

## DRAFT

### The Role of the Fannie Mae/Freddie Mac Duopoly in the American Housing Market

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The Federal National Mortgage Association (commonly known as “Fannie Mae”) and the Federal Home Loan Mortgage Corporation (commonly known as “Freddie Mac”) are two of the ten largest companies in the United States measured by assets.<sup>1</sup> While they are for-profit, privately owned mortgage finance companies whose shares trade on the New York Stock Exchange, they are also two of the few companies directly chartered by Congress.<sup>2</sup> Congress created them to develop a liquid national market for residential mortgages in order to encourage homeownership.<sup>3</sup> The privileges attendant to this special relationship with the federal government has been the source of their competitive advantage in the American residential mortgage market.<sup>4</sup>

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 and use those funds to purchase mortgages and related securities. Fannie and Freddie have historically profited in this second line of business because of the spread between their low cost of capital and the amount that they must pay for the mortgage

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1. See THE FORBES GLOBAL 2000, [http://www.forbes.com/lists/2008/18/biz\\_2000global08\\_The-Global-2000-United-States\\_10Assets.html](http://www.forbes.com/lists/2008/18/biz_2000global08_The-Global-2000-United-States_10Assets.html) (last visited April 8, 2009) (showing Fannie Mae ranked at 8 and Freddie Mac ranked at 10).

2. 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.freddie.com/news/archives/investors/2006/20061214\\_nyse\\_arca.html](http://www.freddie.com/news/archives/investors/2006/20061214_nyse_arca.html) ((Freddie Mac common stock will continue to be listed on the New York Stock Exchange.

3. (2006) 12 U.S.C. § 1716.

4. See generally Reiss, D. (2008), *The Federal Government's Implied Guarantee of Fannie Mae and Freddie Mac's Obligations: Uncle Sam Will Pick Up the Tab*, 42 GA. L. REV., p. 1019 .

## DRAFT

investments they keep for their own portfolios.<sup>5</sup> These two activities, and particularly the second one, have driven the rapid growth and high profitability of the two companies in recent years.<sup>6</sup>

In the early 2000s, the two companies were hit by accounting scandals.<sup>7</sup> The fallout of these scandals led to a slowdown in their growth as their regulators and Congress took steps to limit their activities.<sup>8</sup> Just as they put some distance between themselves and their scandals, the ongoing credit crisis began to unfold in 2007. Despite their denials, the two companies had significant exposure to the subprime and Alt-A mortgage markets.<sup>9</sup> Their underwriting of the prime market had also been overly optimistic and the two companies began posting losses that are now being measured in the hundreds of billions of dollars.<sup>10</sup> As the extent of their problems began to come into focus, Congress passed the Housing and Economic Recovery Act of 2008 in the summer of 2008. Within weeks of its passage, then-Secretary of the Treasury Henry M. Paulson, Jr. placed the two companies into conservatorship, pursuant to the Act.<sup>11</sup>

Notwithstanding this turn of events, Fannie and Freddie remain huge: together they own or guarantee more than forty-four percent of all the residential mortgages in the United States.<sup>12</sup> The two companies have a combined \$5.30 trillion in mortgage-related obligations,<sup>13</sup> which is of roughly the same

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5. See FAQ > FANNIE MAE'S BUSINESS, <http://www.fanniemae.com/faq/faq2.jhtml?p=FAQ> (last visited April 13, 2009) (describing Fannie Mae's business); FREDDIE MAC: OUR BUSINESS, available at [http://www.freddiemac.com/corporate/company\\_profile/our\\_business/](http://www.freddiemac.com/corporate/company_profile/our_business/) (last visited April 13, 2009) (describing Freddie Mac's business).

6. On average- "the combined size of the Fannie Mae and Freddie Mac has more than doubled every five years between 1968 and 2002". Moe, R.C. & Kosar, K.R. (2005) Cong. Research Serv., THE QUASI GOVERNMENT: HYBRID ORGANIZATIONS WITH BOTH GOVERNMENT AND PRIVATE SECTOR LEGAL CHARACTERISTICS, p. 11, Cong. Research Serv., CRS Report for Congress Order Code RL30533, May 18).

7. See Reiss, *supra* note 4, pp. 1078-79.

8. See *Ibid.*, pp. 1035-39.

9. Browning, L. (2008), *Ex-Officer Faults Mortgage Giants for 'Orgy' of Nonprime Loans*, N. Y. TIMES, Dec. 10, p. B3.

10. See Hagerty, J.R. & Saha-Bubna, A. (2009), *Freddie Loss Is \$23.9 Billion, More Help Sought*, WALL ST. J., Mar. 12, p. A3 (reporting that Freddie loss for all of 2008 was \$50.1 billion); Hagerty, J.R. & Paletta, D. (2009), *Red Ink Clouds Role of Fannie, Freddie*, WALL ST. J., Feb. 2, p. A2 (reporting that Fannie's loss for all of 2008 was \$58.7 billion).

11. See *Ibid.*, p. 14.

12. Office of Federal Housing Enterprise Oversight, (2008) ENTERPRISE SHARE OF RESIDENTIAL MORTGAGE DEBT OUTSTANDING 1990 - 2008, available at <http://www.ofheo.gov/Research.aspx?Nav=111> (last visited April 13, 2009) (showing outstanding mortgage debt through 2008 with figures updated through Mar. 12, 2009).

13. *Ibid.*

## DRAFT

magnitude as the \$5.81 trillion of federal government debt held by the public.<sup>14</sup> They also continue to have an extraordinary impact on the operations of the secondary mortgage market. The crisis that they find themselves in does present, however, an opportunity to reevaluate their proper role in the American residential mortgage market.

This article proceeds as follows. Part I defines the “government sponsored enterprise,” which is the type of hybrid public/private entity that Fannie and Freddie are. Part I also provides a brief introduction to the other significant GSEs. Part II explains what Fannie and Freddie do in the American mortgage market. Part III provides a brief history of how they developed. Part IV evaluates the two companies as duopolists in the conforming mortgage market. Part V concludes by suggesting that the current crisis presents an opportunity to rethink whether the Fannie/Freddie duopoly continues to serve the public interest.

### **I. The Government Sponsored Enterprise**

Fannie and Freddie are government sponsored enterprises (“GSEs”). A GSE is “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.”<sup>15</sup> Congress has a long history of relying upon government sponsored enterprises to spur private investment.

The special privileges accorded a GSE are variants on the longstanding government practice of spurring private investment in various arenas by granting some privilege or monopoly power to a party that will infuse the activity with needed capital or bring focused attention to it. For example, government-granted monopolies can take the form of a charter granting a monopoly on trade, such as the one granted

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<sup>14</sup> See Federal Reserve Board, (2008), *Federal Debt Subject to Statutory Limitation*, in STATISTICAL SUPPLEMENT TO THE FEDERAL RESERVE BULLETIN, December 2008, available at [http://www.federalreserve.gov/pubs/supplement/2008/12/table1\\_40.htm](http://www.federalreserve.gov/pubs/supplement/2008/12/table1_40.htm) (providing public debt data as of Sept. 30, 2008). (Last visited April, 13 2009).

<sup>15</sup> Carnell, R.S. (2005), *Handling the Failure of a Government-Sponsored Enterprise*, 80 WASH. L. REV. 565, p. 570; see also 2 U.S.C. § 622 (2006) (giving similar definition for purposes of Congressional Budget Act).

## DRAFT

by Queen Elizabeth I to the English East India Company in 1600 in order to increase English trade with Asian nations.<sup>16</sup> They can take the form of a system such as that governing American patents, granting patent-holders the sole right to exploit a patent for a certain period in order to encourage innovation.<sup>17</sup> Or they can take the form of a regulated natural monopoly, like a utility company, that is regulated not only to protect consumers from monopoly pricing but also to ensure that the company can make a fair return on its investment.<sup>18</sup>

Congress typically relies on the GSE structure to provide liquidity to a fragmented credit market. The Farm Credit System is the oldest GSE. It is a network of “borrower-owned lending institutions comprised of cooperatives and related service organizations.”<sup>19</sup> This network “provides privately financed credit to agricultural and rural communities.”<sup>20</sup> Farmer Mac, another GSE, is an independent institution which is a part of the Farm Credit System.<sup>21</sup> It was chartered for the primary purpose of creating “a secondary market for agricultural real estate and rural home mortgages.”<sup>22</sup> Farmer Mac, a publicly traded corporation like Fannie and Freddie, is able to exploit its regulatory privilege in ways that are similar to those two companies, although it operates in a smaller market.<sup>23</sup>

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16. Lawson, P. (1993), *THE EAST INDIA COMPANY: A HISTORY (STUDIES IN MODERN HISTORY)*, Longman, Harlow, pp.5-6.

17. U.S. Const., art. 1 § 8.

18. See Grossman, P.Z. & Cole, D.H. (2003), *Introduction*, in Grossman, P.Z. & Cole, D.H. (eds) *THE END OF A NATURAL MONOPOLY: DEREGULATION AND COMPETITION IN THE ELECTRIC POWER INDUSTRY*, JAI, Amsterdam, pp. 1-10.

19. Farm Credit Services, *ABOUT THE FARM CREDIT SYSTEM*, <http://www.farmcredit.com/map/FCSystem.html>. (Last visited April 13, 2009).

20. FEDERAL BUDGET, FISCAL YEAR 2008, *Whitehouse*, <http://www.whitehouse.gov/omb/budget/fy2008/pdf/appendix/gov.pdf>, p. 4. (Last visited April 13, 2009).

21. Walker, D.M. (2004), *COMPTROLLER GENERAL OF THE UNITED STATES GENERAL ACCOUNTING OFFICE, GOVERNMENT SPONSORED ENTERPRISES: A FRAMEWORK FOR STRENGTHENING GSE GOVERNANCE AND OVERSIGHT*, p. 7 - available at <http://www.gao.gov/new.items/d04269t.pdf>. (Last visited April 13, 2009).

22. FEDERAL BUDGET, FISCAL YEAR 2008, *Whitehouse*, <http://www.whitehouse.gov/omb/budget/fy2008/pdf/appendix/gov.pdf>, p. 5. (Last visited April 13, 2009).

23. See Farmer Mac website, <http://www.farmermac.com/company/profile/profile.aspx>; *Press Release, FARMER MAC, FARMER MAC REPORTS 2006 THIRD QUARTER RESULTS AND COMPLETES FINANCIAL RESTATEMENT – BUSINESS VOLUME FOR QUARTER A RECORD \$1.3 BILLION (Nov. 9, 2006)*, available at <http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/11-09-2006/00044713708&EDATE=-> (Last visited April 13, 2009).

## DRAFT

The other major GSE is the Federal Home Loan Bank System.<sup>24</sup> The System is comprised of twelve regional banks that are structured as cooperatives.<sup>25</sup> The twelve banks operate semi-independently, each maintaining its own president and board of directors.<sup>26</sup> The system's primary mission "is to provide cost-effective funding to members for use in housing, community, and economic development; to provide regional affordable housing programs, which create housing opportunities for low- and moderate-income families; to support housing finance through advances and mortgage programs; and to serve as a reliable source of liquidity for its membership."<sup>27</sup> Because of its overlapping mission, the FHLBS is effectively a smaller sibling of Fannie and Freddie.<sup>28</sup>

## II. What Fannie and Freddie Do

Fannie and Freddie are by far the largest of the GSEs. They are also the entities that have had the biggest role in creating and developing the modern secondary market for residential mortgages. Mortgages have always been bought and sold by investors, but until relatively recently, the secondary mortgage market has been an informal arrangement.<sup>29</sup> The introduction of residential mortgage-backed securities (RMBS) in the 1970s changed that; once mortgages are converted into RMBS, they can be

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24. The Federal Home Loan Bank members are lending institutions such as federally insured savings associations, commercial banks, credit unions and insurance companies. Federal Home Loan Banks website, <http://www.fhlbanks.com/html/faq.html>.

25. Federal Home Loan Banks website, <http://www.fhlbanks.com/>.

26. Federal Home Loan Banks website, [http://www.fhlbanks.com/html/fhlb\\_system.html](http://www.fhlbanks.com/html/fhlb_system.html).

27. *Ibid.*

28. Federal Home Loan Banks website, - <http://www.fhlbanks.com/html/faq.html>. Congress has created other GSEs at various points for a variety of reasons. In 1987, the federal government created a GSE, the Financing Corporation ("FICO"), to take on the obligations of the insolvent Federal Savings and Loan Insurance Corporation ("FSLIC"). See COMPETITIVE EQUALITY BANK ACT OF 1987, Pub. L. 100-86, Title III (codified at 12 U.S.C. § 1441 (2006)). See generally White, L.J. (1991), THE S & L DEBACLE, Oxford University Press, New York City, (reviewing history of S&L crisis), § 1441(e)(6). In 1989, Congress created the Resolution Funding Corporation ("REFCO") to deal with the ongoing effects S&L crisis. Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) of 1989, Pub. L. No. 101-73, 103 Stat. 183 (establishing REFCO). Sallie Mae (originally, the Student Loan Marketing Association), a former GSE that has been privatized, finances student loans. See Reiss, *supra* note 4, pp. 1078-79.

29. Van Order, R. (2000), *The U.S. Mortgage Market: A Model of Dueling Charters*, 11 J. HOUSING RES., VOL. 2, P. 233, P. 236.

## DRAFT

easily traded on the secondary market with comparatively few transaction costs.<sup>30</sup> In the simplest terms, this is how it works:

1. Borrowers get mortgages from lenders in the primary market;<sup>31</sup>
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;<sup>32</sup> 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.<sup>33</sup>

As mentioned above, 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.<sup>34</sup> Because of their consistently cheaper borrowing costs, Fannie and Freddie have been able to profit greatly from this second line of business. This is because they can make money on the spread between their low cost of funds and what they must pay for the mortgage-related investments in their portfolios.<sup>35</sup>

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.<sup>36</sup> 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

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30. *See Ibid.* (“The rise in the secondary market in the 1970s and (especially) 1980s came about largely because of standardization of pools of mortgages . . .”).

31. *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).

32. *See* OUR ROLE IN THE SECONDARY MARKET, Freddie Mac, [http://www.freddiemac.com/corporate/company\\_profile/our\\_mission/secmkt/index.html](http://www.freddiemac.com/corporate/company_profile/our_mission/secmkt/index.html) (last visited April 13, 2009) (showing how Freddie Mac enters secondary market).

33. *See Ibid.*

34. *See* ABOUT FANNIE MAE: THE INDUSTRY, <http://www.fanniemae.com/aboutfm/industry/index.jhtml> (last visited April 13, 2009) (explaining involvement in U.S. housing industry); FREDDIE MAC: OUR BUSINESS, *supra* note 7 (describing activity in secondary mortgage market).

35. *See* FAQ > FANNIE MAE’S BUSINESS, <http://www.fanniemae.com/faq/faq2.jhtml?p=FAQ> (last visited April 13, 2009) (describing Fannie Mae’s business); FREDDIE MAC: OUR BUSINESS, [http://www.freddiemac.com/corporate/company\\_profile/our\\_business/](http://www.freddiemac.com/corporate/company_profile/our_business/) (last visited April 13, 2009) (describing Freddie Mac’s business).

36. Jaffee, D.M. (2006), *Reining in Fannie Mae and Freddie Mac*, REGULATION, Vol. 29, no. 3, Fall, p. 22.

## DRAFT

its term when interest rates have dropped) poses a greater threat to profitability.<sup>37</sup> 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).<sup>38</sup> Finally, Fannie and Freddie are exposed to operational risk, “the risk of loss due to inadequate or failed internal procedures and systems.”<sup>39</sup> The accounting scandals that have overtaken the two companies in recent years have highlighted the danger that operational risk can pose to large financial institutions.<sup>40</sup>

The GSEs’ charters restrict the mortgages they may buy.<sup>41</sup> 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<sup>42</sup> and may not buy mortgages with principal amounts greater than an amount set each year.<sup>43</sup> Loans that comply with the restrictions placed on Fannie and Freddie are known as “conforming” loans.<sup>44</sup> Those that do not comply with either of these restrictions are known as “nonconforming” loans, which may not be purchased by Fannie or Freddie.<sup>45</sup>

The two companies effectively have no competition in the conforming market because of advantages granted to them by the federal government in their charters.<sup>46</sup> The most significant of these

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37. See Weiss, E. (2005) LIMITING FANNIE MAE’S AND FREDDIE MAC’S PORTFOLIO SIZE, p.4, Cong. Research Serv., CRS Report for Congress Order Code RS22307, Oct. 21. (“Prepayment risk is potentially more serious [than credit risk].”).

38. See *Ibid.*, pp. 4-5 (“Interest rate risk can be very serious. Many savings and loan associations became insolvent in the early 1980s because of it.”).

39. *Ibid.*, p. 5.

40. See *Ibid.* (“Fannie Mae’s current accounting problems, and those of Freddie Mac in 2003, raise questions about internal controls.”).

41. Passmore, S.W., Sparks, R. & Ingpen, J (2002), *GSEs, Mortgage Rates, and the Long-Run Effects of Mortgage Securitization*, 25 J. REAL EST. FIN. & ECON., pp. 215 - 217.

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

43. Press Release, CONFORMING LOAN LIMIT FOR U.S. TO REMAIN \$417,000 IN 2009; DIFFERENT LIMITS IN SOME AREAS, p. 1 (Nov. 7, 2008), <http://www.ofheo.gov/newsroom.aspx?ID=481&q1=1&q2=None>. (last visited April 13, 2009).

44. See GLOSSARY OF FINANCE AND ECONOMIC TERMS, A-F - FREDDIE MAC, [http://www.freddie.com/smm/a\\_f.htm](http://www.freddie.com/smm/a_f.htm) (last visited April 13, 2009) (defining “conforming mortgage”).

45. See Bruskin, E., Sanders, A.B. & Sykes, D. (2000), *The Nonagency Mortgage Market: Background and Overview*, in Fabozzi, F.J., Ramsey, C. & Marz, M. (eds) (2<sup>nd</sup> ed) THE HANDBOOK OF NONAGENCY MORTGAGE-BACKED SECURITIES, John Wiley & Sons, Hoboken, pp. 5 - 7 (identifying major categories of nonconforming loans as jumbos and B/C quality, which includes subprime low-doc and no-doc loans).

46. See generally *Ibid.*

## DRAFT

advantages has been the federal government's implied guarantee of Fannie and Freddie's obligations.<sup>47</sup> The government's guarantee allows Fannie and Freddie to borrow funds more cheaply than its fully-private competitors and thereby offer the most attractive pricing in the conforming market, a market in which they can effectively act as duopolists.<sup>48</sup>

Fannie Mae and Freddie Mac now own or securitize roughly forty-four percent of the outstanding stock of single-family residential mortgages.<sup>49</sup> The remainder of the secondary market (other than the portion originated by Ginnie Mae – see below) comes from “private label” firms—a large component of which is composed of jumbo and subprime mortgage securitizations.<sup>50</sup> Private-label firms are not in a position to compete head on with GSEs as their cost of capital is greater.<sup>51</sup>

Notwithstanding their huge size, there was a consensus that Fannie and Freddie were insufficiently monitored as compared to other federally regulated financial institutions such as members of the Federal Reserve System and the Federal Deposit Insurance Corporation.<sup>52</sup> As part of the Housing and Economic Recovery Act of 2008, Congress strengthened the regulatory oversight for Fannie and Freddie.<sup>53</sup> Prior to the passage of the Act, Fannie and Freddie's “financial safety and soundness” regulator was OFHEO, which was an independent agency located within HUD.<sup>54</sup> The Act replaced

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47. *Ibid.*, p. 1033. Some commentators believe, with good reason, that what had been characterized as an implied guarantee had been converted into an explicit guarantee once the Housing and Economic Recovery Act of 2008 was passed. See, e.g., Wallison, P.J. (2008), *Fannie and Freddie by Twilight*, FIN. SERVICES OUTLOOK, p. 1 (Aug) (describing post-Act Fannie and Freddie as “explicitly government-backed entities”).

48. See Standard and Poor's, (2000), PRICING AND PREPAYMENT CHARACTERISTICS OF NONCONFORMING MORTGAGE POOLS, Standard and Poor's, New York City, p.1. The nonconforming rate usually is twenty-five to fifty basis points higher than the conforming rate.

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

50. See Van Order, *supra* note 29, p. 237 (describing breakdown of secondary mortgage market and use of “private label” secondary market).

51. Wallison, P.J. & Ely, B. (2000), NATIONALIZING MORTGAGE RISK: THE GROWTH OF FANNIE MAE AND FREDDIE MAC, American Enterprise Institute Press, Washington, D.C., p. 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.”).

52. See, for example, Nott, L. & Miles, B. (2006) GSE REGULATORY REFORM: FREQUENTLY ASKED QUESTIONS, 2, Cong. Research Serv., CRS Report for Congress Order Code RS21724, (Apr), (“There is a general consensus that the current regulatory regime is ill-equipped to deal effectively with the housing GSEs.”).

53. *Pub. L.* No. 110-289 (2008), 122 Stat. 2008.

54. FEDERAL HOUSING ENTERPRISES FINANCIAL SAFETY AND SOUNDNESS ACT OF 1992, 12 U.S.C. §§ 4501-4641 (2006).

## DRAFT

OFHEO with a new independent Federal Housing Finance Agency (the “Agency”).<sup>55</sup> The Agency has general regulatory authority over Fannie and Freddie as well as the Federal Home Loan Banks. The Agency is similar to OFHEO, but it has been granted significantly more power. Indeed, Congress intended it to be a first class financial regulator like the Federal Deposit Insurance Corporation.<sup>56</sup>

### III. A Brief History of Fannie and Freddie

Fannie and Freddie effectively created the modern secondary market for residential mortgages in the early 1970s.<sup>57</sup> 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.<sup>58</sup> Fannie’s origin stretches back, however, to the Great Depression.

Fannie Mae was originally chartered in the 1930s for the limited purpose of providing a government-owned secondary market for loans insured by the Federal Housing Administration.<sup>59</sup> In 1954, Fannie Mae was reorganized to allow private capital to replace federal funds.<sup>60</sup> It operated by issuing its debt and purchasing mortgages that it held in its portfolio.<sup>61</sup> The Housing and Urban Development Act of 1968 partitioned Fannie Mae into a privately-financed secondary market institution,

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55. See HOUSING AND ECONOMIC RECOVERY ACT OF 2008 § 1101; see *ibid.* § 1301 (abolishing OFHEO); *ibid.* § 1311 (abolishing, in addition, Federal Housing Finance Board which regulated Federal Home Loan Banks).

56. See SUMMARY OF THE HOUSING AND ECONOMIC RECOVERY ACT OF 2008, available at [http://banking.senate.gov/public/\\_files/HousingandEconomicRecoveryActSummary.pdf](http://banking.senate.gov/public/_files/HousingandEconomicRecoveryActSummary.pdf).

57. See Van Order, *supra* note 29, p. 236 (discussing history of secondary mortgage market).

58. Thomas, H. (1999), DEVISING AN EFFECTIVE LEGAL FRAMEWORK FOR SUPERVISING THE PUBLIC BENEFITS AND PUBLIC COSTS OF GOVERNMENT SPONSORED ENTERPRISES, p. 2(3), available at [http://wbln0018.worldbank.org/html/FinancialSectorWeb.nsf/\(attachmentweb\)/september8,2000finalpaper/\\$FILE/september+8,+2000+final+paper.pdf](http://wbln0018.worldbank.org/html/FinancialSectorWeb.nsf/(attachmentweb)/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 have since been lifted). With the modernization of the financial system, the *raison d’être* of Fannie and Freddie disappeared, but they remained. See Felsenfeld, C. (1998) BANKING REGULATION IN THE UNITED STATES, Juris Publishing, Huntington, N.Y., p. 152(62). (reviewing loosening of restrictions on interstate banking in latter part of twentieth century).

59. Van Order, *supra* note 29, p. 236.

60. Lea, M.J. (1996), *Innovation and the Cost of Mortgage Credit: A Historical Perspective*, 7 HOUSING POL’Y DEBATE 147, 164.,

61. Van Order, *supra* note 29, p. 236.

## DRAFT

today's Fannie Mae, and a government agency called the Government National Mortgage Association, today's Ginnie Mae.<sup>62</sup>

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.<sup>63</sup> 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.<sup>64</sup> 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.<sup>65</sup> Fannie and Freddie, as the dominant purchasers of residential mortgages, have effectively standardized prime residential mortgages by promulgating buying guidelines.<sup>66</sup> Such standardization has led to increases in the liquidity and attractiveness of mortgages as investments to a broad array of investors.<sup>67</sup>

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 allowed both GSEs to purchase and securitize conventional mortgages as well as government-insured or guaranteed mortgages.<sup>68</sup> In the late 1970s, RMBS securitization took off as traditional lenders could not keep up with the demand for home mortgages.<sup>69</sup> Investment in RMBS exploded again after institutional investors entered the market; indeed, the RMBS market has increased

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62. *See ibid.*

63. *See* ABOUT FANNIE MAE > OUR CHARTER, <http://www.fanniemae.com/aboutfm/charter.jhtml?p=About+Fannie+Mae> (last visited April 13, 2009).

64. *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).

65. Van Order, *supra* note 29, p. 236. While Fannie and Freddie started out with different missions, they grew to have the same one. *See ibid.*, p. 236.

66. *See* Stanton, T.H. (1991), A STATE OF RISK: WILL GOVERNMENT-SPONSORED ENTERPRISES BE THE NEXT FINANCIAL CRISIS?, Harper Collins, p. 86.

67. *See* Jensen, R.A. (1972), *Mortgage Standardization: History of Interaction of Economics, Consumerism and Governmental Pressure*, 7 REAL PROP. PROB. & TR. J., p. 397, 400 (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").

68. *See* Carozzo, P.M. (2005), *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) (describing enactment of EHFA).

69. *See* Kendall, L.T. (1996), *Securitization: A New Era in American Finance*, in Kendall, L.T. & Fishman, M.J. (eds), A PRIMER ON SECURITIZATION, MIT Press, Cambridge, Massachusetts., p. 1, 6 (describing funding shortfall caused by strong desire for home ownership).

## DRAFT

by more than five hundred percent from 1984 through the early 2000s.<sup>70</sup> Starting in the late 1970s, non-federal-related issuers, such as commercial banks and mortgage companies, began to issue “private label” RMBS, a market that exploded in the ensuing years.<sup>71</sup> The subprime boom and bust of the 2000s took place in large part in this “private label” RMBS market.

### IV. Fannie and Freddie as Duopolists

Commentators have argued that Fannie and Freddie effectively have a duopoly in the conforming mortgage market because they can borrow money so much more cheaply than their competitors, thereby excluding them from that market.<sup>72</sup> Unlike pure duopolists, Fannie and Freddie’s duopoly is limited by the nature of their competitive advantage: in an otherwise efficient market, the maximum amount that they can retain as duopoly profits is the spread between the interest rates they must pay and those that their competitors must pay.<sup>73</sup> And retain duopoly profits they do.<sup>74</sup>

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70. Lore, K. & Cowan, C. (2005) MORTGAGE-BACKED SECURITIES, DEVELOPMENTS AND TRENDS IN THE SECONDARY MARKET, Thomson-West Publications, Eagan, MN, §§ 1.3, 2.23.

71. See Forte, J.P (1996), *Capital Markets Mortgage: A Ratable Model for Main Street and Wall Street*, 31 REAL PROP. PROB. & TR. J., p. 489, 491.

72. See, e.g., Seiler, R. (1999), *Fannie Mae and Freddie Mac as Investor-Owned Utilities*, 11 J. PUB. BUDGETING ACCT. & FIN. MGMT., p. 117, 125; see also Mortgage Bankers Association, (2005), WHY THE BRIGHT LINE HELPS MORTGAGE MARKETS, p. 4, available at [www.mortgagebankers.org](http://www.mortgagebankers.org) (“[T]he GSEs have established a duopoly in loan underwriting technology.”); Gan, J. & Riddiough, T.J. (2007), *Monopoly and Information Advantage in the Residential Mortgage Market*, 3 REV. OF FINANCIAL STUDIES, p. 3 (forthcoming), available at <http://ssrn.com/abstract=962321> (“GSEs effectively lend directly to consumers as an informationally advantaged monopolist.”).

73. Some may argue that the “conforming mortgage market” is not a meaningful market for the purposes of an analysis of whether Fannie and Freddie are engaged in anticompetitive behavior; rather, the argument goes, they should be seen as just two of the competitors in the significantly larger “residential mortgage market” along with that larger market’s numerous lenders. It might then follow that Fannie and Freddie are better characterized as rent-seekers in the entire residential mortgage market than as duopolists in the conforming market. Whether Fannie and Freddie are best characterized as duopolists or rent-seekers does not impact my ultimate thesis: their regulatory privilege does not appear to be in the public interest. See Macey, J.R. (1988), *Symposium on The Theory of Public Choice: Transaction Costs and The Normative Elements of The Public Choice Model: An Application to Constitutional Theory*, 74 VA. L. REV., p. 471, 472 n.4. (“An example of rent-seeking is a firm’s attempt to secure government-granted monopolies. Such monopolies allow a firm to increase its prices above competitive levels. The resulting profits represent economic rents from government regulation.”); Mueller, D. (1989), PUBLIC CHOICE II, Cambridge University Press, Cambridge, p. 229 (noting that the government can “help create, increase, or protect a group’s monopoly position. In so doing, the government increases the monopoly’s rents of the favored groups, at the expense of the buyers of the group’s products and services. The monopoly rents that the government can help provide are a prize worth pursuing, and the pursuit of these rents has been given the name of rent seeking.”).

74. 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, (2001) FEDERAL SUBSIDIES AND THE HOUSING GSES, p.27 (estimating Fannie and Freddie retain sixteen basis points of government subsidy out of total forty-one).

## DRAFT

If Fannie and Freddie were a duopoly, one might reasonably wonder whether their actions violate Section 2 of the Sherman Act, which forbids monopolization.<sup>75</sup> The Supreme Court has interpreted Section 2 to mean that the monopolization resulted from “the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historical accident.”<sup>76</sup> Given that Fannie and Freddie were created by the federal government, they would seem to be immune from the charge of “willful acquisition or maintenance.” Moreover, the federal government has already designed a regulatory regime with which it can evaluate Fannie and Freddie’s past behavior and mold their future actions.<sup>77</sup> Thus, it seems (a conclusion that is further supported by the absence of litigation regarding this issue) that the two companies do not violate the Sherman Act.<sup>78</sup>

One might also wonder whether Fannie and Freddie are best described as duopolists or oligopolists. The fewer firms there are in a market, the more likely they are to act like duopolists.<sup>79</sup> This is because the opportunities for passive collusion are greater when there are fewer competitors. Passive

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75. 15 U.S.C. § 2 (2006).

76. *U.S. v. Grinnell Corp.*, 384 U.S. 563, 571-72 (1966).

77. In *Credit Suisse v. Billing*, the Supreme Court set forth four elements to determine whether antitrust law should defer to a financial regulation regime. The four elements are: “(1) an area of conduct squarely within the heartland of securities regulations; (2) clear and adequate SEC authority to regulate; (3) active and ongoing agency regulation; and (4) a serious conflict between the antitrust and regulatory regimes.” 127 S. Ct. 2383, 2397 (2007); see Stigler, G. (1986), *The Economic Effects of the Antitrust Laws*, in Leube, K. & Moore, T. (eds) THE ESSENCE OF STIGLER, Hoover Institution Press, Stanford University, Stanford, CA., p. 184, 192. (“Most exempt industries are subjected to regulation of other sorts, and presumably have economic characteristics which distinguish them from nonexempt unregulated industries.”). The same logic applied to Fannie and Freddie would lead to the conclusion that antitrust law should not apply, given that they are regulated by three instrumentalities of the federal government, the Agency (and previously, OFHEO), HUD and the Treasury. See Reiss, *supra* note 4, p. 1033-36.

78. See Weiser, P.J. (2005), *The Relationship of Antitrust and Regulation in a Deregulatory Era*, 50 ANTITRUST BULLETIN, p. 549, 550 (Winter) (“where regulatory agencies are on the scene, antitrust courts should retreat”); see Schneider, B.H. (2002), *Credit Suisse v. Billing and a Case for Antitrust Immunity for Mortgage Lenders Subject to Federal Regulation*, 124 BANKING LAW J., 124., p. 833 (arguing that Freddie Mac’s standardized mortgage buying guidelines have antitrust immunity); but see Stanton, T. & Moe, R. (2002), *Government Corporations and Government-Sponsored Enterprises*, in Salaman, L.M. (ed.) THE TOOLS OF GOVERNMENT: A GUIDE TO THE NEW GOVERNANCE, OUP, Oxford, p. 80 – 90. (“Until 1989, the Freddie Mac charter also contained other provisions that confused public and private characteristics. Although Freddie Mac was a privately owned company, its charter conferred upon the GSE, ‘. . . all immunities and priorities, including . . . all immunities and priorities under any such law or action, to which it would be entitled if it were the United States or if it were an unincorporated agency of the United States.’ This provision thus exempted Freddie Mac from antitrust laws and also conferred sovereign immunity from suit and a priority in claims in bankruptcy, among other benefits. Fortunately, Congress repealed that provision in 1989 before Freddie Mac grew to a size where the need for the discipline of the antitrust laws became especially important.”).

79. Vives, X. (2000) OLIGOPOLY PRICING: OLD IDEAS AND NEW TOOLS, p. 6.

## DRAFT

collusion can take the form of failing to vigorously compete. It is also more likely where potential duopolists can monitor their competitors for “cheating” (that is, attempting to take more market share by competing more vigorously). This is easier to do “where the number of firms in the industry is small, the firms are similar in product offerings and technology, the firms have frequent interactions through the process of attracting customers, and it is easy for the firms to observe the actions of their competitors.”<sup>80</sup>

As Robert Seiler makes clear, Fannie and Freddie have a number of the characteristics of duopolists: there are only two of them; they finance similar mortgages, they use similar technology and they have frequent interactions.<sup>81</sup> Seiler does note that the two firms cannot directly monitor the terms that the other has negotiated with lenders who provide them with loans. Seiler finds, however, that Fannie and Freddie can indirectly monitor each other such that they can maintain the equilibrium necessary to act as a duopoly.<sup>82</sup> There is also some empirical support for the claim that Fannie and Freddie have opportunities to collude, based on their historically high profits.<sup>83</sup> Thus, Fannie and Freddie are best described as duopolists in the conforming residential mortgage market.<sup>84</sup> Because their duopoly is the result of government-granted privileges (and is not a natural monopoly), it is suspect from the perspective of competition theory.

## V. Conclusion

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80. Seiler, *supra* note 72, p. 125.

81. *Ibid.*

82. *Ibid.* Fannie Mae, unsurprisingly, disagrees with this assessment. *Ibid.* (citing Fannie Mae (1996), *Fannie Mae Review of the Hermalin-Jaffee Paper*, in (1996) STUDIES IN PRIVATIZING FANNIE MAE AND FREDDIE MAC, U.S. Department of Housing and Urban Development, Washington, D.C., p. 314.

83. Hermalin, B.E. & Jaffee, D.M. (1996), *The Privatization of Fannie Mae and Freddie Mac: Implications for Mortgage Industry Structure*, in STUDIES IN PRIVATIZING FANNIE MAE AND FREDDIE MAC, U.S. Department of Housing and Urban Development, Washington, D.C., p. 225; Goodman, J.L. & Passmore, W.S. (1992), MARKET POWER AND THE PRICING OF MORTGAGE SECURITIZATION, Federal Reserve Board’s Finance and Economics Discussion Series, Number 187.; Susan Woodward, who has consulted for Freddie Mac, disputes the notion that Fannie and Freddie act as duopolists because of the murkiness in market for Fannie and Freddie’s guarantee fees. See Woodward, S.A. (2001), RECHARTING FREDDIE MAC AND FANNIE MAE: THE POLICY ISSUES, pp. 27 – 31. (working paper, Sand Hill Econometrics, Menlo Park, Calif., 2005) (on file with author). Indeed, she believes that such a market approximates pure competition. *Ibid.*, p. 28.

84. It is a widely accepted hypothesis that oligopolists “wish to collude to maximize joint profits.” Stigler, G. (1986), *A Theory of Oligopoly*, in Leube, K. & More, T. (eds) THE ESSENCE OF STIGLER, Hoover Institution Press, Stanford University, Stanford, CA., p. 153. This is because the “combined profits of the entire set of firms in an industry are maximizes when they act together as a monopolist.” *Ibid.*, p. 154.

## DRAFT

Fannie and Freddie were chartered to create a liquid secondary market for residential mortgages. They achieved that goal. Because they were also profit-driven private companies, they also developed lines of business which allowed them to dominate the conforming mortgage market to the exclusion of all competitors. As a result, they grew extraordinarily large. Because of the risks that they took and because of the extraordinary conditions throughout the mortgage market in the last few years, they became critically undercapitalized such that the federal government found it necessary to place them in conservatorship. While this particular crisis shall cost the American taxpayer hundreds of billions to rectify, it also presents an opportunity to rethink whether the Fannie/Freddie duopoly is still necessary for a healthy residential mortgage market in the United States. And clearly the burden of proof rests on Fannie and Freddie to demonstrate that their duopoly does serve the public interest.<sup>85</sup>

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<sup>85</sup> See generally Reiss, D. (2009) FANNIE MAE AND FREDDIE MAC AND THE FUTURE OF FEDERAL HOUSING FINANCE POLICY: A STUDY OF REGULATORY PRIVILEGE , available at <http://ssrn.com/abstract=1357337> (arguing that Fannie and Freddie should be privatized because their privilege position imposes a net cost on the public).