of their shareholders and management.[134] GSE shareholders appear to retain about half of the federal subsidy, in the form of increased profits.[135]

Of course, from the perspective of the individual homeowner, this is still better than the alternative: borrowing at the unsubsidized and higher rates offered by fully private lenders. The GSEs' uniformly better mortgage terms compound the benefit to the

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> Some observers have suggested that enactment of [a bill that would repeal Fannie Mae's and Freddie Mac's exemptions from the SEC's registration and disclosure requirements] would reduce the strength of the implied federal guarantee. If so, one effect could be to raise rates on the GSEs' securities. However, other analysts disagree. They note that the legislation leaves intact the GSEs' other privileges. In addition, investors' perceptions may be influenced by the size of the enterprises in the capital and housing markets as well as by provisions of law. If so, investors could conclude that the implicit guarantee would be unaffected by that statutory change.

CONG. BUDGET OFFICE, EFFECTS OF REPEALING FANNIE MAE'S AND FREDDIE MAC'S SEC EXEMPTIONS 23 (2003), *available at* http://www.cbo.gov/ftpdocs/41xx/doc4199/05-06-03-GSEs.pdf.

[132] Passmore, *supra* note 115, at 477. *But see* Vern McKinley, *The Mounting Case for Privatizing Fannie Mae and Freddie Mac*, 293 POL'Y ANALYSIS (1997), http://www.cato.org/pubs/pas/pa-293.html (noting that "Fannie Mae contends that it 'is impossible to accurately measure the value of a subsidy that does not explicitly exist' "). Passmore calculates that the value of the implied guarantee makes up nearly ninety percent of the federal government's subsidy of the two companies. *See* Passmore, *supra* note 115, at 466 ("My calculation also suggests that roughly 44–89% of the GSEs' market value is due to their implicit government subsidy.").

[133] Passmore, *supra* note 115, at 484.

[134] The Congressional Budget Office (CBO) estimated that Fannie and Freddie kept up to as much as forty percent of the spread and passed the remainder on to borrowers. *See* CONG. BUDGET OFFICE, FEDERAL SUBSIDIES AND THE HOUSING GSES 27 (2001) (estimating Fannie and Freddie retain sixteen basis points of subsidy out of total forty-one). The spread is the difference between the interest paid on one security, such as a private-label RMBS, and another, such as a Fannie or Freddie RMBS. *Id.*

[135] *See id.* at 1 ("The ultimate beneficiaries of that subsidy include . . . the shareholders . . . .").

individual borrower.[136] It is only at the macro level—netting out the benefits to all individual homeowners with the costs to all individual taxpayers—that the cost of the implied guarantee becomes clear.

While the contemporary valuation of the implied guarantee is enormous, the market's understanding of it "emerged gradually" as GSEs sold their securities to investors who "inferred a moral obligation" under which the federal government would back their obligations in case of default.[137] There is an eminently practical reason that the federal government would now guarantee Fannie and Freddie obligations: there are trillions of dollars of Fannie and Freddie obligations outstanding and Fannie and Freddie's failure could trigger a systemic shock to the international financial system, much as the Long-Term Capital Management crisis did.[138] In other words, Fannie and Freddie, like Long-Term Capital Management before them, are "Too Big to Fail."

The term "Too Big to Fail" refers to a policy where a government chooses to intervene in the market and bail out insolvent institutions instead of letting them unwind their affairs through normal channels, such as the bankruptcy courts.[139] Governments usually take the Too Big to Fail approach with financial institutions that have significant ties with other financial institutions that would be materially harmed by the failure of the insolvent institution.[140] Thus, the stated rationale for the intervention is to avoid disruptions in various equity, debt, and currency markets.[141] The FDIC has already sought to deflate Too Big to Fail expectations for the banks that it regulates.[142]

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[136] *See* Reiss, *supra* note 1, at 1011–12 (discussing better market position of Fannie and Freddie compared to private-label firms).

[137] STANTON, *supra* note 30, at 26.

[138] *See supra* notes 12–15 and accompanying text.

[139] *See* Carrie Stradley Lavargna, *Government-Sponsored Enterprises Are "Too Big to Fail": Balancing Public and Private Interests*, 44 HASTINGS L.J. 991, 1011 (1993) (defining "Too Big to Fail").

[140] *See id.* at 1011–12 (showing institutions Congress has chosen to bail out); Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. (forthcoming 2008) (manuscript at 7-10, available at http://ssrn.com/abstract=1008326) (discussing systemic risk in context of financial institutions).

[141] *See* Lavargna, *supra* note 139, at 1012 ("The failure of a large financial institution poses systemic risks to the economy because it would disrupt the markets for federal funds, government securities, mortgage-backed securities, and even foreign exchange.").

[142] *See* JONATHAN R. MACEY ET AL., BANKING LAW AND REGULATION 36–37 (3d ed. 2001) (discussing Congress's curtailment of Too Big to Fail expectations). *See generally* George G. Kaufman, *Too Big To Fail in U.S. Banking:* Quo Vadis*?*, *in* TOO BIG TO FAIL: POLICIES AND PRACTICES IN GOVERNMENT BAILOUTS 153 (Benton E. Gup ed. 2004) (discussing history of Too

There is a body of Too Big to Fail literature devoted to Fannie and Freddie in particular.[143] This literature differs from the general Too Big to Fail literature because Fannie and Freddie present systemic risks[144] that result from the fact that many financial institutions hold particularly large portions of their portfolios in the two companies' obligations because of federal regulations that encourage such holdings.[145] As such, the significant ties that other entities have with Fannie and Freddie are actually encouraged by the federal

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Big to Fail concept).

[143] *See, e.g.*, Benton E. Gup, *Are Fannie Mae and Freddie Mac Too Big to Fail?*, *in* TOO BIG TO FAIL: POLICIES AND PRACTICES IN GOVERNMENT BAILOUTS, *supra* note 142, at 287, 307 (arguing that Treasury and Federal Reserve ought to make joint policy statement that Freddie and Fannie are not too big to fail and provide strategy for dealing with risk of their failure); Lavargna, *supra* note 139, at 1038 ("The enterprises are clearly 'too big to fail,' as liquidating an enterprise would significantly disrupt the nation's economy."); Jaffee, *supra* note 116, at 20 ("A key implication of the immense size of F&F is that it makes more understandable why investors in F&F debt and MBS are so confident that the implicit guarantee will be honored; the firms are truly too big to be allowed to fail."); Sebastian Mallaby, *Response to Richard Christopher-Whalen*, *in Risk-Return Profile*, FOREIGN AFF., May–June 2007, at 163, 164 ("A financial system is most vulnerable when it is dominated by a small number of large institutions. If one megabank blows up, there will be mountains of unpaid debt to other banks; this could cause the other banks to fail, setting off a chain reaction. In the U.S. financial system, two institutions stand out for the risk associated with their size: Fannie Mae and Freddie Mac, the two semiofficial mortgage financiers."); *see also* JAMES C. MILLER III & JAMES E. PEARCE, REVISITING THE NET BENEFITS OF FREDDIE MAC AND FANNIE MAE 30–32 (2006) (reviewing empirical literature relating to systemic risk posed by Fannie and Freddie).

[144] The President's 2007 budget, prepared by the Office of Management and Budget, defines systemic risk as:

> the risk that a failure in one part of the economy could lead to additional failures in other parts of the economy—the risk that a small problem could multiply to a point where it could jeopardize the country's economic well-being. The particular systemic risk posed by the GSEs is the risk that a miscalculation, failure of controls, or other unexpected event at one company could unsettle not only the mortgage markets but other vital parts of the economy.

OFFICE OF MGMT. & BUDGET, ANALYTICAL PERSPECTIVES: BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2007, at 72 (2006).

[145] *See, e.g.*, Gup, *supra* note 143, at 304 (describing effect of federal regulations on investors' perceptions); Emil W. Henry Jr., Assistant Sec'y for Fin. Inst., U.S. Dep't of the Treasury, Address Before the Housing Policy Council of the Financial Services Roundtable (June 26, 2006) (transcript available at http://www.treas.gov/press/releases/js4338.htm) (stating that "as of December 31, 2005, commercial banks held $264 billion in GSE debt obligations . . . [which] exceeded 50 percent of capital for 54 percent of these commercial banks, and GSE debt obligations exceeded 100 percent of capital for 34 percent of these commercial banks. In addition, the GSEs' interest rate positions are highly concentrated and pose significant risks to a number of large financial institutions."); *see also* OFFICE OF FED. HOUS. ENTER. OVERSIGHT, SYSTEMIC RISK: FANNIE MAE, FREDDIE MAC AND THE ROLE OF OFHEO 113–14 (2003) (discussing actions OFHEO would take to reduce systemic disruption caused by financial difficulties at Fannie or Freddie).

government itself, making the federal government appear to be responsible, at least in part, for resolving a potential systemic failure caused by the insolvency of Fannie, Freddie, or both. If the government seeks to reduce the Too Big to Fail expectations surrounding Fannie and Freddie, it must start by stripping away the various regulatory privileges that signal to other financial institutions that Fannie and Freddie securities are safer than those of other private entities.[146]

IV. THE ARGUMENT FOR THE IMPLIED GUARANTEE: FANNIE AND FREDDIE HAVE A PRIVILEGED STATUS COMPARED TO OTHER PRIVATELY-OWNED COMPANIES

Notwithstanding the explicit denial of a guarantee of Fannie and Freddie securities,[147] market players will look beyond that to see what links exist between a GSE and its sovereign government in order to determine whether there is an implied guarantee. Moody's notes that "[t]o the extent the government exercises greater governance or regulatory control over a GSE, the greater may be the potential that it will have a stronger implied or 'moral' obligation to provide assistance, if needed."[148] This is reflected in the market view that the relationship between the federal government and Fannie and Freddie has many indicia of "governance and regulatory control," as shall be seen below.[149] Indeed, the level of control is so great that the federal government may have more than a "moral obligation" to

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[146] Some might argue that Fannie and Freddie would be considered "Too Big to Fail" even if these regulatory privileges were revoked. Since the S&L crisis, the federal government has sought to reduce Too Big to Fail expectations for federally-related entities. *See generally* Larry D. Wall, *Too-Big-to-Fail After FDICIA*, ECON. REV., Jan.–Feb. 1993, at 1, 1–14 (reviewing implementation of Federal Deposit Insurance Corporation Improvement Act of 1991, which was designed in part to end Too Big to Fail expectations for large FDIC-insured financial institutions).

[147] *See supra* note 9 and accompanying text.

[148] KRIZ, *supra* note 106, at 3 ("The more severe these dislocations, the greater the potential likelihood of government support: the cost of supporting the GSE may be cheaper than letting it fail and then having to incur the 'clean-up' costs, which may be widespread given GSEs' often-key roles in national economies. A nation's pension funds and banks, for example, may be major GSE debtholders, and may even be encouraged to hold such obligations. Furthermore, some governments impose lower capital charges on banks and other financial institutions for holdings of GSE obligations than for non-GSE corporate obligations--again implying a special, 'protected' status for a GSE. These dislocations could also include foreign affairs to the extent foreign central banks or other key overseas investors hold securities of the GSE, or to the extent a GSE's failure could adversely affect foreigners' willingness to hold direct government, or government-related, debt.").

[149] *See* Part IV.

provide them with assistance; it could arguably have a legal obligation.

Stanton and Carnell, among others, have addressed the web of relationships between the federal government on the one hand and Fannie and Freddie on the other.[150] But no one has provided an exhaustive and in-depth description of this web and evaluated its legal significance as a whole. In this Part, I will do so.

A. FANNIE'S AND FREDDIE'S CHARTERS GRANT THEM UNEQUALED PRIVILEGES AMONG PRIVATELY-OWNED COMPANIES

Fannie and Freddie are granted a unique set of privileges by their federal charters.[151] These privileges have been the basis of the many arguments that Fannie and Freddie's obligations are guaranteed by the federal government.[152] The explicit disclaimers in their enabling statutes, however, undercut these arguments. This part outlines the charter privileges and explains how they support the argument that the federal government does in fact guarantee Fannie's and Freddie's obligations.

1. Congress Created Fannie and Freddie to Achieve a Public Purpose. Fannie and Freddie are unlike other publicly traded corporations in that they were created and designed to achieve a public purpose, in addition to the traditional profit-maximization that private corporations engage in.[153]

a. Fannie and Freddie Were Designed to Create a National Mortgage Market. In creating Fannie Mae, Congress declared that it was guided by the following purposes: to establish secondary market

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[150] *See* STANTON, *supra* note 30, at 204 ("Many elements of the implicit federal guarantee . . . are found in the enterprise charter acts."); Carnell, *supra* note 22, at 581–82 ("Federal statutes give GSEs various benefits unavailable to ordinary private firms.").

[151] *See* CONG. BUDGET OFFICE, *supra* note 134, at 14 (stating that Fannie's and Freddie's "advantages have not been granted to any other shareholder-owned companies"); KRIZ, *supra* note 106, at 1 ("Most GSEs are created by and governed under special statutes, and not under general business incorporation laws. Thus, GSEs may have powers, governance regimes or bankruptcy provisions that differ from most other corporations."). The CBO concludes that, "[t]he law treats the GSEs as instrumentalities of the federal government, rather than as fully private entities." CONG. BUDGET OFFICE, *supra* note 134, at 13.

[152] *See, e.g.*, *supra* notes 124–27 and accompanying text. The charters are not wholly blessings: they are rigid and limit the businesses that Fannie and Freddie can enter into. *See* STANTON, *supra* note 30, at 58–60 ("The charter provisions are quite specific.").

[153] *See, e.g.*, THOMAS H. STANTON, GOVERNMENT-SPONSORED ENTERPRISES: MERCANTILIST COMPANIES IN THE MODERN WORLD 13–22, 49–62 (2002) (discussing unique characteristics of GSEs).

facilities for residential mortgages; to provide stability in the secondary market for residential mortgages; to provide ongoing assistance to the secondary market for residential mortgages, particularly mortgages on housing for low- and moderate-income families; to increase the liquidity of mortgage investments and to improve the distribution of investment capital available for residential mortgage financing; and to "promote access to mortgage credit throughout the Nation . . . by increasing the liquidity of mortgage investments."[154] The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 updated the goals of Fannie and Freddie as follows: "to provide stability in the secondary market for home mortgages"; "to respond appropriately to the private capital market"; and "to provide ongoing assistance to the secondary market for home mortgages," particularly those securing affordable housing.[155]

While commentators generally agree that Fannie and Freddie have created a liquid RMBS market,[156] leading critics of the companies argue that Fannie and Freddie lag behind ordinary banks when it comes to providing financing to low- and moderate-income as well as minority families[157] and have failed to appreciably increase the rate of American homeownership.[158] Nonetheless, Fannie and Freddie are clearly instruments of federal policy.

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[154] 12 U.S.C. § 1716 (2006).

[155] Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 § 731.

[156] *See, e.g.*, Jay Cochran, III & Catherine England, *Neither Fish nor Fowl: An Overview of the Big-Three Government-Sponsored Enterprises in the U.S. Housing Finance Markets* 1 (Mercatus Ctr., Working Papers in Regulatory Studies, 2001), *available at* http://www.mercatus.org/repository/docLib/MC_RSP_RP-FishNorFowl_011115.pdf ("[T]here is little doubt that Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System (the third housing GSE) have contributed to one of the most dynamic mortgage markets in the world.").

[157] WALLISON, STANTON & ELY, *supra* note 72, at 13. They conclude that "[t]his should be a lesson to lawmakers that attempting to turn shareholder-owned companies into government agencies is bound to fail." *Id.* at 20; *see also* Frame & White, *supra* note 67, at 173 ("Fannie Mae and Freddie Mac do not do an especially good job of focusing on the low- and moderate-income first-time buyer, where the social argument for support of homeownership is strongest.").

[158] *See* Frame & White, *supra* note 67, at 172 ("While some research has found that Fannie Mae and Freddie Mac have recently increased the supply of mortgage credit available to low- and moderate-income households, it does not appear that the companies' activities have appreciably affected the rate of homeownership in the United States."); *see also* Xudong An & Raphael W. Bostic, *GSE Activity, FHA Feedback, and Implications for the Efficacy of the Affordable Housing Goals*, 36 J. REAL EST. FIN. & ECON. 209, 223 (2008) (reviewing research that finds that Fannie and Freddie have responded positively to their affordable housing goals,

b. The President Has the Power to Appoint Five of the Members of Fannie's and Freddie's Boards of Directors. The President of the United States has the power to appoint five of the eighteen members of Fannie's and Freddie's Boards of Directors,[159] a characteristic of Fannie and Freddie that certainly distinguishes them from other publicly traded corporations. The Presidential appointments have a clear policy objective, as the enabling statutes require that members appointed to the Freddie Board by the President include:

> at least 1 person from the homebuilding industry, at least 1 person from the mortgage lending industry, at least 1 person from the real estate industry, and at least 1 person from an organization that has represented consumer or community interests for not less than 2 years or 1 person who has demonstrated a career commitment to the provision of housing for low-income households.[160]

Moreover, the President may remove any appointed member "for good cause."[161] Fannie Mae has a comparable provision for appointment and removal of directors.[162] This further demonstrates the power that the federal government has in setting the direction of the two GSEs. While one might question whether Presidential board appointments is a "privilege" per se, there is no question that it signals that Fannie and Freddie are materially different from other publicly traded corporations and that they have, effectively, a direct line to the President right in the board room.[163]

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but finding that implementing those goals and those of FHA "work in opposite directions and can leave credit supply and homeownership unchanged or possibly even reduced"). *But see* Roberto G. Quercia et al., *The Impacts of Affordable Lending Efforts on Homeownership Rates*, 12 J. HOUSING ECON. 29 (2003) (Freddie Mac-supported research finding that GSE activities increase rate of homeownership, particularly among minorities).

[159] 12 U.S.C. § 1452(a)(2)(A) (2006).

[160] *Id.*

[161] *Id.* § 1452(a)(2)(B).

[162] *See id.* § 1723(b) (showing requirements for board of directors).

[163] *See* A. Michael Froomkin, *Reinventing the Government Corporation,* 1995 U. ILL. L. REV. 543, 587–89 (discussing ambiguous nature of presidential appointees to federal government corporate boards). President George W. Bush has chosen not to make appointments to the boards of Fannie and Freddie, Alex J. Pollock, *The Housing GSEs: Through Competition to Privatization*, FIN. SERVICES OUTLOOK (Am. Enter. Inst. for Pub. Policy Research, Wash., D.C.), Aug. 1, 2004, at 4, consistent with his desire to signal that there is no implied guarantee of Fannie and Freddie's obligations, *cf.* Lawrence J. White, *Fannie Mae, Freddie Mac, and*

2. Congress Exempted Fannie and Freddie from Many Laws. Fannie's and Freddie's charters exempt them from the reach of many investor protection and state laws. These exemptions both emphasize their special status and give them competitive advantages over other financial companies.

a. Fannie and Freddie Are Exempt Under the Securities Acts. As issuers of exempt securities, Fannie and Freddie are not required to register with the SEC.[164] Securities issued or guaranteed by Freddie are "deemed to be exempt securities within the meaning of the laws administered by the Securities and Exchange Commission," to the same extent as "securities that are direct obligations of or obligations guaranteed as to principal or interest by the United States."[165] Fannie's enabling act has a comparable provision.[166] This not only saves Fannie and Freddie the registration fees that the SEC charges securities issuers,[167] but it may also allow them to withhold

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Housing Finance: Why True Privatization is Good Public Policy, 528 POL'Y ANALYSIS 17 n.7 (2004) ("In 2004 the Bush administration announced that it would cease appointing any members to either board, as an effort to begin to reduce the special status of the two companies.").

[164] *See* 15 U.S.C. § 78m(a) (2006) (requiring every security issuer to file with SEC). If a securities issuer only issues "exempted securities," it need not register with the SEC, as required by 15 U.S.C. § 78L. *Id.* §§ 78L, 78o(d); *see also* § 78c(12)(A)(i) (defining "exempted securities" to include "government securities"); *id.* § 78c(42)(C) (defining "government securities" to include Fannie and Freddie securities). Professor Carnell argues that Fannie and Freddie securities also are exempt pursuant to 15 U.S.C. § 77c(a)(2) because they are "instrumentalities" of the United States. Carnell, *supra* note 22, at 581 n.97. Fannie and Freddie have been moving toward voluntary registration with the SEC in response to congressional critics. *See* Allison Bisbey Colter, *Freddie Sees Dividends and Buybacks,* WALL ST. J., Oct. 5, 2005, at B3A ("[Freddie and Fannie] under pressure from Congress, agreed in 2002 to voluntarily register their stock . . . .").

[165] 12 U.S.C. § 1455(g) (granting Freddie exemption for all "securities issued or guaranteed by the Corporation (other than securities guaranteed by the Corporation that are backed by mortgages not purchased by the Corporation)"). The laws administered by the SEC are the Securities Act of 1933, 15 U.S.C. §§ 77a–77bbbb (2006) and the Securities Exchange Act of 1934, *id.* §§ 78a–78mm.

[166] *See* 12 U.S.C. § 1719(d), (e) (expressly exempting from SEC regulation various Fannie Mae securities "which are direct obligations of or obligations guaranteed" by United States); *id.* § 1723c ("All stock, obligations, securities, participations, or other instruments issued pursuant to this subchapter [relating to Fannie Mae and Ginnie Mae] shall, to the same extent as securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, be deemed to be exempt securities within the meaning of laws administered by the Securities and Exchange Commission.").

[167] *See* Dawn Kopecki & Patrick Barta, *Mortgage Firms' Stance Is Disputed*, WALL ST. J., May 7, 2003, at B7 (estimating Fannie and Freddie fees of $16.2 million if they had been required to register with SEC). Fannie and Freddie have begun to voluntarily register with the SEC. *Testimony Concerning the Application of Federal Securities Law Disclosure and Reporting Requirements to Fannie Mae, Freddie Mac and the Federal Home Loan Banks Before the S.*

sensitive financial information that other companies must release as part of their SEC filings.[168] This, of course, gives Fannie and Freddie a significant advantage in developing their business strategies. The Congressional Budget Office has stated that:

> [S]pecial treatment of GSE securities in federal law signals to investors that those securities are relatively safe. Investors might reason, for instance, that if the securities were risky, the government would not have exempted them from the protective safeguards it put in place to prevent losses of public and private funds.[169]

b. Fannie and Freddie Are Exempt from Most State and Local Taxes. Fannie and Freddie are generally exempt from state and local taxes, other than real estate taxes.[170] This is, of course, a dramatic

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Comm. on Banking, Housing, and Urban Affairs, 108th Cong. 5 (2004) (statement of Alan L. Beller, Director, SEC Division of Corporation Finance).

[168] *See* Patrick Barta, *Freddie Mac, Fannie Mae Face Disclosure Rules*, WALL ST. J., July 2, 2002, at A2 ("Many bond investors say they believe Fannie Mae and Freddie Mac don't want to register because it would possibly require them to disclose more information about the loans they put in their mortgage-backed security pools. Investors have long complained that Fannie Mae and Freddie Mac don't provide enough detail about their loans, including whether they are considered 'prime' or 'subprime'; such information is considered by some to be vital in determining the value of the loans."). It should be noted that Fannie and Freddie have disclosure requirements that private companies do not, such as those imposed by OFHEO pursuant to its authority under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992. *See, e.g.*, 12 U.S.C. § 4513 (authorizing director of OFHEO to require Fannie and Freddie to submit certain financial reports).

[169] CONG. BUDGET OFFICE, *supra* note 134, at 14. The CBO continues, "This implied assurance appears to outweigh the explicit disavowal of responsibility in every prospectus for GSE securities." *Id.* Richard Carnell argues that:

> The GSEs' statutory exemption from the registration and reporting requirements of the federal securities laws is an anachronism and deserves to be repealed. The exemption sends the wrong signal: that GSEs are so "special," so close to the government, that investors in their securities have no need for the protections afforded by those requirements.

Improving, *supra* note 73, at 18 (statement of Richard S. Carnell, Professor, Fordham University School of Law).

[170] *See* 12 U.S.C. § 1452(e) (exempting Freddie, "including its franchise, activities, capital, reserves, surplus, and income," from "all taxation now or hereafter imposed by any territory, dependency, or possession of the United States or by any State, county, municipality, or local taxing authority, except that any real property of the Corporation shall be subject to State, territorial, county, municipal, or local taxation to the same extent according to its value as other real property is taxed"); *id.* § 1723a(c)(2) (exempting Fannie, "including its franchise, capital, reserves, surplus, mortgages or other security holdings, and income," from "all taxation now or hereafter imposed by any State, territory, possession, Commonwealth, or dependency of the United States, or by the District of Columbia, or by any county, municipality, or local taxing

and quantifiable advantage that Fannie and Freddie have over their competitors in the mortgage markets. This is a benefit that is made available to certain other federally-chartered entities as well as instrumentalities of the federal government, further emphasizing the privileged status of Freddie and Fannie.[171]

c. Freddie and Fannie Are Exempt from Various Other Laws. At least since the Supreme Court ruled in *McCulloch v. Maryland* that the federally chartered Second Bank of the United States could not be impeded by the acts of a state, it has been clear that federally chartered entities could preempt state law.[172] This is an additional privilege of Fannie's and Freddie's that they can wield to their competitive advantage and that further reflects their special relationship with the federal government.[173] Courts have also held that Freddie Mac benefits from sovereign immunity in certain contexts, such as finding that Freddie Mac could not be estopped by the actions of a third-party mortgage company acting beyond its authority because that would thwart Freddie's congressionally prescribed purposes.[174]

In addition, Freddie Mac has explicit broad immunity to most laws pursuant to its enabling statute; Freddie's rights and remedies are

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authority, except that any real property of the corporation shall be subject to State, territorial, county, municipal, or local taxation to the same extent as other real property is taxed"). Fannie and Freddie are not exempt from federal tax. *See* Bradley K. Krehely, Note, *Government Sponsored Enterprises: A Discussion of the Federal Subsidy of Fannie Mae and Freddie Mac*, 6 N.C. BANKING INST. 519, 530 (2002) (noting GSEs exemption from state and local, but not federal, tax).

[171] *See, e.g.*, Osborn v. Bank of the U.S., 22 U.S. (9 Wheat.) 738, 870 (1824) (holding that federally chartered bank is exempt from state taxation).

[172] *See* McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 436–37 (1819) ("[T]he States have no power, by taxation or otherwise, to retard, impede, burden, or in any manner control, the operations of the constitutional laws enacted by Congress to carry into execution the powers vested in the general government.").

[173] *See* Carnell, *supra* note 22, at 581 (citing *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) at 436–37) (discussing benefits of GSEs including ability to preempt state laws through federal charters); *cf.* CONG. BUDGET OFFICE, *supra* note 134, at 14 ("GSE securities are . . . exempt from the provisions of many state investor protection laws. Those advantages have not been granted to any other shareholder-owned companies.").

[174] *See* Mendrala v. Crown Mortgage Co., 955 F.2d 1132, 1140 (7th Cir. 1992) (holding that Freddie Mac is federal instrumentality for estoppel purposes because it has congressionally mandated purpose of maintaining secondary mortgage market); McCauley v. Thygerson, 732 F.2d 978, 981–82 (D.C. Cir. 1984) (finding that Congress intended Freddie Mac to be federal entity for purposes of estoppel claim in employment law context).

> immune from impairment, limitation, or restriction by or under . . . any law . . . which becomes effective after the acquisition by the Corporation of the subject or property on, under, or with respect to which such right or remedy arises or exists or would so arise or exist in the absence of such law . . . .[175]

Freddie is also "authorized to conduct its business without regard to any qualification or similar statute in any State."[176] Fannie has a similar provision regarding state qualification statutes.[177]

3. Congress Treats Fannie and Freddie Like Extensions of the Federal Government. Congress has mandated that various arms of the federal government including the Treasury and the Federal Reserve Board, as well as federally regulated banks, give Fannie and Freddie a variety of privileges that are usually reserved for federal instrumentalities.

a. The Secretary of the Treasury Is Authorized to Purchase Fannie and Freddie Debt. The Secretary of the Treasury may purchase up to $2,250,000,000 of Freddie's obligations.[178] Moreover, "[a]ll redemptions, purchases and sales by the Secretary of the Treasury" of such obligations "shall be treated as public debt transactions of the United States,"[179] meaning that the federal government effectively converts those purchased obligations into obligations of the federal government itself because the "faith of the United States Government is pledged to pay" obligations and interest on the public debt.[180] Fannie Mae's enabling statute has analogous provisions.[181] Fitch Ratings has described the credit lines to Fannie

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[175] 12 U.S.C. § 1456(a).

[176] *Id.*

[177] *See id.* § 1723a(a) ("[Fannie can] conduct its business without regard to any qualification or similar statute in any State of the United States . . . .").

[178] *Id.* § 1455(c)(2).

[179] *Id.* § 1455(c)(5).

[180] 31 U.S.C. § 3123(a) (2000).

[181] *See* 12 U.S.C. § 1719(b) (prescribing which obligations Fannie is authorized to issue); *id.* § 1719(c) (authorizing Treasury to purchase Fannie's authorized obligations and indicating that such purchases are to be treated as public debt transactions). The Treasury Assistant Secretary for Financial Institutions, Emil W. Henry Jr. notes, however, that "at least in the context of GSE reform legislation, the Treasury Department is on record suggesting that this line of credit will only be utilized under very limited circumstances such as a GSE emerging from receivership." Henry, *supra* note 121. A Treasury report notes that in its "transition to private ownership, Fannie Mae relied on interim borrowing from the Treasury. Effective July 1, 1969, Fannie Mae established a line of credit with a nationwide group of commercial banks.

and Freddie as being "more symbolic than economically significant" because the credit lines represent a small proportion of the two companies' outstanding debt.[182] The symbolism, however, is clear; the Treasury is explicitly authorized to come to the rescue of Fannie and Freddie in a way that other private companies can only dream of.

b. Fiduciaries May Invest in Fannie and Freddie's Obligations As If They Were Government Securities. Securities sold by Freddie pursuant to its enabling statute are "lawful investments, and may be accepted as security for all fiduciary, trust, and public funds, the investment or deposits of which shall be under the authority and control of the United States or any officers thereof."[183] Fannie has a comparable provision.[184] Federal law also preempts state law so that Fannie and Freddie securities are eligible for investment to the same extent as "obligations issued by or guaranteed as to principal and interest by the United States or any agency or instrumentality thereof."[185] What is pertinent about this provision is that it explicitly compares Fannie and Freddie obligations to those of the United States and its agencies like Ginnie Mae, thereby signaling that the

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Since that time, Fannie Mae has not borrowed from the Treasury." U.S. DEP'T OF THE TREASURY, *supra* note 120, at A-97 n.5; *see also* Cochran & England, *supra* note 156, at 33 ("Neither Fannie Mae nor Freddie Mac has ever drawn on its credit line, but its mere existence serves to reinforce the notion that an implied government guarantee stands behind GSE-issued debt.").

[182] *See* Fitch Ratings Definitions, *supra* note 118, at 3 ("Fitch has stated previously that removal of the $2.25 billion line of credit at the Treasury likely would not warrant a rating action, in and of itself.").

[183] 12 U.S.C. § 1452(g); *see also id.* § 1455(e)(1) (stating that Freddie's enabling statute authorizes any person, trust, or organization to purchase, hold, or invest in Freddie's obligations sold pursuant to that statute "to the same extent that such person, trust, or organization is authorized under any applicable law to purchase, hold, or invest in obligations issued by or guaranteed as to principal and interest by the United States or any agency or instrumentality thereof"). Moreover, where "State law limits the purchase, holding, or investment in obligations issued by the United States by such a person, trust, or organization, such Corporation mortgages, obligations, and other securities shall be considered to be obligations issued by the United States for purposes of the limitation." *Id.* § 1455(e)(1).

[184] *See id.* § 1723c ("All obligations, participations, or other instruments issued by either [Fannie Mae and Ginnie Mae] shall be lawful investments, and may be accepted as security for all fiduciary, trust, and public funds, the investment or deposit of which shall be under the authority and control of the United States or any officer or officers thereof. All stock, obligations, securities, participations, or other instruments issued pursuant to this subchapter shall, to the same extent as securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, be deemed to be exempt securities within the meaning of laws administered by the Securities and Exchange Commission.").

[185] 15 U.S.C. § 77r-1(a)(1) (2006).

former is as safe as the latter, notwithstanding any state law to the contrary.[186]

Moreover, notwithstanding any other provision of law, "any institution, including a national bank or State member bank of the Federal Reserve System or any member of the Federal Deposit Insurance Corporation, trust company, or other banking organization, organized under any law of the United States, including the laws relating to the District of Columbia, shall be authorized to purchase shares of common stock of [Fannie Mae] . . . ."[187] This is another strong vote of confidence in Fannie's prospects.[188]

c. Federal Reserve Banks Act As Fannie and Freddie's Fiscal Agents. The Federal Reserve Banks are required by statute to act as fiscal agents for Fannie and Freddie.[189] This is a role that the Federal Reserve Banks primarily play for the federal government.[190] Again, Fannie and Freddie are known by the company they keep; they are treated like the federal government in this context as well.

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[186] *See supra* note 118 and accompanying text.

[187] 12 U.S.C. § 1718(d); *see also* 12 U.S.C. § 1464(c)(1)(D) (allowing federal savings association to buy Fannie Mae stock); *see also id.* § 1464(c)(1)(E) (allowing federal savings and loans to buy Freddie Mac preferred stock). As a general rule, banks are barred from owning stock or other equity stakes in for-profit corporations. Patricia A. McCoy, BANKING LAW MANUAL: FEDERAL REGULATION OF FINANCIAL HOLDING COMPANIES, BANKS AND THRIFTS § 7.03 (2d ed. 2003).

[188] Not everyone is sanguine about the outlook for Fannie and Freddie stock performance: a former Federal Reserve economist found that Fannie and Freddie equity shares are vulnerable to increases in short-term interest rates and changes in the spread between long-term and short-term interest rates. Frank A. Schmid, *Stock Return and Interest Rate Risk at Fannie Mae and Freddie Mac*, FED. RES. BANK OF ST. LOUIS REV., Jan.–Feb. 2005, at 35, 35.

[189] *See* 12 U.S.C. § 1452(d) (allowing Freddie to appoint Federal Reserve Bank as its fiscal agent); *id.* § 1723a(g) (authorizing and directing Federal Reserve banks to act as Fannie's fiscal agent).

[190] 31 C.F.R. § 306.0, n.1 (2007) (stating that fiscal agent regulations governing U.S. securities apply to most U.S. transferable and nontransferable securities but that they also may be "applied to securities issued by certain agencies of the United States and certain Government and Government-sponsored corporations"). As fiscal agents, "the Reserve Banks maintain securities issued by GSEs and international organizations on the Fedwire Securities Service and make interest and redemption payments to depository institutions on each issuer's behalf, in addition to providing other payment services generally related to these fiscal agency services." Board of Governors of the Federal Reserve System, Policy Statement on Payments System Risk, at 2 n.3 (Docket No. OP-1182, Sept. 23, 2004), *available at* http://www.federalreserve.gov/boarddocs/press/Other/2004/20040923/attachment.pdf.

The privileges identified in the Fannie and Freddie charters make it abundantly clear that Fannie and Freddie not only are favored entities, but also that the federal government encourages other financial institutions to see them as such. That being said, the explicit language in Fannie's and Freddie's charters, to be included on their securities, states that their "obligations, together with the interest thereon, are not guaranteed by the United States and do not constitute a debt or obligation of the United States or of any agency or instrumentality thereof other than the corporation."[191] This denial of a guarantee is augmented by the Congressional findings contained in the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, which state that Fannie and Freddie are not "backed by the full faith and credit of the United States."[192] This language appears to counter any argument that the Fannie and Freddie charters are the basis of a legally enforceable guarantee. But still, the regulatory environment in which they operate cuts in the other direction.

B. OTHER FEDERAL STATUTES AND REGULATIONS GRANT FANNIE AND FREDDIE A PRIVILEGED STATUS

In addition to the unique privileges contained within their charters, Fannie and Freddie have been granted a series of regulatory privileges in a number of other federal statutes and regulations. The Federal Reserve Board (FRB), in particular, treats them like extensions of the federal government.[193] The net result of the regulatory environment created by these statutes and regulations is the enhancement of "the perception that Fannie Mae's securities are Federal agency issues."[194] The same logic applies to the perception of Freddie's securities. The market understands this web of privileges to constitute an implied guarantee of Freddie and Fannie's obligations.[195]

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[191] *See* sources cited *supra* note 9.

[192] 12 U.S.C. § 4501.

[193] *See infra* Part IV.B.*1*. The FRB has restricted some of these privileges in recent years. *See* Board of Governors of the Federal Reserve System, *supra* note 190 (limiting GSE intra-day overdraft privileges).

[194] U.S. DEP'T OF THE TREASURY, *supra* note 120, at A-14.

[195] *See, e.g.*, Cochran & England, *supra* note 156, at 34 ("All of these provisions—from depository institutions' ability to hold unlimited amounts of GSE debt to the GSEs access to the Federal Reserve and the federal agency debt markets—expand the market for GSE paper and

1. The Federal Reserve Board Treats Fannie and Freddie Securities Like Government Securities. The Federal Reserve Board grants Fannie and Freddie significant privileges conferring a status upon them akin to instrumentalities of the federal government.[196] Federal Reserve Banks accept Fannie and Freddie's debt as collateral for discount window loans. To do this, the Federal Reserve rules interpret the phrase, "direct obligation of, and obligation fully guaranteed as to principal and interest by, the United States" from section 14(b) of the Federal Reserve Act to include Fannie and Freddie obligations.[197] Other acceptable collateral includes U.S. Treasuries, state and local government securities, and certain collateralized obligations.[198] Given that not all of Fannie and Freddie's debt is collateralized, this broad reading of section 14(b) is an extraordinary vote of confidence in the two companies by the Federal Reserve, and provides additional support for the existence of the implied guarantee because it equates Fannie and Freddie securities with government securities.[199] It is also evidence that the

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enhance its liquidity relative to corporate debt of similar grade and maturity. . . . [T]hese privileges do more than just confer a funding cost advantage on the GSEs. They also reinforce the perception of a federal guarantee on GSE debt obligations.").

[196] *See* STANTON, *supra* note 30, at 204 ("[T]he rules and regulations of government agencies like . . . the Federal Reserve Board may confer federal agency status on enterprise obligations and securities for specific purposes.").

[197] 12 U.S.C. § 347 (governing advances to member banks); *id.* § 355(2) (also known as section 14(b) of the Federal Reserve Act) (stating that every Federal Reserve Bank shall have power to "buy and sell in the open market . . . any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, any agency of the United States"); 12 C.F.R. § 201.108(b) (2007) (interpreting § 355 to encompass Fannie and Freddie securities). Member institutions borrow funds at the discount rate at the Federal Reserve's discount window. The Discount Window-Fedpoints-Federal Reserve Bank of New York, http://www.newyorkfed.org/aboutthefed/fedpoint/fed18.html (last visited July 1, 2008). The discount rate is the interest rate that the Federal Reserve Banks charge to member institutions, and typically refers to the primary rate (as opposed to the secondary rate) charged "to depository institutions with strong financial positions and ample capital." *Id.* Discount window loans "are secured by collateral that exceeds the amount of the loans." *Id.*; *see also* FED. RESERVE SYS., ALTERNATIVE INSTRUMENTS FOR OPEN MARKET AND DISCOUNT WINDOW OPERATIONS 1–15 (2002) (discussing use of discount window).

[198] *See* 12 C.F.R. § 201.108(d) (listing obligations eligible as collateral for advances); FED. RESERVE SYS., *supra* note 197, at 1–15 (discussing broader framework for eligible collateral under Federal Reserve). "In 1999, the Federal Reserve expanded the range of acceptable collateral to include such items as investment-grade certificates of deposit and AAA-rated commercial mortgage-backed securities." The Discount Window-Fedpoints-Federal Reserve Bank of New York, *supra* note 197.

[199] *See* 12 U.S.C. § 347 ("[A]ny Federal reserve bank may make advances for periods not exceeding ninety days to its member banks on their promissory notes secured by such notes, drafts, bills of exchange, or bankers' acceptances as are eligible for rediscount or for purchase by

institutional support within the federal government for Fannie and Freddie extends beyond Congress and includes the Federal Reserve as well.

2. Fannie and Freddie's Securities Are Eligible for Unlimited Investment by Federally Regulated Lenders. Federally regulated lenders, including national banks, federal savings associations, and federal credit unions, can make unlimited investments in Fannie and Freddie obligations, in contrast to the more restricted ability of those entities to invest in the obligations of other publicly traded corporations.[200] National banks are barred from dealing in securities for their own account except with the permission of the Comptroller of the Currency.[201] The limitations and restrictions placed on national banks regarding dealing in and underwriting securities

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Federal reserve banks under the provisions of this [Act] or secured by such obligations as are eligible for purchase under section 355 of this title."); *id.* § 355 (providing for purchase and sale by Federal reserve banks of "obligations of National, State, and municipal governments"). 12 C.F.R. § 201.108(b) interprets § 355 to mean that obligations of Fannie and Freddie are among the principal agency obligations eligible as collateral for advances, along with the obligations of Ginnie Mae and the U.S. Postal Service among other agencies. 12 C.F.R. § 201.108(b). Section 201.108(c) continues:

> Nothing less than a full guarantee of principal and interest by a Federal agency will make an obligation eligible. For example, mortgage loans insured by the Federal Housing Administration are not eligible since the insurance contract is not equivalent to an unconditional guarantee and does not fully cover interest payable on the loan. Obligations of international institutions, such as the Inter-American Development Bank and the International Bank for Reconstruction and Development, are also not eligible, since such institutions are not agencies of the United States.

Id. § 201.108(c). This is a striking statement by the Federal Reserve, equating Fannie and Freddie obligations with those of federal agencies.

[200] *See GSE Oversight: The Need for Reform and Modernization: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. 33-34 (2003) (statement of Dr. Jay Cochran, Mercatus Center at George Mason University), *available at* http://financialservices.house.gov/media/pdf/062503jc.pdf ("Banks and S&Ls may hold GSE securities in unlimited amounts. Normally, banks face strict limits on the amount they can lend to a single borrower. This safeguard is designed to protect the bank's solvency in the event a borrower defaults. The exceptions to these lending limits are U.S. Treasury debt and GSE debt."); STANTON, *supra* note 30, at 204 (describing implicit guarantee of enterprise obligations). *See generally* McCoy, *supra* note 187, § 7.03 (explaining securities powers of banks).

[201] 12 U.S.C. § 24; *see id.* § 335 ("State member banks [of the Federal Reserve System] shall be subject to the same limitations and conditions with respect to the purchasing, selling, underwriting, and holding of investment securities and stock as are applicable in the case of national banks under paragraph 'Seventh' of section 24 of this title."). The Gramm-Leach-Bliley Act of 1999 has liberalized these limitations somewhat by allowing commercial banks to have securities underwriting affiliates. *See generally* McCoy, *supra* note 187, §§ 7.02–7.03 (discussing impact of Gramm-Leach-Bliley Act).

exclude certain types of obligations, including certain obligations of, among others, the United States, the United States Postal Service, various government authorities, various entities insured by the federal government, and Ginnie Mae.[202] Added to this list are the obligations of Fannie and Freddie (as well as the Federal Home Loan Banks (FHLBs)).[203] Treating the obligations of these two publicly traded corporations the same as those of these ultra-safe government, government-insured and government-directed entities clearly telegraphs that Fannie and Freddie have an important public purpose that the United States stands behind.

The Home Owners' Loan Act (HOLA) makes similar provisions for federal savings associations. A federal savings association can invest without limitation in obligations of Fannie and Freddie.[204] Indeed, HOLA refers to the "obligations, participations, securities, or other instruments issued by, or fully guaranteed as to principal and interest by [Fannie Mae]" as government securities.[205] The Federal Credit Union Act contains similar provisions, allowing federal credit unions to invest unlimited funds in obligations of Fannie and Freddie, as well as a variety of federally-sponsored and guaranteed institutions.[206] The clear message of these statutes is that all of

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[202] *See* 12 U.S.C. § 24 *Seventh* (also listing obligations of Environmental Financing Authority, public housing agencies, and Washington Metropolitan Area Transit Authority, among others).

[203] *Id.* Notwithstanding these limitations, banks "may offer discount and full-service securities brokerage . . . [and] engage in the private placement of securities." McCoy, *supra* note 187, § 7.03. They may also invest in "a wide variety of debt obligations, other than junk bonds," a result partially brought about by the Gramm-Leach-Bliley Act. *Id.*

[204] *See* 12 U.S.C. § 1464(c)(1)(D)–(F); *see also id.* (allowing for FHLB investments). Other possible unlimited investments for federal savings associations in unsecured obligations include United States securities; state securities; certain insured loans; loans to financial institutions supervised by the federal government and to brokers and dealers registered with the SEC; stock and partnership investments arising under the Housing and Urban Development Act of 1968 as well as certain HUD insured and guaranteed investments; obligations of state housing corporations; certain small business related securities; credit card loans; and educational loans. *Id.* § 1464(c)(1). Federal savings associations may make only limited investments in other corporate debt. *Id.* § 1464(c)(2)(D). The Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) also prohibits savings associations from acquiring below-investment-grade securities, but makes an exception for securities of those entities, including Fannie and Freddie, that are enumerated in 12 U.S.C. § 1464(c)(1)(D)–(F) and 12 U.S.C. § 1831e(d). The other enumerated entities are federal home loan banks, Sallie Mae (when it was a GSE) and federal agencies. *Id.* § 1464(c)(1)(D)–(F).

[205] *Id.* § 1464(c)(1)(F).

[206] *Id.* § 1757(7)(E). Other possible unlimited investments for federal credit unions include (i) obligations of the federal government or securities fully guaranteed as to principal and interest thereby; (ii) shares or accounts of S&L associations or mutual savings banks, the

these federally regulated lenders will not be put at risk by investing in Fannie and Freddie securities.

3. Fannie and Freddie Have Weaker Capital Requirements Than Other Financial Institutions. Fannie Mae and Freddie Mac are only required to hold 2.5% of their capital against mortgages and mortgage-backed securities retained in their portfolios.[207] Other financial institutions typically have higher capital requirements.[208] This disparity translates to a dramatic benefit because it allows Fannie and Freddie to leverage their investments more than other financial institutions. Such leverage can lead to much greater profits and, it should also be noted, losses.[209]

4. Fannie and Freddie Have a Variety of Additional Unique Privileges. Fannie and Freddie have an array of privileges scattered throughout the web of federal law and regulation. For instance, they are exempt from certain privacy restrictions and creditworthiness requirements. These privileges further support the existence of the implied guarantee. First, these privileges grant competitive advantages. Second, creditworthiness exemptions signal that Fannie and Freddie obligations pose no risk of default.

Fannie and Freddie are exempt from the Gramm-Leach-Bliley financial privacy restrictions.[210] This exemption is another cost

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accounts of which are insured by the Federal Savings and Loan Insurance Corporation or the Federal Deposit Insurance Corporation; (iii) obligations issued by federal land banks, federal intermediate credit banks, or designated wholly owned Government corporations; (iv) obligations, participations, or other instruments of or issued by, or fully guaranteed as to principal and interest by Ginnie Mae; (v) obligations, participations, securities, or other instruments of, or issued by, or fully guaranteed as to principal and interest by any other agency of the United States; (vi) participation certificates evidencing beneficial interests in obligations, or in the right to receive interest and principal collections therefrom, which obligations have been subjected by one or more government agencies to a trust or trusts for which any executive department, agency, or instrumentality of the United States (or the head thereof) has been named to act as trustee; (vii) shares or deposits of any central credit union in which such investments are specifically authorized by the board of directors of the federal credit union making the investment; (viii) shares, share certificates, or share deposits of federally insured credit unions; (ix) capital stock of the National Credit Union Central Liquidity Facility; and (x) obligations issued by federal home loan banks and the Federal Home Loan Bank Board. *Id.* § 1757(7).

[207] Frame & White, *supra* note 67, at 170.

[208] *See* McCoy, *supra* note 187, § 6.03 (reviewing capital requirements applicable to banks and thrifts).

[209] *See* OFFICE OF FED. HOUS. ENTER. OVERSIGHT, *supra* note 145, at 15–17 (discussing impact of various financial crises on highly levered financial institutions). The potential for greater losses leads, of course, to the potential for greater taxpayer exposure to the implied guarantee.

[210] 15 U.S.C. § 6809(3)(D) (2006) (exempting Fannie and Freddie from definition of

advantage that the federal government grants to Fannie and Freddie.[211] And it is another signal that Fannie and Freddie are "different" from other financial institutions and more like the government, thereby possibly enhancing the implied guarantee.

HUD regulations group Fannie and Freddie, along with federal, state, and municipal governmental agencies, Federal Reserve Banks, and Federal Home Loan Banks, as "approved lender[s]" for the purposes of certain mortgage and loan insurance programs, are exempt from the "net worth requirement" applicable to other "approved lender[s]."[212] Again, the clear message here is that Fannie and Freddie are not at risk of defaulting on their obligations.

* * *

Some of the privileges outlined above clearly support the existence of the implied guarantee. For instance, the treatment of Fannie and Freddie securities like government securities, the eligibility of those securities for unlimited investment by federally regulated lenders, and Fannie and Freddie's weaker capital requirements all send a clear message that investors can have faith in their creditworthiness. Other privileges do not send such a clear message. For instance, the presidential appointments to the board and Fannie's and Freddie's exemption from federal privacy law do not directly speak to the implied guarantee. But that is mostly beside the point. The first set of privileges so clearly creates the implied guarantee that the individual privileges of the second set have only marginal importance to the case for the implied guarantee. And, at a minimum, the second set of privileges supports the "web" theory of the implied guarantee promoted by many of those taking the market view on this issue.[213]

"financial institution" for purposes of act so long as Fannie and Freddie "do not sell or transfer nonpublic personal information to a nonaffiliated third party"); *see also id.* § 6801(a) (stating that rationale of statute is to protect security and confidentiality of nonpublic personal information of financial institutions' customers).

[211] MORTGAGE BANKERS ASS'N, *supra* note 68, at 4 ("Less expensive access to vast amounts of personal consumer information is another anti-competitive benefit the GSEs enjoy as a result of their loan underwriting technology.").

[212] 24 C.F.R. § 202.10(a) (2007). Fannie and Freddie also are excluded from the definition of servicer for certain purposes of the Real Estate Settlement Procedures Act. 12 U.S.C. § 2605(i)(2) (2006). This exclusion thereby reduces the applicability of the Homeowners Protection Act, which relates to the regulation of private mortgage insurance, to Fannie and Freddie. *See id.* § 4901(16) ("The term 'servicer' has the same meaning as in [12 U.S.C. § 2605(i)(2)], with respect to a residential mortgage.").

[213] *See supra* note 118 and accompanying text.

C. THE STRONG CLAIM: THE IMPLIED GUARANTEE IS A LEGAL OBLIGATION OF THE FEDERAL GOVERNMENT

The securities disclaimer language in the Fannie and Freddie charters denying the existence of a federal guarantee of their obligations presents a difficult—perhaps insurmountable—hurdle to the claim that the federal government is legally required to guarantee those obligations. But given the conflict between that language and the regulatory environment described above, it is worth at least vetting the case.

1. The Lack of a Provision for Receivership Demonstrates That Congress Does Not Contemplate That Fannie and Freddie Can Become Insolvent. Professor Carnell has documented that no adequate insolvency mechanism exists for Fannie and Freddie because, "[u]nlike ordinary business firms, they cannot liquidate or reorganize under the Bankruptcy Code."[214] The very fact that there is no such mechanism supports the notion that there is an implied guarantee because Congress would only have omitted such a mechanism if it did not expect that the two companies could fail. This state of affairs helps to feed the Too Big to Fail mentality regarding Fannie and Freddie discussed above.[215]

2. The Statutory Disclaimer of a Guarantee Is Ambiguous. Fannie and Freddie are just two of a number of GSEs, each with its own

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[214] Carnell, *supra* note 22, at 567. A conservator could be appointed, but that would not address more serious financial distress. *Id.* ("If Fannie or Freddie became sufficiently troubled, its regulator could appoint a 'conservator' to take control of the firm and attempt to restore the firm's financial health. But by then the firm's problems could well have become too severe for a conservator to resolve. The conservator would have only limited powers.").

[215] *See supra* notes 137–46 and accompanying text; *see also Proposals*, *supra* note 120, at 12 (statement of David F. Wilson, National Association of Home Builders) ("Last year, some, including Standard and Poor's (S&P), speculated that giving receivership powers to the new GSE regulator would cause investors to abandon their notion of an implicit guarantee and, as a result, increase their yield requirements on GSE mortgage-backed securities and debt."); Brent W. Ambrose & Tao-Hsien Dolly King, *GSE Debt and the Decline in the Treasury Debt Market*, 34 J. MONEY, CREDIT & BANKING 812, 816 (2002) (arguing that "the extent to which the GSEs are able to increase the value of the conjectural guarantee, by either taking on more risk or increasing their size, they increase the perception that they are 'too-big-to-fail' "). The Too Big to Fail mentality also undercuts arguments for privatization. WALLISON, STANTON & ELY, *supra* note 72, at 21 ("Most plans for the privatization of Fannie Mae and Freddie Mac founder on two shoals: that the companies, when privatized, will still be so large as to be 'too big to fail' and that privatization will disrupt the process of residential financing, thus harming the U.S. economy.").

enabling statute.[216] The enabling statutes of Fannie and Freddie do not explicitly state that their obligations are not obligations of the federal government: they merely require that their obligations indicate on their face that there is no federal guarantee.[217] Other GSEs, however, have explicit denials of liability in their enabling statutes in addition to any requirements that their obligations show such a disclaimer on their face.[218] Thus, there is arguably some ambiguity as to whether the federal government actually disclaims liability for the obligations of Fannie or Freddie due to the absence of the explicit denial of a federal guarantee in their enabling statutes.[219]

The enabling act of the Farm Credit System explicitly states that the "United States shall not be liable or assume any liability directly or indirectly" on the obligations of the Farm Credit System.[220] The Financing Corporation (FICO) and the Resolution Funding Corporation (REFCO) enabling statutes combine the Fannie/Freddie language and the Farm Credit System language; for instance, the FICO statute states that obligations of FICO "and the interest payable on such obligations shall not be obligations of, or guaranteed as to principal or interest by, the Federal Home Loan Banks, the United States, or the [Federal Savings and Loan Insurance Corporation] Resolution Fund and the obligations shall so plainly state."[221]

Assuming that Congress intended there to be a difference between these three different approaches to the federal government's responsibilities toward GSE obligations, it would seem that Congress intended for the Farm Credit System, FICO, and REFCO denials of

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[216] Others include the Federal Home Loan Bank System, the Financing Corporation, the Resolution Funding Corporation, the Farm Credit System, and Farmer Mac.

[217] *See, e.g.*, 12 U.S.C. § 1435 ("All obligations of Federal Home Loan Banks shall plainly state that such obligations are not obligations of the United States and are not guaranteed by the United States."); *id.* § 2279aa-6(e)(3)(B) (stating that Farmer Mac obligations "shall clearly indicate that the obligation is not an obligation of, and is not guaranteed as to principal and interest by, the Farm Credit Administration, the United States, or any other agency or instrumentality of the United States (other than the Corporation)").

[218] *See* sources cited *infra* notes 220–21.

[219] I thank Larry Solan for suggesting this line of inquiry.

[220] 12 U.S.C. § 2155(c).

[221] *Id.* § 1441(e)(6); *see also id.* § 1441b(f)(10) ("Obligations of the Funding Corporation [REFCO] shall not be obligations of, or guaranteed as to principal by, the Federal Home Loan Bank System, the Federal Home Loan Banks, the United States, or the Resolution Trust Corporation and the obligations shall so plainly state.").

responsibility to be stronger than the Fannie/Freddie language.[222] This is particularly true because (i) the Farm Credit System language was enacted prior to the statute implementing Fannie and Freddie's current regulatory regime;[223] (ii) the Farm Credit System, FICO and REFCO statutes were amended (in the case of the Farm Credit System)[224] or enacted (in the case of FICO[225] and REFCO[226]) after the Fannie/Freddie enabling statutes were enacted;[227] and (iii) Congress has substantially amended the Fannie and Freddie statutes since the amendment of the Farm Credit System statute and the enactment of the FICO and REFCO statutes.[228] Thus, Congress is presumed to have had the opportunity to review the variations in the GSE enabling statutes relating to the denial of a federal guarantee and is therefore presumed to have intentionally chosen to implement these subtle differences.

It is difficult, of course, to understand what rationale Congress would have for such subtle differences between the statutes. Perhaps the best interpretation is that "Homer nodded" and that there are no substantial differences among these statutes. Another interpretation is that Congress intended to imply greater support for Fannie and Freddie than for other GSEs, such as the Farm Credit System, in order to promote the growth of owner-occupied housing, a

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[222] *Cf.* WILLIAM N. ESKRIDGE, JR., PHILIP P. FRICKEY & ELIZABETH GARRETT, LEGISLATION AND STATUTORY INTERPRETATION 291–94 (2006) (stating that Congress is presumed to know that a law will be interpreted in context of prior laws that had sections incorporated into more recent law).

[223] *Compare* Farm Credit Act of 1971, Pub. L. No. 92-181, 85 Stat. 583 (codified at 12 U.S.C. § 2155(c)) (creating the Farm Credit System), *with* Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Pub. L. No. 102-550, 106 Stat. 3941 (codified as amended at 12 U.S.C. §§ 4501–4641) (establishing, *inter alia*, risk-based and minimal capital standards for Fannie and Freddie).

[224] *See* Farm Credit Administration Handbook, Statutes, http://www.fca.gov/download/Statutes.pdf (last visited July 25, 2008) (listing amendments to Farm Credit Act of 1971).

[225] *See* Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552 (relevant section codified at 12 U.S.C. § 1441(e)(6)).

[226] *See* Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (relevant section codified at 12 U.S.C. §1441b(f)(10)).

[227] *See* Federal Home Loan Bank Act of 1932, Pub. L. No. 304, 47 Stat. 725 (codified at 12 U.S.C. § 1435).

[228] *Compare* Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Pub. L. No. 102-550, 106 Stat. 3941 (codified as amended at 12 U.S.C. §§ 4501–4641) (amending regulatory framework for Fannie and Freddie), *with* Food, Agriculture, Conservation, and Trade Act Amendments of 1991, Pub. L. No. 102-237, 105 Stat. 1818 (amending Farm Credit Act of 1971, Pub. L. No. 92-181, 85 Stat. 583), Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552 (establishing FICO), *and* Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) of 1989, Pub. L. No. 101-73, 103 Stat. 183 (establishing REFCO).

key goal of American housing policy.[229] A third interpretation is that Congress required the Fannie/Freddie language to be placed on their securities in order to prevent third parties from having a cause of action based on the special status of Fannie and Freddie while leaving open the possibility that Fannie and Freddie, or the federal government itself, could plausibly assert that the federal government was authorized to guarantee Fannie/Freddie debt, if they were to become insolvent.[230]

The matter of interpretation is only complicated by the congressional findings contained in the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, which state that Fannie and Freddie are not "backed by the full faith and credit of the United States."[231] The complication, of course, is that Congress could have incorporated into the statute language like that of the Farm Credit System, denying the existence of the guarantee. But instead, Congress includes such a disclaimer in the findings contained in the preamble to the statute. The meaning of the disclaimer gets even more complicated later in that statute, where Congress states that:

> This title and the amendments made by this title may not be construed as obligating the Federal Government, either directly or indirectly, to provide any funds to the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, or the Federal Home Loan Banks, or to honor, reimburse, or otherwise guarantee any obligation or liability of the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, or the Federal Home Loan Banks. This title and the amendments made by this title may not be construed as implying that any such enterprise or Bank, or any obligations or securities of such an enterprise or Bank, are backed by the full faith and credit of the United States.[232]

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[229] *See* HUD FHA Celebrates Homeownership, http://www.hud.gov/initiatives/homeownership/ (last visited July 20, 2008) ("Helping more low and moderate income Americans become homeowners is a national priority, especially first-time homebuyers and minority families.").

[230] The existence of Fannie's and Freddie's lines of credit with the Treasury supports this argument, as it is evidence that the enabling statute intended to give the federal government the authority to come to Fannie and Freddie's rescue.

[231] 12 U.S.C. § 4501(4).

[232] *Id.* § 4503.

This is oddly drafted because it does not explicitly deny the existence of the implied guarantee; it merely states that its source is not the 1992 Act itself. This odd drafting makes it appear as if Congress intended to maintain the ambiguity surrounding the implied guarantee that existed at the time the 1992 Act was being considered by Congress.

One might also look to the legislative history of the Fannie and Freddie enabling statutes to determine whether Congress intended to guarantee their obligations. There are some interesting aspects to the legislative history, including the fact that it was "budget pressures from the Vietnam war" that led Congress to transform Fannie Mae from a government corporation to an off-budget GSE.[233] But the legislative history is ultimately unsatisfying as it is ambiguous and conflicting. If it demonstrates anything, it is that Congress did not focus on the implied guarantee and did not even begin to imagine that Fannie and Freddie would become the behemoths they are today.

3. The Federal Government Could Be Estopped from Denying the Implied Guarantee. The regulatory environment that the federal government has promulgated regarding Fannie and Freddie appears to firmly support the existence of the implied guarantee, notwithstanding the disclaimer language prescribed in Fannie's and Freddie's charters. Nonetheless, it is very difficult as a general rule to assert promissory estoppel against the government.[234]

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[233] Robert Van Order, *A Microeconomic Analysis of Fannie Mae and Freddie Mac*, 23 REGULATION 27, 28 (2000); *see* Froomkin, *supra* note 163, at 559 ("[Federal Government Corporations] classified as either mixed-ownership or private tend to be given 'off budget' status. Once excluded from the national accounts, their borrowing is not counted as part of the official measure of the federal deficit. When Congress operates under spending caps or deficit reduction targets, pursuant to the Gramm-Rudman-Hollings budget reduction process for example, off-budget items are usually excluded from the official total 'spent' by the government. As a result, a few GSEs were created as little more than accounting devices designed to allow the federal government to borrow funds without appearing to increase the deficit." (citations omitted)).

[234] *See* 28 AM. JUR. 2D *Estoppel and Waiver* § 139 (2000) ("A litigant asserting estoppel against the government bears a heavy burden, particularly when the government acts in a sovereign or governmental role rather than a proprietary role. In fact, it has been held that estoppel may not be applied against the government acting in its sovereign capacity. However, some courts do not apply a rigid distinction between sovereign and proprietary activities in determining the applicability of estoppel against the government, but instead hold that estoppel may be applied against the government even while exercising governmental functions under appropriate circumstances." (citations omitted)).

4. The Existence of a Legally Enforceable Implied Guarantee Is Irrelevant and, in Any Case, Would Never Be Reached by a Court. The case for a legally-binding guarantee appears weak. This is, however, mostly irrelevant. If injured parties needed to go to the court for redress, the delays, even the shortest delays, would wreak havoc on the global financial system. The guarantee of payment is the most important aspect of the implied guarantee, but the guarantee of *timely* payment is of great importance as well.[235] Indeed, credit rating agencies value timeliness as a key component of creditworthiness.[236] Fannie and Freddie guarantee the timely payment of their securities.[237] This guarantee of timely payment is a significant part of the attraction of Fannie and Freddie obligations for investors and is integral to the market's understanding of the implied guarantee. If Fannie and Freddie found themselves unable to make timely payments on their obligations and the federal government did not provide them with the necessary funds to do so, it would likely set off a financial crisis that would be at least on par with the implosion of Long-Term Capital Management in the late 1990s.[238] Given that Fannie and Freddie securities are

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Moreover, the Federal Tort Claims Act (FTCA) does not apply to Fannie and Freddie. *See* Mendrala v. Crown Mortgage Co., 955 F.2d 1132, 1138 (7th Cir. 1992) (holding that Freddie Mac "is not a federal agency for purposes of the FTCA"); *see also* 28 U.S.C.S. § 2680(h)–(i) (Lexis 2006) (enumerating exceptions to FTCA for claims based on misrepresentation and fraud as well as claims "for damages caused by the fiscal operations of the Treasury or by the regulation of the monetary system").

[235] The "principal credit risk of concern to the rating agencies is the possibility that cash flows may be impaired or *interrupted* . . . ." JASON H.P. KRAVITT, SECURITIZATION OF FINANCIAL ASSETS § 7.02[C] (2d ed. 2004 Supp.) (emphasis added).

[236] *See, e.g.*, Philippe Jorion et al., *Informational Effects of Regulation FD: Evidence from Rating Agencies*, 76 J. FIN. ECON. 309, 313 (2005) ("[Creditworthiness] has been defined by Moody's [ ] as an 'opinion of the future ability, legal obligation, and willingness of a bond issuer or other obligor to make full and *timely* payments on principal and interest due to investors.' " (emphasis added)).

[237] *See, e.g.*, Mortgage-Backed Securities: Basics of Fannie Mae MBS, http://www.fanniemae.com/mbs/mbsbasics/remic/issuance.jhtml (last visited July 20, 2008) (noting that Fannie Mae REMICs "carry a guaranty of timely payment of principal and interest").

[238] *See generally* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2000) (describing Long-Term Capital Management's implosion); *see also* STANTON, *supra* note 30, at 26 ("The government faces immense pressure to stand behind a failing government-sponsored enterprise, just as it ultimately guaranteed all of the obligations of the Continental Illinois Corporation, the large and completely private holding company parent of the Continental Illinois National Bank. Only a small fraction of total Continental debt was held by depositors in the bank's federally insured accounts. The bank had about $40 billion in assets, making it a much smaller institution than are most enterprises today.").

ubiquitous in the portfolios of investors throughout the world, it would likely be much worse.[239] Thus, the federal government is likely to act well before any court has had a chance to rule on the enforceability of the implied guarantee.

D. THE WEAK CLAIM: THE IMPLIED GUARANTEE IS A MORAL OBLIGATION THAT THE FEDERAL GOVERNMENT MUST HONOR

There is every reason to believe, as the market does, that the federal government will honor the implied guarantee. First, Congress assisted Fannie Mae once before when it was insolvent. Second, Congress has bailed out other GSEs. Third, the secondary impacts on the financial markets—in addition to the likelihood of a global financial panic discussed above—would be so severe that it is hard to imagine that the federal government would find them acceptable. Underlying all of these arguments is the fact that nearly every federal law and regulation affecting Fannie and Freddie supports the markets' view that the federal government guarantees their obligations.

The federal government has never permitted a federally chartered corporation to fail from insolvency.[240] In fact, the federal government bailed out Fannie Mae when it was insolvent on a market-value basis in the late 1970s and early 1980s.[241] In 1987, the federal

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[239] *See* Ruth Simon, James R. Hagerty & James T. Areddy, *Housing-Bubble Talk Doesn't Scare Off Foreigners*, WALL ST. J., Aug. 24, 2005, at A1 (discussing international demand for mortgage-backed securities); *see also* Henry, *supra* note 145 ("[T]he GSEs' interest rate positions are highly concentrated and pose significant risks to a number of large financial institutions.").

[240] STANTON, *supra* note 30, at 206.

[241] White, *supra* note 118, at 14 n.7. *But see* Peter J. Wallison, *The Evolution of a Policy Idea: How Restrictions on the Size of the GSEs' Portfolios Became the Central Issue in Reform of Their Regulation*, NETWORKS FIN. INST. 2006-PB-03, at 10 (2006), *available at* http://ssrn.com/abstract=923571 (arguing that at time of Fannie Mae's insolvency "[t]here was little doubt in the markets that the government could bail out Fannie Mae, if necessary, without creating a heavy cost to taxpayers."). The fact that Fannie Mae was insolvent on a market-value basis did not mean that it could not keep current with the payments on its due and payable obligations. Thus, this episode did not present the type of crisis that insolvency on a cash-flow basis would. Insolvency on a cash-flow basis would mean that Fannie was not able to keep current with its payments. The bailout took the form of supervisory forbearance. *See* Edward J. Kane & Chester Foster, *Valuing Conjectural Government Guarantees of FNMA Liabilities*, *in* BANK STRUCTURE AND COMPETITION, PROCEEDINGS OF THE FEDERAL RESERVE BANK OF CHICAGO 347, 348 (1986) (arguing that regulatory forbearance during Fannie Mae's insolvency was unfair to taxpayers); Eisenbeis et al., *supra* note 118, at 6 n.10 ("During the late 1970s and early 1980s, Fannie Mae was insolvent on a market value basis and benefited from supervisory

government also created a GSE, FICO, to take on the obligations of the insolvent Federal Savings and Loan Insurance Corporation (FSLIC).[242] Moody's has stated that the "past provision of government assistance to a GSE can not only boost a GSE's current financial health, but more important it can indicate that further assistance could be forthcoming if required. It can be a 'test case' for implied support."[243] In addition to assisting Fannie Mae during its financial crisis, Congress has bailed out other GSEs.

In 1987, Congress came to the rescue of the Farm Credit System.[244] What is most important about the Farm Credit System bailout for the purposes of this Article is that the federal government "developed and implemented a $4 billion bailout plan, confirming the capital markets' view about what the government would do if Fannie and Freddie were to experience financial difficulty."[245] Similarly, Congress authorized FICO to issue over eight billion dollars in bonds for the purpose of recapitalizing FSLIC.[246] And when concern grew that FICO might default on these bonds, Congress enacted a law that reduced the risk of default.[247] That action "set an important precedent by reinforcing the bond markets' belief that the federal government stands behind the debt of any private firm it has established."[248]

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forbearance."). It is worth noting, of course, that the federal government also bailed out the S&L industry at around the same period. *See* Lawrence J. White, THE S&L DEBACLE 123–204 (1991) (discussing regulatory response and cleanup of S&L industry).

[242] *See* Competitive Equality Bank Act of 1987, Pub. L. 100-86, Title III (codified at 12 U.S.C. § 1441 (2006)). *See generally* White, *supra* note 241 (reviewing history of S&L crisis).

[243] KRIZ, *supra* note 106, at 2. One might think the fact that the federal government has previously bailed out Fannie would be dispositive as the existence of the implied guarantee. I do not believe that is the case. Chrysler, for instance, was bailed out by the federal government in the 1980s and is facing serious trouble once again; no one thinks that the federal government would bail out a manufacturing company again. *See* Micheline Maynard, *This Time, No Roadside Assistance*, N.Y. TIMES, Feb. 25, 2007, § 3, at 1 ("No one is talking about a government-financed bailout to give Chrysler another chance . . . ."). Thus, the previous bailout of Fannie Mae is best seen as an important, but not dispositive, fact.

[244] WALLISON, STANTON & ELY, *supra* note 72, at 3; White, *supra* note 118, at 14 n.7. For a history of the Farm Credit System bailout, see generally STANTON, *supra* note 30.

[245] WALLISON, STANTON & ELY, *supra* note 72, at 3.

[246] Keith J. Leggett & Robert W. Strand, *The Financing Corporation, Government-Sponsored Enterprises, and Moral Hazard*, 17 CATO J. 179, 179 (1997).

[247] *Id.*

[248] *Id.* "The 1996 law—indeed the very fact that it was proposed—sets an important precedent. Federal officials stated publicly that the reason the FICO bonds had to be protected was to ensure that the bond markets would not become concerned about debt issued by other GSEs." *Id.* at 182.

Obviously, these bailouts create a cycle of expectations. At this point, a refusal to bail out a GSE "is likely to cause severe credit shortages in the relevant markets and to cause a great decline in confidence in the other" federal government corporations (including GSEs) that operate in the credit markets.[249] The implied guarantee, even if not a legal obligation, is real.

V. THE IMPLIED GUARANTEE SHOULD BE TERMINATED

This Article argues that Fannie and Freddie should be privatized and that the implied guarantee should thereby be terminated. This is generally considered a political nonstarter, particularly because Fannie and Freddie have many allies in the Republican and Democratic parties.[250]

As a result, there has been no shortage of relatively modest proposed responses to Fannie and Freddie's privileged status. These include limiting the size of their mortgage portfolios;[251] limiting their debt issuance;[252] stripping GSEs of some of their unique privileges to signal to the market that the implied guarantee has been weakened;[253] freezing the conforming loan value to limit the size of mortgages they can buy, thereby limiting their overall size;[254] requiring them to obtain ratings from rating agencies for their debt issuances that discount the implied guarantee;[255] chartering additional GSE competitors to spread the risk that Fannie and Freddie pose as well as to erode their monopoly profits;[256] imposing

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[249] Froomkin, *supra* note 163, at 580. Froomkin uses the term "federal government corporation" to refer to a range of government-created corporations that are wholly-owned and partially-owned by the federal government as well as government-created corporations that are owned by private parties (e.g., Fannie and Freddie). *See id.* at 546 (discussing federal government corporations).

[250] *See* Lee & Dash, *supra* note 113 (noting many influential figures are involved with Fannie and Freddie).

[251] Jaffee, *supra* note 116, at 1.

[252] *Proposals*, *supra* note 120, at 10.

[253] Kulp, *supra* note 117.

[254] White, *supra* note 118, at 18 n.23.

[255] STANTON, *supra* note 30, at 176.

[256] STANTON, *supra* note 29, at 3; *Oversight of the Government Sponsored Enterprises: The Risks and Benefits to Consumers: Hearing Before the Subcomm. on Financial Management, the Budget, and International Security of the S. Comm. on Governmental Affairs,* 108th Cong. 33 (2003), *available at* http://www.senate.gov/~gov_affairs/072103pollock.pdf (statement of Alex J. Pollock, President and Chief Executive Officer, Federal Home Loan Bank of Chicago) (arguing that Federal Home Loan banks are natural competitors to Fannie and Freddie because, "due to

user fees;[257] regulating them as public utilities;[258] and strengthening their subordinated debt programs.[259] And Congress has recently considered a GSE reform bill that had garnered some bipartisan support.[260] The bill would have only slightly increased the funding and supervisory power of OFHEO.[261] But these proposals would not end the risk posed by the implied guarantee, particularly because Fannie and Freddie's powerful lobbying forces would be sure to dilute any half-measures that were enacted as soon as the public's focus shifted to other areas of concern.

Just as the FDIC managed Too Big to Fail expectations for the banks it regulates, the federal government needs to do the same thing for Fannie and Freddie: privatization is needed to achieve this goal. And while privatization is currently not being seriously considered by Congress, it has been a perennial topic at the highest levels of the federal government; indeed, the Treasury Department has argued across Democratic and Republican Administrations that it "is appropriate to wean a GSE from Federal sponsorship once the GSE becomes economically viable and successfully fulfills the purpose for which it was created with Federal sponsorship, or when the purpose for which it was created ceases to exist."[262]

Professor White has simply and elegantly framed the ideal privatization as follows:

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the special privileges conferred in GSE charters, only a GSE has the ability to compete with another GSE in the business of funding long-term mortgages").

[257] James F. Gatti & Ronald W. Spahr, *The Value of Federal Sponsorship: The Case of Freddie Mac*, 25 REAL EST. ECON. 453, 482 (1997) (proposing imposition of user fees to reduce cost of Fannie and Freddie subsidy).

[258] STANTON, *supra* note 29, at 3.

[259] Valerie L. Smith, *Subordinated Debt Issuance by Fannie Mae and Freddie Mac* 37–47 (OFHEO Working Paper 07-3, 2007), *available at* http://www.ofheo.gov/media/WorkingPapers/workingpaper073.pdf. Properly structured subordinated debt can be deployed to signal credit risk. *Id.*

[260] *See supra* note 108 and accompanying text.

[261] *See supra* notes 108–09 and accompanying text.

[262] *Joint Hearing on Privatizing Government Sponsored Entities (GSEs) Before the Subcomm. on Postsecondary Education, Training and Life-Long Learning of the H. Comm. on Economic and Educational Opportunities and the Subcomm. on National Economic Growth, Natural Resources, and Regulatory Affairs of the H. Comm. on Government Reform and Oversight*, 104th Cong. 2 (1995) (statement of Darcy Bradbury, Deputy Assistant Secretary, Federal Finance, Department of Treasury); *see also* PRESIDENT'S COMM'N ON PRIVATIZATION, PRIVATIZATION: TOWARD MORE EFFECTIVE GOVERNMENT 38 (1988) (recommending that Fannie and Freddie be fully privatized).

> Figuratively, public policy should shake the hands and pat the backs of the senior managements of the two companies (and their predecessors for the past three decades), praise them and tell them "job well done" (for helping bring about the securitization revolution), and point them toward the Delaware Secretary of State's office in Dover for their new corporate charters.[263]

There obviously would be costs associated with privatizing Fannie and Freddie.[264] First, to the extent that Fannie and Freddie play a role in stabilizing the residential mortgage markets, other federal instrumentalities would need to replace them. Second, some studies indicate that the spreads for GSE securities would widen from twenty-two to sixty basis points from comparable Treasuries.[265] This will, of course, impact home owners who would pay slightly higher interest rates for their conforming mortgages. These costs are quite

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[263] White, *supra* note 118, at 17.

[264] In addition to evaluating the costs and benefits to homeowners and taxpayers of privatizing Fannie and Freddie, scholars also have evaluated the costs and benefits to Fannie and Freddie and their shareholders of maintaining their privileged regulatory status. *See, e.g.*, Michael J. Lea, *Privatizing a Government Sponsored Enterprise: Lessons from the Sallie Mae Experience*, NETWORKS FIN. INST. 2006-PB-09 (2006), *available at* http://ssrn.com/abstract=923461. This is important not only to ensure basic fairness to the company, its investors, and its employees, but also to ensure that GSEs that may be chartered in the future are not hamstrung by expectations of a "bait and switch" by the government once they have achieved the goals Congress has set for them. *Cf. id.* at 3 ("Three rationales emerged for the privatization of Sallie Mae. First, the public policy purpose for which it was created had been achieved; second, investors faced a significant threat to the value of their investment from the political uncertainty surrounding the GSL program; and third, there were significant foregone opportunities associated with Sallie Mae's restrictive charter."). The greatest cost of losing GSE status would be the increased cost of borrowing that they would face without the implied guarantee. *See id.* at 6 (discussing up-front costs). Fannie and Freddie also would face increased costs caused by the loss of their various privileges regarding taxes and securities regulation compliance discussed above. *See supra* Part IV.A. These lost privileges might be compensated by the increased freedom that Fannie and Freddie would have to compete with other financial institutions in new markets. If the experience of Sallie Mae is any guide, this could be very valuable to Fannie and Freddie. *See* Lea, *supra*, at 5 (describing new opportunities resulting from privatization).

[265] Kulp, *supra* note 117. A basis point is equal to one-hundredth of a percentage point. LEE GREMILLION, MUTUAL FUND INDUSTRY HANDBOOK: A COMPREHENSIVE GUIDE FOR INVESTMENT PROFESSIONALS 7 (2d ed. 2005). Recent events provide some support for Fannie and Freddie's claim that they provide liquidity when financial markets are in turmoil. *See* Ruth Simon, *Home Inequity: Borrowers with Good Credit Are Paying Higher Rates on Jumbo Mortgages Because of Fallout from Subprime Crisis*, WALL ST. J., Aug. 16, 2007, at D1 (noting that "the gap between the prices of jumbo and conforming mortgages has widened to 0.77 percentage point, according to HSH Associates. That's up from a recent low of 0.17 percentage point and well above the 0.24-percentage-point average since 2000.").

manageable for the typical homeowner, particularly given that he or she would be relieved of a proportionate share of the contingent liability represented by the implied guarantee that could result in higher taxes or reduced services if the federal government ever had to make good on the guarantee.[266]

Finally, Fannie and Freddie, because of their market dominance and their origins as government-created enterprises, have imposed pro-consumer terms on much of the residential mortgage market.[267] Similarly, Fannie and Freddie have imposed a variety of best practices on secondary mortgage market players, like loan originators.[268] These practices would need to be maintained through legislation or regulation as part of any privatization initiative.

There is a useful precedent for privatization. In the mid-1990s, Congress commenced the process of privatizing Sallie Mae, a GSE that provided loans for higher education to students and their parents.[269] Sallie Mae's managers and shareholders supported this process as their regulatory environment became less and less friendly.[270] The privatization was accomplished with the creation of a non-GSE holding company which gradually rid itself of Sallie Mae's GSE obligations.[271] Once the GSE obligations were all satisfied, Sallie Mae became just another private company. Both the ultimate privatization and the process of privatization were considered a great success by legislators and Sallie Mae's employees and shareholders;[272] indeed, the company completed the privatization

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[266] Assuming an increased forty-one point spread (average of twenty-two and sixty) on a $200,000 mortgage, a borrower would pay an additional sixty-eight dollars each month in interest. Kulp, *supra* note 117. Fannie and Freddie shareholders also may suffer, of course, from the loss of the portion of the subsidy they retain, but such a result would be one of the intended effects of privatization. It also might be offset by Fannie and Freddie's ability to enter new lines of business once privatized.

[267] *See generally* Julia Patterson Forrester, *Fannie Mae/Freddie Mac Uniform Mortgage Instruments: The Forgotten Benefit to Homeowners*, 72 MO. L. REV. 1077 (2007) (discussing benefits to homeowners).

[268] *See* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2061, 2095 (2007) (describing due diligence best practices imposed by Fannie and Freddie).

[269] *See* WALLISON, STANTON & ELY, *supra* note 72, at 25 (noting resemblance to Sallie Mae's privatization).

[270] *See* Mark Overend, *The Privatization of Sallie* Mae, *in* SERVING TWO MASTERS, YET OUT OF CONTROL: FANNIE MAE AND FREDDIE MAC 170, 173 (Peter J. Wallison ed., 2001) (describing many benefactors of Sallie Mae's privatization).

[271] WALLISON, STANTON & ELY, *supra* note 72, at 25.

[272] *See* Lea, *supra* note 264, at 9 ("The process and structure was a win-win for the government and the shareholders of Sallie Mae.").

almost four years ahead of the deadline imposed by Congress.[273] Michael Lea has outlined three lessons that can be learned from the privatization of Sallie Mae that are of note in the context of Fannie and Freddie: (1) GSE privatization can be done; (2) privatization is moved along by motivated parties, most importantly GSE shareholders and management; and (3) the sky does not fall when government support is terminated.[274]

Only privatization will protect the federal government from the serious risks posed by the implied guarantee and it should not be dismissed merely because it has not yet gained traction in Washington. Moving a privatization agenda forward, however, will likely take a significant scare in the conforming mortgage market. Such a scare would need to be complemented by an unusual alliance of libertarians, good government groups, and populist politicians who object that the burden of the implied guarantee has been unfairly placed upon their taxpaying constituents.[275] It would also need to be complemented by a program to preserve some of the benefits that Fannie and Freddie provide to the stability of the secondary mortgage market and to the consumer protection regime in the primary mortgage market. Indeed, it is hard to imagine how the Democratic Party, in particular, could move ahead with a proposal that failed to provide for significant consumer protection in that market.

VI. CONCLUSION

How did these eight hundred pound gorillas end up in the mortgage market? Well, sometimes the government makes bad, shortsighted decisions. In the case of Fannie and Freddie, the

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[273] *Id.* at 1.

[274] *Id.* at 9–10. This is not to say that the Sallie Mae privatization was ideal; there were critiques of it. *See, e.g.*, Jonathan D. Glater, *Lender to Pay So Students Can Learn Loan Options*, N.Y. TIMES, Apr. 12, 2007, at A14 (reporting that Sallie Mae entered into settlement with New York Attorney General Andrew Cuomo requiring Sallie Mae to adhere to new code of conduct).

[275] *See* David Reiss, *No Safety Net for Fannie and Freddie*, CHRISTIAN SCI. MONITOR 9, 9 (July 13, 2006) ("Moreover, principled commentators on the right and the left, including American Enterprise Institute scholars and Public Citizen's Ralph Nader, agree that the implicit guarantee is no longer justified in today's sophisticated mortgage market. For the former, the guarantee amounts to the privatization of profits and the socialization of losses. For the latter, it is just another example of corporate welfare. And indeed, in today's world, it is both of those things.").

government created off-budget entities to achieve a public good without putting pressure on the federal budget process.[276] But Fannie and Freddie, driven by the ever-present profit motive, were able to exploit their regulatory privileges to an extraordinary degree, and in ways predicted by no one. They have also been able to duck and weave through their negative publicity over the years in order to maintain this regulatory privilege. And they will continue to do so until there is a major financial crisis or until Congress focuses sufficiently on the massive risks that these entities pose to the federal budget and the American taxpayer.

Such a crisis in the mortgage markets is no longer merely an unlikely doomsday scenario. Two trends, the significant drop in housing prices—the first since the Great Depression[277]—and the increase in interest rates, have already devastated the subprime mortgage market for both homeowners and investors.[278] There are already signs that this contagion might spread to other parts of the mortgage market and to Fannie and Freddie themselves.[279] While the two companies do not appear to be at risk right now, it is not too hard to imagine a scenario extrapolated from current subprime market trends that would set off a crisis throughout the rest of the mortgage markets.

It is obviously preferable to act before such a crisis arises. As Professor Carnell warns, a crisis is "a particularly inopportune time for attempting to reeducate market participants about the scope of the government's undertakings."[280] Fannie and Freddie appear to

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[276] *See supra* note 233 and accompanying text. *See generally* Part IV.A.*1*.

[277] *See* Trista Winnie, *First Drop in Housing Prices Since the Depression?*, NUWIRE INVESTOR, Jan. 28, 2008, http://www.nuwireinvestor.com/articles/first-drop-in-housing-prices-since-the-depression-51417.aspx (reporting on first annual drop in median existing home prices on record).

[278] *See* Vikas Bajaj & Ron Nixon, *Subprime Loans Going from Boon to Housing Bane: Minority Buyers Especially Hurt As Interest Rates Adjust Higher,* N.Y. TIMES, Dec. 6, 2006, at C1 (reporting on effects of subprime mortgage crisis).

[279] *See* Ip & Hilsenrath, *supra* note 1 (discussing tightening credit conditions); Hagerty, *supra* note 46 ("Falling prices on subprime mortgage bonds have cut the value of such securities held by Fannie Mae and Freddie Mac by $4.7 billion . . . .").

[280] *Improving*, *supra* note 73, at 16 (statement of Richard S. Carnell, Professor, Fordham University School of Law). Notwithstanding the varied policy fixes proposed to remedy the implied guarantee, those who study, but are not affiliated with, Fannie and Freddie speak in one voice about the risks that the implied guarantee poses. *See, e.g.*, Frame & White, *supra* note 71, at 60 ("In a perfect world, the American polity would realize that the social benefits of continuing Fannie Mae and Freddie Mac (and also the FHLBs) as GSEs fall short of the social costs, and true privatization of those enterprises would readily follow."); Jaffee, *supra* note 116,

have stabilized after getting a handle on their respective accounting crises.[281] Thus, the time to address the risks that they pose is now, no matter the political challenges such a path presents.[282]

Such challenges are not, of course, new ones. People have always sought to acquire regulatory privilege for themselves. President Jackson accompanied his veto of the rechartering of the Second Bank of the United States, an antecedent to today's GSEs,[283] with the following message:

> The powers, privileges and favors bestowed in the original charter operate as a gratuity to the stockholders. If the government sell [sic] monopolies and exclusive privileges, then they should at least exact for them as much as they are worth in the open market.
>
> Admit that the bank ought to be perpetual, and as a consequence the present stockholders will be established as a privileged order, clothed both with great political power and enjoying immense pecuniary advantages from their connection with the government.[284]

The fundamental issues facing the federal government remain the same today, as does the political dynamic. Jackson stared down extraordinary political opposition to his veto, but it stood—and the Bank fell.[285]

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at 16 ("[I]t is a [sic] fair to say that [Fannie and Freddie] rather fully protect their shareholders [sic] equity against the small and foreseeable risks, while imposing on US taxpayers the large and distant risks that would eventually require a US Treasury bailout.").

[281] *See, e.g.*, Jody Shenn & James Tyson, *2 Mortgage Lenders Are Heroes After Subprime Fallout*, INT'L HERALD TRIB., June 6, 2007, at 16 (reporting on financial comeback of Fannie and Freddie).

[282] *See* KRIZ, *supra* note 106, at 4 (noting Moody's report on GSEs throughout world that "[t]here is a global trend by governments to reduce their contingent liabilities and business activities").

[283] The Second Bank of the United States was federally chartered, had private shareholders, and financially benefited from a special relationship with the federal government. *See* ARTHUR M. SCHLESINGER JR., THE AGE OF JACKSON 74–102 (1945) (providing history of Second Bank of United States).

[284] Alex J. Pollock, *Open Forum: End GSEs' Perpetual Charters,* NAT'L MORTGAGE NEWS, Jan. 23, 2006, at 4 (quoting veto message of President Jackson).

[285] *See* SCHLESINGER, *supra* note 283, at 88–102 (noting history of President Jackson's veto of Second Bank).